

Chapter 3

Role of central agencies

3.1 Although not stakeholders in the normal sense, the central agencies—Department of the Prime Minister and Cabinet (PM&C), the Department of Finance (Finance) and the Treasury—have an important part in the consideration and approval of major capability proposals.¹ In this chapter, the committee considers the role of the central agencies in the government's decision to exclude Australian defence industry from tendering for the AORs replacement project.

First Pass Consideration

3.2 Before a project, such as SEA 1654, Phase 3, can be submitted to government for first pass approval, it must undergo a comprehensive process of refinement and reach a stage 'where a new capability can be acquired.' This phase includes the creation of 'Capability Definition Documents' to support progression through Defence committees to government approval.²

3.3 The Capability Systems Division in Defence leads the development of the capability proposals and the supporting documents that form the basis of the ministerial or cabinet submission that is presented to government.³ The relevant project manager in the Capability Systems Division manages a particular project and coordinates the development of the suite of project documents that underpin the project. The project manager 'uses this information to produce a complete and well-argued capability proposal and all supporting evidence'.⁴ The Defence Capability Development Handbook stipulates that the project manager should only engage central agencies in consultation with the Capability Investment and Resources Division in Defence.⁵

3.4 This Division has the lead role for engagement with the central agencies. It provides independent analysis and review of capability proposals and related costs, including the overall balance of investment in current and future capability, major investment proposals and priorities. The Division is responsible for: 'ensuring that the DCP is appropriately programmed, independently reviewing capital and operating

1 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 3.2.15n, [http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20\(DCDH\)%202014%20-%20internet%20copy.pdf](http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20(DCDH)%202014%20-%20internet%20copy.pdf) (accessed 8 August 2014).

2 Department of Defence, *Defence Capability Development Handbook 2014*, paragraphs 1.5.8–1.5.13.

3 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 1.6.7.

4 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 1.6.8.

5 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 3.2.15n.

costs for all projects going to the Defence committees, and managing Net Personnel and Operating Costs (NPOC) estimates for all DCP projects...⁶ The First Assistant Secretary Capability Investment and Resources heads the division.⁷

3.5 Key responsible authorities within Defence review the draft ministerial or cabinet submission before it is submitted to the Secretary of the Department and the Chief of the Defence Force for clearance to go to government. The authorities do so in order 'to ensure that the detail is correct and aligns with departmental policies and allocations'. The role of the CEO of the Defence Materiel Organisation (DMO) is to concur with the summary acquisition strategy and cost, schedule and risk estimates. The CEO also 'provides independent written advice on the cost, schedule and commercial aspects as an attachment to the submission'.⁸ Mr Warren King, CEO DMO, explained that his organisation can spend a limited amount of money in the lead-up to first pass doing market research—'understanding what is available: understanding the market'. He explained further that Defence rarely undertakes industry solicitation of DCP projects prior to first pass approval and the assessment of capability options and other options is conducted through open market research.⁹ He noted, however, that:

...genuine approaches to market—approaches that may lead to the award of a contract or future work—cannot be pursued until we have first-pass approval.¹⁰

3.6 With regard to the acquisition of the new supply ships, Defence informed the committee that it had developed estimated cost, capability and schedule information for the project based on its open market research, unsolicited proposals and other recent approaches to market. These approaches included the exchange of information from similar Canadian and New Zealand projects, and reports into Australian shipbuilding available capacity.¹¹ Defence explained that notwithstanding the limitations of its research:

...the level of information available on the various ship options in the marketplace was widely available through open source information and sufficiently detailed to enable Defence to obtain information on available options to meet the capability requirement.¹²

6 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 1.6.9, [http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20\(DCDH\)%202014%20-%20internet%20copy.pdf](http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20(DCDH)%202014%20-%20internet%20copy.pdf) (accessed 8 August 2014).

7 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 1.6.10.

8 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 3.6.2.

9 Department of Defence, answer to question on notice No. 3.

10 *Committee Hansard*, 21 July 2014, p. 18.

11 Department of Defence, answer to question on notice No. 22.

12 Department of Defence, answer to question on notice No. 21.

3.7 After the government's first pass approval, the DMO becomes progressively more involved in the procurement process and is responsible for the acquisition strategy.

3.8 The central agencies provide an additional level of scrutiny and advice on capability development proposals from a whole-of-government perspective. The Department of Finance informed the committee that it has:

...developed specific expertise in providing advice to government on defence capability matters. In addition to the Department's role in advising on whole of government procurement matters, and in advising the Finance Minister on the cost and quality of new policy proposals put forward by agencies, Finance has developed a specialised defence capability assessment role.

Expertise at the Senior Executive Service Band 1 level is dedicated to this role with support provided by the Defence, Capability and Intelligence Branch. The work undertaken by Finance in this regard includes advising the Finance Minister on: priority cost and risk issues; cost contingency, cost models and supporting documentation; and other policy matters raised in Submissions.¹³

3.9 At first pass, Finance is required to endorse the detailed acquisition and operating costs and financial risk assessment. The Defence Capability Development Handbook states further that this requirement is especially important in 'the case for decisions on DCP capabilities or decisions having important political, workforce and/or financial implications for Government'.¹⁴

Commonwealth Procurement Rules (CPRs)

3.10 Mr John Sheridan, Business Procurement and Asset Management Group, Department of Finance, informed the committee that a procurement needs to be considered in the context of the Commonwealth Procurement Rules (CPRs).¹⁵ Commonwealth officials must comply with the rules.

3.11 Paragraph 10.3 of the CPRs stipulates that a relevant entity must only conduct a procurement at or above the relevant procurement threshold through limited tender in certain strict circumstances. The procurement threshold for non-corporate

13 *Submission 14*, p. 2.

14 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 3.6.6, [http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20\(DCDH\)%202014%20-%20internet%20copy.pdf](http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20(DCDH)%202014%20-%20internet%20copy.pdf) (accessed 8 August 2014).

15 *Committee Hansard*, 21 July 2014, p. 3.

Commonwealth entities is \$80,000, other than for procurements of construction services (for procurement of construction services the threshold is \$7.5 million).¹⁶

3.12 Mr King, DMO, informed the committee that he understood that the CPRs required DMO not to discriminate for a procurement over \$80,000: that DMO would have to go to the open market if the acquisition were over \$80,000.¹⁷ Indeed, the Defence Procurement Policy Manual stipulates that, in accordance with the CPRs, it is mandatory for an open tendering process to be used for 'all procurements at or above the relevant procurement threshold (other than Exempt Procurements)'. This requirement applies 'unless the conditions for limited tendering or prequalified tendering can be satisfied'.¹⁸

3.13 With the acquisition cost for the supply vessels expected to exceed \$1 billion, the Commonwealth procurement rules would generally require that the tender for the supply ships be open unless an exemption applies.

Exemptions

3.14 Defence defines a limited tender as a procurement process in which Defence has invited either a single potential supplier or a number of potential suppliers to submit a response without using an open procurement process.¹⁹ Defence's procurement policy recognises that in some circumstances it may be appropriate to limit the number of potential suppliers to whom a Request for Tender (RFT) is released. Defence's Procurement Policy Manual states:

Limited tendering should only be used where there is a sound basis for identifying interested and eligible potential suppliers. When using a limited tendering approach the process must be non-discriminatory and ensure that a sufficient number of potential suppliers are invited to participate so as to ensure a sound value for money outcome.²⁰

3.15 The CPRs allow for an exemption from having to adhere to the rules. Paragraph 2.6 of the CPRs provides an overarching exemption which removes the need to apply the CPRs where, for clearly defined reasons, an Accountability Authority has determined it was necessary. Paragraph 2.6 states that:

Nothing in any part of these CPRs prevents an *official* from applying measures determined by their *Accountable Authority* to be necessary for the

16 *Commonwealth Procurement Rules*, July 2014, see paragraph 9.7 for procurement thresholds, <http://www.finance.gov.au/sites/default/files/2014%20Commonwealth%20Procurement%20Rules.pdf> (accessed 8 August 2014).

17 *Committee Hansard*, 21 July 2014, p. 12.

18 Department of Defence, *Defence Procurement Policy Manual*, p. 3.1–1, <http://www.defence.gov.au/dmo/multimedia/dppm-9-5247.pdf> (accessed 8 August 2014).

19 Department of Defence, *Defence Procurement Policy Manual*, glossary–13 and also p. 3.1–5, <http://www.defence.gov.au/dmo/multimedia/dppm-9-5247.pdf> (accessed 8 August 2014).

20 Department of Defence, *Defence Procurement Policy Manual*, p. 3.1–5.

maintenance or restoration of international peace and security, to protect human health, for the protection of essential security interests, or to protect national treasures of artistic, historic or archaeological value.²¹

3.16 Finance explained that, in practice, this exemption 'allows an entity to undertake an alternative form of procurement, such as a limited tender, should they choose'.²² Under paragraph 2.6, the Secretary and CEO DMO have determined that the procurement of certain goods be categorised as Defence Exempt Procurements, which includes ships and marine equipment.²³

3.17 Speaking generally about the application of this exemption, Mr King explained that a limited tender did not mean limited to Australia; it meant that limitations are placed on the tender. He elaborated on this point:

It is an exemption simply to go to a limited tender. That does not mean a limited tender to overseas; it just means a limited tender. Sometimes I have used that exemption to be a limited tender for Australia. For example, ...although it is not yet at a tender stage, there will be tendered work—the work to be done to see if we can build a future frigate in Australia will rely on that exemption. I will have to exercise that exemption to say, if the government so chooses, that the only place we are going to build the future frigate is in Australia. Otherwise, I would have to go to the world market and see who wanted to supply us with a frigate.²⁴

3.18 Mr King explained that, if DMO in any way undertook a limited tender, the exemption had to apply. According to Mr King, whenever he limits a 'tender in any way, shape or form, whether as to country of supply or type of supply', he has to use the exemption that was used for the two supply ships.²⁵ He explained that the purpose of the exemption was to make sure that the DMO could 'provide essential defence equipment'.²⁶

3.19 Mr Sheridan informed the committee that the exemption would also allow for a rapid acquisition.²⁷

21 Department of Finance, *Commonwealth Procurement Rules*, July 2014 (emphasis in original).

22 *Submission 14*, p. 2.

23 See Finance and Public Administration References Committee, *Commonwealth procurement procedures*, July 2014, Appendix 3.

24 *Committee Hansard*, 21 July 2014, p. 13.

25 *Committee Hansard*, 21 July 2014, p. 15.

26 *Committee Hansard*, 21 July 2014, p. 18.

27 *Committee Hansard*, 21 July 2014, p. 5.

Central agencies and DMO's role in decision for restricted tender

3.20 As noted earlier, the Minister announced that the government had given first pass approval for Defence to conduct a limited competitive tender process between Navantia of Spain and Daewoo Shipbuilding and Marine Engineering of South Korea for the construction of two replenishment vessels based on existing designs. Mr King explained his role in advising government on the tender process for the supply ships:

I am the executive within DMO and within the department who formed the opinion that the exemption could apply and should apply to these ships.²⁸

3.21 Mr Sheridan understood that this procurement would be conducted under the exemption provided in paragraph 2.6 of the Commonwealth Procurement Rules that permit exemptions for national security measures. According to Mr Sheridan, the procurement rules reflect the US free trade agreement that allows carve outs for particular purposes including matters related to security.

3.22 In this regard, Chapter 15 of the Australia–United States Free Trade Agreement sets out the specific rules, procedures and transparency standards to be applied in the conduct of government procurement, consistent with non-discrimination. Both the US and Australia, however, have exempted procurement of items that are critical to their national security such as military equipment, systems and essential supplies. Australia has also reserved the right to maintain the Australian Industry Involvement Program for defence procurement.²⁹ Mr Sheridan's understanding of the application of this exemption is consistent with the Defence Procurement Policy Manual which states that:

If a procurement is subject to Division 2 of the CPRs due to its estimated procurement value, it may...still be exempt from the operation of this Division for 'essential security' reasons if it is a Defence Exempt Procurement in accordance with paragraphs 28–30 of this chapter.³⁰

3.23 One of the two methods by which a procurement may be deemed an exempt procurement is where a Defence exemption may apply a measure under paragraph 2.6 of the CPRs as pre-determined by the Chief Executive. As noted above, paragraph 2.6 of the CPRs permits the Chief Executive of an agency to determine that a measure is necessary for, among other things, the protection of 'essential security' interests. Paragraph 27 of the Defence Procurement Policy Manual lists the procurement of goods and services that the Secretary and CEO DMO have determined to be categorised as Defence Exempt Procurements under the measure. The list contains 25 categories of goods and services and include the following US Federal Supply

28 *Committee Hansard*, 21 July 2014, p. 13.

29 See Australia–United States Free Trade Agreement—Guide to the Agreement, Chapter 15, Government Procurement, <http://www.dfat.gov.au/fta/ausfta/guide/15.html> (accessed 8 August 2014).

30 Department of Defence, *Defence Procurement Policy Manual*, p. 2.1–4, <http://www.defence.gov.au/dmo/multimedia/dppm-9-5247.pdf> (accessed 8 August 2014).

Codes (FSC) FSC 19—Ships, Small Craft, Pontoons and Floating Docks; and FSC 20—Ships and Marine Equipment.³¹ In effect, under the carve-out provision in the CPRs, the acquisition of the replenishment vessels was eligible for exemption from the Commonwealth procurement requirement for an open tender.³²

3.24 Mr Sheridan understood that the Secretary of Defence and the CEO of DMO made the decision to apply through the defence procurement mechanism to use the exemption provided under paragraph 2.6 in respect of procuring the supply ships. Further, that Budget Group in the Department of Finance, whose responsibilities involve liaison with Commonwealth agencies around spending proposals and budget issues, made enquiries as to whether this exemption would be applicable in these particular circumstances.³³ Mr Sheridan informed the committee that on 1 April 2014, Finance officers in the Budget Group asked his division whether paragraph 2.6 of the CPRs applied in these circumstances.³⁴ According to Finance, the Budget Group initiated contact with the Business Procurement and Asset Management Group to establish the conditions under which the proposed procurement may be exempt under paragraph 2.6. This request emanated from Budget Group and not the Minister for Finance.³⁵ Mr Sheridan explained that his response was simply a matter of fact—the exemption was 'applicable to the procurement of ships':³⁶

...the procurement of ships is an exemption. That is really a matter of fact. It does not need much context for me to interpret that. Is it a ship? Yes. That is it.³⁷

3.25 Mr John Edge, Finance, explained that Defence was 'responsible for forming the view that they did around the application of that exemption'.³⁸ He stated further:

31 Department of Defence, *Defence Procurement Policy Manual*, paragraph 27, p. 1.2–5, According to Mr Sheridan paragraph 27 lists the things which are carved out under article 22.2 of the Australia–United States Free Trade Agreement, which refers to essential security. *Committee Hansard*, 21 July 2014, p. 2. There is a list of some 25 categories of the procurement of goods which utilise that carve-out. Article 22.2—Essential Security—stipulates that nothing in the Agreement shall be construed:

- to require a Party to furnish or allow access to any information the disclosure of which it determines to be contrary to its essential security interests; or
- to preclude a Party from applying measures that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

http://www.dfat.gov.au/fta/ausfta/final-text/chapter_22.html (accessed 8 August 2014).

32 Mr John Sheridan, *Committee Hansard*, 21 July 2014, p. 2.

33 Mr John Sheridan and Mr John Edge, *Committee Hansard*, 21 July 2014, pp. 7 and 10.

34 *Committee Hansard*, 21 July 2014, p. 2.

35 Department of Finance, answer to question on notice No. 1, p. 4 in *Submission 14*.

36 *Committee Hansard*, 21 July 2014, p. 7.

37 *Committee Hansard*, 21 July 2014, p. 9.

38 *Committee Hansard*, 21 July 2014, p. 5.

Ultimately it is Defence's assessment and Defence's decision to use an exemption that may exist in the Commonwealth Procurement Rules for a particular project. So, while we will obviously talk internally to our colleagues in budget group and we will, on occasions, talk to agencies about the application of the Commonwealth Procurement Rules, as Mr Sheridan said, ultimately it is a decision for the agency involved as to whether to apply those rules.³⁹

3.26 Mr King stated that, under the rules, clearly he was the responsible officer for forming the opinion that it should be a limited tender, which became part of the departmental submission and was ultimately reflected in the government's decision. He explained:

The department formulates advice for the ministers, and the ministers then take it to the government, but our advice to the minister was that this should be pursued by a limited tender.⁴⁰

3.27 According to Mr King, the central agencies review all cabinet submissions, but he could not say how it was handled inside Finance. In his view, the Department of Finance or others could have rejected the advice, but 'I am saying I take accountability for forming that opinion'.⁴¹ The Department of Finance informed the committee that it provided advice on the submission dealing with the acquisition of the new supply ships and to the Minister for Finance 'in the usual way'.⁴²

Government approval—first pass

3.28 When the government considers submissions relating to major acquisitions, it typically approves 'a solution-class option (comprising a number of options) for further investigation'.⁴³ According to the Defence Capability Development Handbook, the level at which first pass approval is 'required with Government depends on the estimated cost of the proposal and on whether there are any political or diplomatic sensitivities associated with the proposal'. It states:

The level of Government consideration required is one Minister (ie the Minister for Defence) for projects up to \$20 million, two Ministers (ie Minister for Defence plus Minister for Finance) for projects between \$20 million and \$100 million and the NSC [National Security Committee of Cabinet] for projects over \$100 million. The Minister for Defence will often

39 *Committee Hansard*, 21 July 2014, p. 6.

40 *Committee Hansard*, 21 July 2014, p. 13.

41 *Committee Hansard*, 21 July 2014, p. 13.

42 *Submission 14*, p. 2.

43 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 3.6.8, [http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20\(DCDH\)%202014%20-%20internet%20copy.pdf](http://www.defence.gov.au/publications/docs/Defence%20Capability%20Development%20Handbook%20(DCDH)%202014%20-%20internet%20copy.pdf) (accessed 8 August 2014).

determine the appropriate mechanism for approval depending on a project's sensitivity, previous considerations, etc.⁴⁴

3.29 The submission on the acquisition of the new replenishment vessels, with its estimated costs well over \$100 million, would necessarily have gone before the National Security Committee for final decision.

3.30 According to the Department of Finance, the NSC gave first pass consideration of the proposed new replenishment ships on 4 April 2014, which was followed by the Minister for Defence's announcement of the government's decision on 6 June to go to a limited tender.⁴⁵

Conclusion

3.31 The Defence Capability Development Handbook sets out clearly the procedures and documents that must be prepared in readiness to submit an acquisition proposal to cabinet. The CEO of DMO, Mr King, made clear that he was responsible for advising the government on the preferred tender process, which in this case was to proceed with a restricted tender between Navantia of Spain and Daewoo Shipbuilding and Marine Engineering of South Korea. He formed the view that the government could do so consistent with the exemption provided in the Commonwealth Procurement Rules. The relevant section in the Department of Finance confirmed that the rules allowed for such an exemption.

3.32 There is no evidence to suggest that the proposed limited tender for the two supply ships contravenes the Commonwealth Procurement Rules. Furthermore, although Mr King's advice to the Minister was to opt for a restricted tender, the decision was ultimately one for government.

44 Department of Defence, *Defence Capability Development Handbook 2014*, paragraph 3.6.8.

45 Department of Finance, *Submission 14*, p. 2.

