



6 May 2011

Dr Kathleen Dermody
Secretary
Senate Foreign Affairs, Defence and Trade Committee
Parliament House
CANBERRA ACT 2600

Dear Dr Dermody

Thank you for your letter dated 16 February 2011 regarding the Senate Foreign Affairs, Defence and Trade Committee Inquiry into Defence Procurement, in which you sought a submission from the Australian Industry Group. I'm pleased to be able to provide a submission, which is attached.

Representatives of the Ai Group Defence Council are willing to attend hearings related to this inquiry.

Should you need any additional information, I invite you to contact John (Johnno) O'Callaghan, Executive Officer to the Defence Council. He can be contacted on 6233 0700 or 0438 627 255, or via email (johnno@aigroup.asn.au).

Yours sincerely

Innes Willox
Director, International & Government Relations

Australian Industry Group Defence Council

Submission

to the

Senate Committee on Foreign Affairs, Defence and Trade

on the

Inquiry into Defence Procurement

May 2011

Introduction

The Australian Industry Group Defence Council (referred to hereon as the Defence Council) welcomes the opportunity to make a submission to the Senate Foreign Affairs, Defence and Trade Committee on its inquiry into Defence procurement.

The inquiry is appropriate and timely, noting that it provides an opportunity to offer constructive views on the state of, and additional measures to improve, Defence procurement.

Executive Summary

Australian Defence procurement for the Australian Defence Force (ADF) would not occur without a vibrant Australian defence industry.

The ADF would be unable to meet its many operational commitments, including in Afghanistan, without defence industry providing and sustaining the ADF's equipment.

Successive Government have championed a healthy Australian defence industry, including the need to foster essential in-country industry capabilities for defence self-reliance. Defence Council welcomes this as an ongoing, desirable policy commitment.

Australian-based defence companies offer world-class, affordable and timely solutions to meet the majority ADF equipment capability acquisition and sustainment requirements.

The Defence Council recognises the benefits of Military-off-the-Shelf (MOTS) and Civilian-off-the-Shelf (COTS) for some defence equipment acquisitions. Such solutions should only be pursued when it is clearly demonstrated that Australian defence industry is unable to meet the respective capability requirement at an affordable cost and manageable risk. This includes proper consideration, and exposure, of the cost of supporting equipment through its long life, often for more than 30 years.

The current high value of the dollar is impacting negatively on manufacturing. The Australian Industry Group has called on the Federal Government to pull whatever levers it can to help business including around improving productivity, reducing the company tax rate, lifting investment in skills and supporting exports and innovation. These measures are critically important for the survival and growth of defence companies, including small and medium sized (SME) companies.

Our defence industry, which employs more than 30,000 highly skilled professionals and trades people, is an important contributor to the health of Australia's manufacturing sector. The Defence White Paper 2009 outlined a \$100 billion program over the next decade on capability acquisition and sustainment. If implemented, this will require a substantial lift in the number of people working in Australia's defence industry to over 34,000. The booming resource sector with its skills needs and the resultant pressure from its growth is placing considerable pressure on the defence industry's ability to meet this challenge. Defence companies are committed to meeting this skilling requirement. Expanding the Government's successful Skilling Australia Defence Industry (SADI) program will also assist.

Defence procurement has been the subject of a number of reviews under successive governments. These include those led by Kinnaird, Mortimer, Pappas and McKinsey. Each achieved a number of improvements in Defence procurement. Despite this, there is a need for ongoing improvement to make the procurement system more efficient, more responsive and, perhaps most importantly, more commercially oriented.

Defence and industry must continue to learn from the lessons of procurement successes and failures, and make the changes necessary to avoid future problems.

Identifying procurement challenges early in the capability acquisition process and offering solutions to remedy them is critical to later success. And, taking remedial action when problems occur during procurement acquisitions and sustainment is essential. Doing so will assist to reduce the potential for projects to enter the *Projects of Concern List*.

Defence and industry need to build a stronger level of trust. While many project office working relationships – both Defence and industry – are harmonious and productive, others are not. This leads to project failure. The *Projects of Concern* office within the

Defence Materiel Organisation (DMO), working closely with industry, has assisted to improve this situation.

The Kinnaird Review laid the foundation for the current capability development process recommending introduction of a two-pass system for all major equipment acquisition and sustainment projects. However, the Defence Incoming Government Brief “Red Book”, released by the Government on 28 October 2010, indicated that the two-pass process has stalled, undermining industry’s investment in infrastructure and skilling. This has caused major cash-flow and staffing problems particularly for SME companies. Action needs to be taken to address the reasons for the delays and introduce measures to overcome them.

Successive recent Ministers for Defence have committed to ensuring that the Government sign off on individual capability acquisitions only after assuring themselves that taxpayers will receive value-for-money. The Defence Council supports this goal and believes that a reinvigoration of the Capability Development Advisory Forum (CDAF), along with solid industry input through its subsidiary Environmental Working Groups (EWGs), will provide a higher degree of assurance sought by ministers. The Defence Council welcomes movement by Defence on this measure.

The Mortimer Review recommended other measures to improve Defence procurement. This included making the DMO an *Executive Agency* under the *Public Service Act 1999*, but this was not supported by the Government. This measure could offer additional efficiencies and further cultural improvements within the organisation. There would be significant merit in revisiting this proposal.

Reintroduction of the DMO Advisory Board would also assist to boost the commercial and other expertise available to improve equipment procurement.

The appointment of the Commercial Manager within the DMO, as recommend by the Mortimer Review, has assisted to address a number of long-term tendering and contracting issues of concern to industry. These include unlimited liability provisions in non-complex contracts, unnecessary insurance burdens and ownership of intellectual property (IP). With active support from the Defence Council, progress has been made by the Commercial Manager and his team on liability and insurance, with attention now turning to IP. Ongoing action is essential to further reduce the cost of tendering and speed up the time to get to contract.

The shift by the Commonwealth to Fixed Price contracts as the standard contract arrangement continues to cause difficulties for companies seeking to price complex equipment acquisitions, especially those involving high risk combat system integrations. Attention should be given to more flexible contracting arrangements, including Cost Plus provisions during development phases of complex projects. This will assist both Defence and industry to better identify the level and sharing of risk, and develop improved cost and schedule estimates. Doing so early in the capability acquisition process will offer greater assurance to Government at the time of Second Pass considerations.

Pappas and McKinsey undertook a Defence Budget Audit which identified substantial waste and inefficiencies within Defence and recommended introduction of the Strategic Reform Program (SRP), aimed at saving \$20 billion over the next decade. The Government said the savings would be redirected into capability upgrades and replacements. The SRP has made a reasonable start, with a substantial savings challenge ahead. Improved work practices and related efficiencies, both within Defence and industry, are essential if the SRP is to be achieved. Industry is playing its part. One option for consideration relates to the number of separate project offices (SPOs) in Defence. Some Prime Contractors have to deal with as many as 30 SPOs. This would build on the promising bundling of maritime sustainment contracts leading to promising efficiencies in contract support within Defence.

In summary, the Defence Council believes that progress has been made in recent years to improve Defence procurement. The fundamental structures are about right. However, further attention needs to be given to earlier identification of risk associated with complex acquisitions, ongoing improvements to tendering and contracting arrangements and identifying additional in-house efficiencies, matching those required of industry. Defence industry is committed to working with Defence to achieve these ongoing improvements.

Recommendations

The Defence Council makes the following recommendations to the Senate Inquiry to further improve Defence procurement:

1. Acknowledge that Australian design, development and construction of new equipment for the Australian Defence Force (ADF) is a first order policy priority for government, which is necessary to sustain defence industry's ability to support new equipment through its whole life, including mid-life upgrades;
2. Ensure that all government decisions to support Military-off-the-Shelf (MOTS) or Civilian-off-the-Shelf (COTS) equipment acquisitions take proper account of the full through-life costs of the equipment, including any risks associated with reliance on off-shore sustainment;
3. Encourage stronger Defence development of, and industry engagement on, the Strategic Industry Capabilities (SICs) and Priority Industry Capabilities (PICs) programs, noting the critical role Australian industry plays in supplying and supporting the ADF to meet its many operational challenges and responsibilities, and offering a higher degree of self-reliance consistent with meeting Australia's strategic requirements;
4. Involve senior defence industry representatives early in the Capability Development process, preferably through a reinvigorated Capability Development Advisory Forum (CDAF), to meet regularly to provide clear direction to its subsidiary Environmental Working Groups (EWGs);

5. Identify early in the Capability Development process the actual level of risk associated with every new major equipment acquisition and sustainment project, and tailor acquisition strategies which matches the risk, including a proper sharing of the risk between the Commonwealth and industry;
6. Application of appropriate contracting arrangements (e.g. Cost Plus) which match the level of risk associated with each major equipment acquisition, including complex systems integrations, particularly during design and development phases and during mid-life upgrades;
7. Invest in R&D early in the Capability Development process, with DSTO and industry working fully in partnership to realise the benefits;
8. Develop a more accurate, more reliable Defence Capability Program (DCP) enabling industry to invest wisely in infrastructure, skills and staffing, including offering full public explanations when changes occur which are different from the previous DCP;
9. Identify and report on why the stalled capability acquisition program, as highlighted in the Incoming Government “Red Book” Brief 2010, occurred and what measures need to be implemented to ensure no recurrence in future years;
10. Revisit the Mortimer Review recommendation to make the Defence Materiel Organisation (DMO) an *Executive Agency* under the *Public Service Act 1999*;
11. Re-introduce the DMO Advisory Board, offering strong, direct commercial and wider central agency expertise on all major procurement activities, including ongoing efficiency improvements within the DMO;
12. Assess how effectively, including through specific measures, Defence has embraced the Mortimer Review recommendations to be more commercially focussed;
13. Embrace speedier tendering and contracting processes and outcomes which incorporate proven cost-effective commercial practices and processes;
14. Expand the Skilling Australian Defence Industry (SADI) program, including offering more flexibility to small and medium-sized (SME) companies to enter and participate in the program;
15. Assess the success to date of the Global Supply Chain program and other industry support programs administered by Defence, and other agencies, including recommendations for improving the opportunities for Australian defence companies, including SMEs, to participate; and

16. Maintain a continuous program of efficiency improvements within Defence, including bundling separate project offices, and industry, including under the Strategic Reform Program (SRP), incorporating smarter, leaner utilisation of personnel within Defence and industry, and embracement of proven commercial practices and processes.

Historical Basis for Defence Procurement

Included at **Attachment A** is a summary of the early development of the procurement process within Defence, including a number of reviews over recent years.

Defence Industry Policy

Successive Federal Governments have committed in-principle to fostering and sustaining a vibrant, efficient and productive Australian defence industry. This is essential to enable the Australian Defence Force (ADF) to meet its many war and peacetime requirements. This includes its ability to operate independently to meet our clear national security policy obligations, including the defence of Australia and its contribution to our alliance arrangements, principally with the United States.

Defence self-reliance is essential if we are to support core capabilities identified in the Federal Government's *Defence Industry Policy Statement 2010*. The statement listed the Priority Industry Capabilities (PICs) and Strategic Industry Capabilities (SICs) which must be fostered within Australia's defence industry. The Defence Council welcomed this policy. To date, however, almost no action has been taken to explain how Defence, in partnership with industry, intends to meet this worthy objective. Without it, business is unable to make wise or informed medium or longer term investment decisions.

Defence Capital Equipment Acquisition Performance

Defence is one of the most scrutinised portfolios, including by the Australian parliament, the Australian National Audit Office (ANAO) and the media.

The public image of Defence is mixed. On ADF operational matters, including disaster relief and support, positive media coverage is common. On management of its personnel, highlighted by a number of recent experiences (e.g ADFA and HMAS Success), there is a clear requirement for the ADF to do better.

On Defence procurement, the focus is often negative. The consistently poor availability and performance of the Collins class submarines, the failed Seasprite helicopter and watercraft programs, and recent non-availability of amphibious ships to assist in response to natural disasters have highlighted ongoing concerns about the quality of Defence procurement. On the other hand, there have been many successful capital procurement programs (e.g. Anzac frigates). Despite this, attention turns to whether Defence procurement processes are appropriate. If not, what needs to be done to improve them?

In a speech in the Senate on 22 March 2011, Senator Mark Bishop, Chairman of the Senate Foreign Affairs, Defence and Trade Legislation Committee said that in regard to defence procurement “In general I think I can say with some confidence that in Australia we do seem to be on the right track.” He posed the question: “what progress have we made in Australia post Kinnaird and Mortimer?”

Senator Bishop reported on recent work by the ANAO addressing progress on 22 current major Defence projects. It found that for all these projects there had been no cost overruns and for off-the-shelf purchases no schedule delays, while for customised Australian needs and the more the development to be undertaken, the greater the slippage.

A wider perspective of performance was presented by Dr Stephen Gumley, CEO of the DMO at the Defence & Industry Conference 2009 which showed that of the 239 projects that had been closed over the previous 10 years, worth \$27 billion, total expenditure had been 98 per cent of the total budget for the period. Of the 239 projects:

- 60% were Under Budget
- 23% were On Budget
- 17% were Over Budget

Defence and industry deserve credit for the positive outcomes identified above. However, further attention is needed to avoid future project slippage as identified by the ANAO. This submission will offer views on how to achieve this.

Senate Committee’s Terms of Reference

The Defence Council offers the following in response to the Senate Committee’s Terms of Reference:

- (a) assess the procurement procedures utilised for major capital projects currently underway or foreshadowed in the Defence White Paper, including the operations of the Capability Development Group and its relevant subcommittees.**

The current major capital project procurement procedures within Defence, which incorporates the two-pass government decision-making process, have essentially evolved from the Kinnaird and Mortimer Reviews.

The two-pass system has the potential to work well. However, it suffers from two major drawbacks, one of which has consistently been the source of political embarrassment related to those projects which have underperformed on budget and schedule. The other, more recent, relating to the National Security policy process has effectively brought the two-pass system to a standstill. The latter has caused cost losses and frustration to industry, noting that companies had understandably geared up to meet the Defence White Paper and Defence Capability Plan (DCP) programs.

The two-pass system has yet to “fire proof” within the capital procurement process those projects which subsequently do not meet budget and schedule, nor the ADF’s stated requirements. These are the ones (e.g. Wedgetail) which eventually appear on the *Projects of Concern List*. The principal cause is a failure to address early and properly the risk, and subsequent sharing of risk, associated with the acquisition. A constant theme is underestimating the complexity of integrating complex, new generation weapons systems into legacy platforms (e.g Seasprite). Both Defence and industry need to work more closely and earlier in the acquisition process to address this problem.

One solution to assist to “fire proof” the capability acquisition process is to reinvigorate the Capability Development Advisory Forum (CDAF) and its three accompanying Environmental Working Groups (EWGs) – Air, Land and Sea. These entities operated quite successfully in the past, led by the capability Development Group (CDG), but were placed in abeyance in recent years. This was unfortunate. Each comprised appropriate departmental and industry representation, including specialist scientific and technical expertise. The Defence Council’s recent suggestion to Ministers Smith and Clare on CDAF is being actioned by Defence.

A second solution relates to further improving the professional working relationship between Defence and industry. The annual Australian Industry Defence Network (AIDN) awards attest to many examples of highly successful project outcomes. These are principally a result of the quality of the working relationship between Defence and the contractor. However, when these relationships break down, as occurred in a number of projects on the *Projects of Concern List*, budget overruns and schedule slippage occurred. Successful remedial work has occurred between Defence and industry on a number of these projects. However, the lesson is that greater attention earlier in the acquisition process could have avoided the negative project outcomes. This requires ongoing, strong leadership in Defence and industry.

Considerable investment has been made over recent years to improve the level of project management expertise within Defence, especially within the Defence Materiel Organisation (DMO). Industry, too, has continued to upskill its project teams, including its project management expertise. This investment will provide a greater level of confidence in the likelihood of successful project outcomes.

The second two-pass system “drawback” was highlighted in the Defence Incoming Government Brief “Red Book”, released by Stephen Smith on 28 October 2010. Of the foreshadowed 29 capability projects to be progressed in 2010-2011, “Defence achieved approval of (disappointingly) only two of the 15 projected first Pass approvals, and eight out of 14 Second Pass projects.”

In a speech to the Royal United Services Institute on 16 February 2011, the Chairman of Thales Australia, Paul McClintock AO, said, among other things, that “...there is a crisis of confidence in the defence industry – a crisis of confidence emanating from a pipeline of defence work that has almost completely stalled, resulting in industry layoffs and

question marks about the viability of continued investment in Australia...Companies large and small are looking nervously to the future.”

The Mortimer Review recommended (Recommendation 2.8 and 2.9) that the ‘Capability Development Group should be adequately resourced in terms of workforce numbers and skills to develop capability proposals and incorporate specialist advice from DMO and the Defence Science and Technology Organisation” and “Capability Development Group and DMO should further develop their ability, and be adequately resourced to accurately estimate the cost and schedule of major acquisition projects.” The Senate Committee may wish to address to what extent these recommendations have been implemented and how effectively.

(b) assess the timeline proposed for defence modernisation and procurement outlined in the Defence White Paper.

The Defence White Paper: Force 2030 announced in May 2009 foreshadowed expenditure of \$100 billion over the next 10 years to upgrade and replace equipment for the ADF. It was foreshadowed that about 55 per cent of this amount would be spent locally.

The program includes:

- 12 Future Submarines, to be constructed in Australia
- 3 Air Warfare Destroyers (ADWs)
- 8 new Surface Combatants, larger than the Anzac frigates
- Up to 100 Joint Strike Fighter (JSAF) aircraft
- 24 Naval Combat helicopters 20 Offshore Combatant Vessels
- 6 new Heavy Landing craft
- Two additional infantry battalions
- 6 Chinook helicopters
- Cruise missiles

The Defence White Paper affirmed the Government’s policy that “the main role of the ADF should continue to be an ability to engage in conventional combat against other armed forces. The ADF must also be prepared to play its part in dealing with intra-state conflict, an enduring feature, and assessed to be the most common form of conflict in the period to 2030. The White Paper produces a substantial additional investment in the capability of our Navy, Army and Air Force. Force 2030 is a balanced force, capable of meeting every contingency the Australian Defence Force may be required to meet in the coming two decades.”

The timeline for introduction and upgrade of equipment for the ADF focuses primarily on the period to around 2019. There is a peak of activity in 2013, driven by expenditure on the ADWs and JSF. However, of significant concern to industry is the four year gap from 2014 to 2018 in shipbuilding activity. The question for industry is how they will retain skilled workers and investment infrastructure during that period, noting that there

will be a surge of shipbuilding, including submarine construction, activity in the following decade? Further consideration needs to be given to achieve a more balanced, smoother flow of shipbuilding work.

(c) assess proposals arising from the Defence accountability reviews, including, the Mortimer Review, the Pappas Review and McKinsey Report (2010), in regards to enhancing accountability and disclosure for defence procurement.

The Defence Council welcomed the Mortimer Review and the thrust of the Pappas and McKinsey Reviews.

Of the 46 recommendations from the Mortimer Review, the Government accepted 42 in full, three partially and rejected one (Recommendation 5.1) that the “DMO should become an Executive Agency under the *Public Service Act 1999*, and retain its Prescribed Agency status under the *Financial Management and Accountability Act 1997*.”

According to Mortimer, drawing on the previous Kinnaird Review, the principal reasons for supporting the DMO becoming an Executive Agency, led by a CEO supported by an advisory board, was to give it a separate identity within Defence, providing “a real opportunity to ensure that significant and fundamental change will occur.” Under the then arrangement, the DMO “does not have full control over its business.”

The Defence Council believes that the Senate Inquiry offers an opportunity to re-examine the option of making the DMO an Executive Agency, drawing on the experience of how well the DMO has performed since the Mortimer Review. On balance, were the change to lead to greater efficiencies within the DMO, including further introduction of commercial processes and practices, there would be benefit in doing so.

The DMO Advisory Board, which played a useful role in overseeing implementation of the Kinnaird Review recommendations, no longer meets. The Defence Council believes that Mortimer was correct to emphasise the benefits of retaining the Board, noting the expertise offered by involvement of independent, experienced business leaders as members, along with, for example, the Secretaries of Prime Minister and Cabinet, Finance and Treasury.

The savings identified in both the Pappas and McKinsey Reviews led to the Strategic Reform Program (SRP). Defence Council views on the SRP are included below.

(d) make recommendations for enhancing the availability of public information and parliamentary oversight and scrutiny of defence procurement in the context of guaranteed 3 per cent real growth in the Defence Budget until 2017018.

Defence is the subject of considerable parliamentary scrutiny, particularly through the Senate Estimates Committee process and the activities of other parliamentary committees. Much of the scrutiny focuses on Defence Procurement, with primary

attention often on *Projects of Concern*. The Defence Council believes there is no requirement to increase the amount of parliamentary oversight.

In regard to the availability of information on Defence, there is the annual Defence Report, regular Defence Capability Plan updates, a commitment to five-yearly Defence White Papers, and regular statements by responsible ministers, senior officials and military chiefs. The Defence Council believes that there is a considerable amount of information about, for example, plans for capital equipment acquisition and sustainment. There is, however, scope to improve the level of detailed reporting by Defence on, for example, progress on implementation of the Mortimer Review, including tangible changes which have occurred in both CDG and DMO. This also applies to the SRP, where a six-monthly public report of progress on each area of savings activity (e.g. Smart Sustainment) would be useful. The report should include information on industry's contribution to the SRP.

Defence Capability Plan

The Defence Capability Plan (DCP) announced by the Government on 1 July 2009 included 110 projects or phases with a total budget of \$60 billion. The DCP foreshadowed that an additional 5,000 jobs in industry would be created as a result of implementation of the DCP.

In announcing the release of the DCP, then Defence Materiel Minister, Greg Combet, said that a "feature of this year's DCP has been the effort that has been made to ensure a greater level of accuracy and reliability than has been previously the case."

Concurrently, Greg Combet, along with then Defence Minister, John Faulkner, announced a project to examine and report on how to improve the DCP as an enhanced tool for industry. Dr Mark Thomson (ASPI) and former Ai Group Executive Director, Leigh Purnell, undertook the consultancy to address this subject. Among other things, they recommended reversal to a 10-year DCP timeframe, but with regular six-monthly, on line updates. The Defence Council strongly supported this approach.

On 17 December 2010, in releasing the updated public DCP, Defence Ministers Smith and Clare announced the cancellation or postponement of 21 major projects or phases of projects. Unfortunately, these changes to the DCP were not properly or fully explained, with the belief that Defence does not understand the negative real impact on business, including SMEs, when such changes are made.

The Defence Council was recently invited by Stephen Smith to give consideration to an alternative arrangement to the DCP. He had in mind the difficulties arising from changes to earlier DCP plans, noting, in particular, the problems posed to industry.

Despite the limitations of the DCP, the Defence Council believes that the current DCP arrangements provide a reasonable basis to assist industry to gear up for the new

equipment and sustainment programs. However, it would be helpful when changes occur in follow-on, public DCPs that an explanation is given for each of them.

Defence Materiel Organisation

The Defence Materiel Organisation (DMO) has evolved considerably over the past five years or so. Its emphasis on upskilling the DMO workforce was necessary and appropriate. This has led to improvements in managing the large number of projects under its responsibility, although concern remains about the complexity and cost of tendering. In the same time period, staff numbers in the DMO have increased to more than 7,000. This is larger than comparable international counterparts.

The appointment of a dedicated Commercial Manager, as recommended by Mortimer, has seen a more commercial approach to tendering and contracting activity. Consequently, progress has been made on a number of long-held issues of concern to industry including liability, insurance and intellectual property. Progress has also been made to revamp the ASDEFCON suite of tendering and contracting templates. The Defence Council has worked closely with the DMO on these improvements, but more needs to be done.

Further attention needs to be given by the DMO to introducing tendering and contracting arrangements which are more appropriate to normal commercial arrangements. This includes reducing the size and information required of Requests for Tenders, reducing the time to assess tenders and speeding up the time to get to contract.

A further contracting issue relates to complex equipment acquisition projects. Currently, these incorporate Fixed Price provisions which take little account of the risk associated with meeting strict budget and scheduling requirements. Consideration need to be given to incorporating more flexible contracting provisions (e.g Cost Plus) during development phases of such high risk projects.

The one outstanding Mortimer recommendation relates to making the DMO and *Executive Agency* under the *Public Service Act 1999*. The Defence Council continues to support this change, noting that it would offer greater flexibility to the CEO of the DMO to introduce additional efficiencies, consistent with commercial best practice.

Skilling Australia Defence Industry

The Skilling Australia Defence Industry (SADI) program provides tangible assistance to defence industry to address one of its key challenges: the shortage of skilled workers.

Defence industry competes with the resources sector for skilled workers. Consequently, the availability of skilled workers, including essential engineers, is becoming a larger problem for defence industry. The SADI program plays a part in addressing this shortfall, although primary responsibility resides with companies to meet their skilling needs.

The Defence Materiel Minister, Jason Clare, recently wrote to the Defence Council confirming that the Government was committed to spending \$138 million over the next four years on Defence industry skilling. He invited applications for the next round of SADI funding amounting to up to \$14 million next financial year and seeking ideas for improving the program.

The Defence Council, whilst welcoming the Government's commitment to SADI, notes that many companies who apply for SADI funding miss out. The Defence Council believes that additional funding ought to be provided to the SADI program. This could come from the Strategic Reform Program savings, offering benefits to both Defence and industry.

Strategic Reform Program

The Strategic Reform Program (SRP) has made a reasonable start, having achieved the identified savings in Year One of nearly \$800 million. But the truly hard work has only just begun if Defence is to achieve its goal of savings of \$20 billion, over 10 years. Over the same period, Defence can expect to spend around \$300 billion.

The first year of SRP activity within Defence focussed on internal structures for handling each element of the program and the contribution expected from industry to the savings program. This includes two pilot projects: one from Qantas Defence Systems and the other from Thales Australia.

The Defence Council welcomes Jason Clare's recent invitation to industry to offer additional projects for inclusion under the SRP.

Industry representatives have attended a number of CEO round-table meetings, chaired by the DMO, to discuss the SRP. This has led to industry offering to find substantial savings and efficiency improvements.

Industry believes that there is scope to focus on substantial efficiency savings in a number of areas of Defence, such as reducing the number of personnel responsible for overseeing commercial-type warehousing arrangements. Another relates to oversight of sustainment of naval platforms, where a large in-house, overseeing workforce duplicates the commercial team undertaking the actual work.

A number of Prime Contractors have responsibility for as many as 30 projects. There can be as many as 30 separate project offices (SPOs) within Defence to provide oversight to each of these projects. This makes little sense, is inefficient and is plainly unwieldy. Further bundling of such oversight arrangements would make considerable sense, offering substantial savings to the DMO and far less pressure on companies to respond to separate, but similar monopsony requests.

Conclusion

The Defence Council believes that progress has been made over recent year to improve Defence procurement. This includes improvements to elements of tendering and contracting arrangements, upskilling of the DMO workforce and the level of engagement between Defence and industry.

The primary structure for Defence procurement, resulting from implementation of the Kinnaird Review recommendations is reasonably sound. However, further improvements are necessary in the Capability Development process, including renewed attention being given to identifying and managing risk in complex equipment acquisition projects.

Further attention needs to be given to improving efficiencies within Defence and industry. This includes the need to work together more constructively to solve problems so as to avoid a repeat of recent project failures (e.g Seasprite). Progress will be made from a greater level of trust between both. The onus rests with both to continue to develop that trust.

Attachment A

The current defence procurement structure and processes have evolved from the Tange Review in the mid-1970s, when the then Government accepted the need to amalgamate the single service departments (Army, Air and Navy) under one Department of Defence. The then Department of Supply, responsible for managing the government-owned dockyards and factories, remained separate.

The single service boards were abolished and replaced with a revised committee structure under a diarchy led by the Secretary (initially Tange) and the then Chief of the Defence Force (CDF). The former had primary responsibility for managing the Defence Budget, while the latter was responsible for the ADF, including its operational deployment and personnel matters.

One of the features of the Tange Review was the creation of the Force Development and Analysis (FDA) Division, including its Systems Analysis Branch. Its genesis was the 1960s McNamara model in the Pentagon, which applied systems analysis as a basis for making sound decisions on complex weapons acquisitions. He also introduced Planning, Programming and Budgeting, including a Five Year Defence Plan (FYDP). This was the key policy document embraced by FDA.

FDA was headed by a civilian, who was responsible for developing the FYDP or "Pink Book", now the DCP. The Pink Book included about 100 projects, or phases of projects.

FDA, comprising 40 people (both civilian and military, including a number of DSTO scientists on secondment), administered the then Force Structure Committee (FSC), which was responsible for scrutinising all major equipment acquisition proposals, including the Pink Book. It examined capability options and recommended the preferred

capability to be acquired, including the number and type (e.g. 100 Tactical Fighter Force aircraft).

The FSC reported to the Defence Force Development Committee (DFDC), chaired by the Secretary. The DFDC comprised the CDF, the Chiefs of Navy, Army and Air Force, three Deputy Secretaries and Chief Defence Scientist. The Secretary of Supply was an invited member. The DFDC was the principal source of equipment acquisition and sustainment advice to the Minister for Defence.

The original forerunner to the Defence Materiel Organisation (DMO) comprised the Defence Industry Division and individual Chiefs of Materiel (Navy, Army and Air Force). It administered the Defence Source Definition Committee (DSDC), which also reported to the DFDC. The DSDC made recommendations on the preferred source of new equipment (e.g. F/A-18 aircraft under an FMS purchase from Boeing and Anzac frigates built at Williamstown, VIC).

Recent Defence Procurement Reviews

Defence procurement has been the subject of a number of reviews in recent years. These include those by Kinnaird, Mortimer, Pappas and McKinsey.

Kinnaird Review:

The Kinnaird Review was established by the Howard Government to examine and review the defence procurement process. It recommended the introduction of a Two-Pass Process for capability acquisition and sustainment.

The First Pass stage was defined as the process during which options will be analysed to meet the identified capability gap, following government's review of the proposed strategic assessment. This assessment would involve a number of options being identified by Defence to achieve a required military effect to meet a capability gap that government has agreed exists.

The First Pass approval was to provide funding for the approved options to be fully analysed and developed prior to second pass consideration by government. The capability gap, options for which have received first pass approval, would form part of the DCP. At this stage government is not committed to acquiring the capability, only to the conduct of detailed studies, analysis and, possibly, funded industry studies.

The Second Pass stage was defined as the process during which the wide range of options approved following first pass were to be subject to detailed and rigorous assessment and the development and presentation to government of separate Acquisition Business Cases for each option. The outcome of second pass would be government approval for Defence to proceed to tender for the agreed solution.

Mortimer Review:

The latest substantive review on Defence Procurement and Sustainment, published on 18 September 2008, was led by experienced industry executive, David Mortimer.

The Mortimer Review evaluated progress made under the Kinnaird reforms and examined acquisition and sustainment processes. It noted the marked improvements in the capability development process in Defence, and the acquisition process in the DMO.

The Mortimer Review concluded that “Over time, the two-pass process proposed by the Kinnaird Review has evolved. Firstly, and most significantly, DCP entry is now separate and distinct from first pass approval. This measure accommodates project entry into the DCP ten years before a proposal goes to government for second pass approval.”

“Secondly, solicitation (usually proceeding to tender) now occurs before second pass approval to provide Government with more accurate information including on costs.”

Mortimer made 46 recommendations, with a focus on ongoing improvements to five principal areas of concern “ranging from inadequate project management resources in the Capability Development Group, the inefficiency of the process leading to government approvals for new projects, shortages in DMO personnel, to delays due to inadequate industry capacity and difficulties in the introduction of equipment into full service. We have also considered measures to promote improved outcomes through a more commercially focussed DMO.”

The Government accepted all except one of the Mortimer recommendations namely 5.1 that the “DMO should become an Executive Agency under the *Public Service Act 1999*, and retain its Prescribed Agency status under the *Financial Management and Accountability Act 1997*.”

Defence Budget Audit (Pappas and McKinsey):

On 28 July 2008, the Government announced the appointment of George Pappas, supported by McKinsey’s, to lead an independent Audit of the Defence Budget. The final report was delivered to the Government in April 2009, making 120 recommendations.

The Defence Budget Audit was undertaken in parallel with preparation of the 2009 Defence White Paper: *Force 2030* and associated companion reviews and the Mortimer Review.

The Audit examined the state of the Defence Budget and its major cost drivers, with a view to finding efficiency gains and reinvestment opportunities.

The Audit identified duplication and inefficiencies across Defence leading to the creation of the 10-year, \$20 billion Strategic Reform Program (SRP). Achievement of these savings would assist delivery of *Force 2030*.