



miller costello & company

level 3, 54 marcus clarke street
(gpo box 1293)
canberra, act 2601

t +61 2 6162 1619
f +61 2 6162 3202

www.millercostello.com

miller costello pty ltd
abn 55 487 926 873

25th July 2011

MC/OUT/2011/25

Dr Kathleen Dermody
Committee Secretary
Senate Standing Committee on Foreign Affairs, Defence and Trade
PO BOX 6100
Parliament House
Canberra ACT 2600

By Email: fadt.sen@aph.gov.au

Dear Dr Dermody

**Submission to the Senate Foreign Affairs Defence and Trade Committee
Procurement Procedures for Defence Capital Projects**

I write in support of the work this committee is conducting. Noting the Committee has recently updated the Terms of Reference to this inquiry, I offer some broad areas of feedback that may be of further interest.

Defence procurement of specialist military equipment takes place in a market that has the same rules and behaviours as other markets with two very important distinctions:

1. The complex manufacturing process required of defence products has no peer. No civil industry faces the same challenges and risks in so many key technology areas.
2. Government acts solely and unilaterally as both regulator and customer.

It is small wonder then that things can and do, go wrong. Frequently.

The Committee has chosen to focus on the way Government brings projects forward to market, through what is termed the capability development process. This is wise, for it takes many years for a major project to reach its execution phase and much of the risk the Government accepts in a project is determined in this time. It's effectiveness and efficiency is crucial to national security outcomes.

When considering future reform measures, it must be remembered that defence procurement is a market, and therefore follows the rules of a market. It is essential that economic theory and proven practice be incorporated into any reform of Defence procurement.

Project performance is broadly measured through metrics such as price, schedule, risk, capability and sustainability. These are outcomes – they indicate whether a project meets our needs. They are also inextricably linked; variance in one measurement alters the others. The success of the project is determined by the inputs to the project. Such inputs include capital, skills, intellectual property, infrastructure and so forth. A very important input is risk management. Risk management are set process designed to execute a program to predetermined tolerances. The risk management process starts from the moment a project is thought up; but the actual tools used change as a project matures.

In Australia, recent Governments have given policy priority to minimising the risks associated with this decision-taking process. The Kinnaird reforms have ushered in risk management processes that simply did not exist in our thinking 10 years ago. Major projects such as the Australian design and build of new radar for Anzac frigates would never have happened without such reform. And while some project decisions taken in this time will inevitably be shown to be unwise, what is not and can never be appreciated is the number of near misses avoided. This is the nature of risk management.

More recently, policy has taken into account the large cost of fielding military systems over their decades long operating life. Recognition that acquisition and sustainment should be part of one market and one process is logical and commendable.

So in relation to the extant capability development and the risk management process in Defence today, the Committee might consider what credible changes would see the market function in such a way that national security outcomes are either positively or adversely affected?

Of the threats to the market, the first would have to be the unwinding of reforms lead by the Kinnaird and Mortimer reviews. At the conceptual heart of such reform is the separation of Defence and the Defence Materiel Organisation – balanced with the need for both agencies to cooperate closely. This separation is based on the concept that the Defence Department should maintain policy responsibility for setting the top-level requirements of military systems (from the strategic down to the project level) and the Defence Materiel Organisation should engage the market to deliver projects against those requirements.

However Kinnaird reforms remain substantially incomplete in certain areas. The present Government acknowledges this. Well-publicised failures in the maintenance of fleets such as helicopters, submarines and amphibious ships, point to the relentless need to continuously improve process. Whatever the solution determined by Government, it must not confuse reforms that have not been implemented to their full effect with failure of the reform itself.

Poor accountability is a clear causal issue in many, if not all, areas of poor performance. But keep in mind everything is connected. More than just desirable, it is essential that measures taken to improve accountability also enhance the Kinnaird/Mortimer reforms.

A secondary threat to desirable project outcomes include variable or lower than forecast demand to industry. The acquisition component of the Defence market is characterised as deep but illiquid – meaning there are few, but large projects in our marketplace. Boom and bust market conditions atrophies skill and knowledge and escalates overhead costs. Projects are adversely affected across the board. If demand is low or variable because we don't need

any more military equipment that is just a fact a life. Nobody wants a military-industrial complex for its own sake. Equally, Government should never approve a project that does not meet the tests of its own internal risk management process. However, where Government defers projects at its discretion or is unable to correctly resource and implement its own process, the tax-payer meets real and completely unnecessary costs.

These are complex issues that even the most sophisticated of businesses seldom perfect. Good risk management and planning process within Government is the first step in avoiding these costs.

An issue that is difficult to classify as either a threat or an opportunity is the preference to minimise risk by procuring equipment from established production lines. In what is termed buying Military Off the Shelf (MOTS) several issues have emerged in our marketplace and they deserve much tighter policy scrutiny. MOTS procurement can be either a model for risk management or it can disguise risk and lead Government into painfully bad decisions. For example, procuring MOTS current generation jet fighters that meet our requirements and come with advanced logistic support packages that are easily transferred into our local sustainment industry is considered best practice. Contrast this to transferring to local production an unfamiliar design that has been manufactured by a different company in a different country. Clearly these are vastly different propositions requiring different risk management and resourcing but both are labelled as being "MOTS".

Finally, an opportunity might be determining whether better outcomes may be achieved with less process. Removing process from Defence is a brave suggestion. The irony being that because Defence is a process labyrinth, it is equally hard to determine which elements of process contribute to better outcomes and which don't. My only advice is to examine such issues through the prism of economic first principle and build on those reforms that have been shown to work.

I would be pleased to discuss these matters further at the Committee's convenience.

Sincerely,

Sean Costello

Managing Partner

Biography for Sean Costello

Sean Costello co-founded Miller Costello & Company, a commercial advisory and risk management firm, specialising in Government procurement, in 2008. Over the past three years, Miller Costello & Company has built a reputation as a trusted advisor to industry and Government on commercial matters within defence industry.

Prior to this, Sean served as a Senior Ministerial Adviser to Coalition Ministers for Defence. Sean's role in the Minister's office included the development and implementation of defence industry policy and the capability development process. During this time, he cooperated closely with the senior executive of the Australian public service and the Coalition Government to develop and win approval for dozens of major capital projects including the Air Warfare Destroyer and Amphibious Ships projects.

Prior to being a Ministerial Adviser, Sean started his career in the Royal Australian Navy, serving in Collins Class submarines.

Sean is the Co-author of "How to build a Submarine", published with Andrew Davies and the Australian Strategic Policy Institute (ASPI). This work costed the Future Submarine project at \$36 billion dollars.

Sean is a graduate of the Australian Defence Force Academy and the Australian National University. He holds a Bachelors Degree in Arts and a Masters Degree in Commerce.