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Australian Government
Department of Finance and Deregulation

David Tune PSM
Secretary

Our Ref: SEC0004702

Senator the Hon Helen Kroger
Chair
Standing Committee on Foreign Affairs, Defence and Trade
Parliament House
CANBERRA ACT 2600

Dear Senator

Thank you for your letter of 15 February 2011 inviting the Minister for Finance and Deregulation, or the Department of Finance and Deregulation (Finance) to make a written submission to the Standing Committee on Foreign Affairs, Defence and Trade Reference Committee inquiry into procurement procedures for items identified in the 2009 Defence White Paper.

I would like to submit the attached written submission on behalf of Finance to be considered in the context of this inquiry.

Yours sincerely

David Tune
15 April 2011

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**SUBMISSION BY THE DEPARTMENT OF FINANCE AND
DEREGULATION TO THE SENATE STANDING COMMITTEE ON
FOREIGN AFFAIRS, DEFENCE AND TRADE REFERENCE
COMMITTEE INQUIRY INTO PROCUREMENT PROCEDURES
FOR ITEMS IDENTIFIED IN THE 2009 DEFENCE WHITE PAPER**

Introduction

Advice from the Department of Finance and Deregulation (Finance) to the Minister for Finance and Deregulation (Minister for Finance) relating to major capital acquisition proposals by the Department of Defence (Defence) is ordinarily provided by Budget Group. The Defence Capability Assessment Branch (Attachment 1 refers), within Budget Group, was established in 2004 as a result of Government's decision to implement the recommendations of the Defence Procurement Review 2003 (the Kinnaird Review). The Defence Capability Assessment Branch is staffed by a small number of specialist cost analysts to evaluate and quality assure the costs and financial risks associated with Defence capability procurement proposals. This branch has an annual operating budget of \$1.76 million.

To implement the recommendations of the Kinnaird Review, Finance and Defence agreed a guide that defines the standards by which Budget Group assesses the cost and risk estimates associated with major Defence capability acquisition proposals. Finance provides the Finance Minister with advice relating to these costs and risks.

The Finance Minister is a member of the Expenditure Review Committee (ERC) and is often coopted to the National Security Committee of Cabinet (NSC) to consider major capability proposals of \$100 million in value or greater that have been brought forward by Defence for Government consideration.

The Defence Minister and the Finance Minister jointly consider proposals with a total project value between \$20 million and \$100 million, unless either Minister refers the project being considered to NSC.

The Kinnaird Two Pass process was adopted by Government following the Kinnaird Review to introduce a more disciplined, systematic approach to the development and consideration of major Defence capability acquisition proposals. The Two Pass process recognises that increased investment early in a capital acquisition process is critical to the development of robust information suitable for decision-making at each stage in the approval process. The Two Pass process provides two opportunities for Government to consider a project proposal for approval to progress.

The Defence White Paper 2009 identifies that Military-Off-The-Shelf and Commercial-Off-The-Shelf solutions to Defence capability requirements will be the benchmark against which a rigorous cost benefit analysis of the military effects and schedule aspects of all proposals will be undertaken. This is consistent with the Defence Procurement and Sustainment Review (Mortimer Review). The key consideration is balancing the need to meet unique or specific capability requirements against the likely increase in project risk.

Off-The-Shelf products generally enjoy relatively large production runs with mature quality assurance processes. This enables industry to spread the cost of development and set up costs across a wide product base. By contrast, developmental projects usually involve small production runs. Unlike those products that have been in use and therefore have proven performance, developmental projects involve a high degree of risk to cost and schedule to achieve the required level of capability.

In providing advice to the Minister for Finance, Finance reviews a detailed set of capability development documents produced by Defence, and as specified in the Defence Capability Development Manual. Finance staff rely heavily on the technical risk assessment provided by the Defence Science and Technology Organisation, the evidence made available to support the Defence cost model, and other Defence capability development documentation, to form an opinion on the veracity of cost and risk estimates.

First Pass Analysis

By using the Kinnaird process to assess First Pass submissions, Finance establishes whether cost estimates are supported by a reasonable basis of evidence, with costs for activities underpinned by a defined scope and supported through a Preliminary Business Case. The cost model for First Pass proposals should refer to individual line items that are directly supportive of a Preliminary Function and Performance Specification, operational requirements, and be representative of the proposed use rate of equipment being procured.

Where costs for First Pass applications are not able to be well defined using a bottom up, or top down cost analysis method, Finance encourages the use of analogous techniques to estimate the basis of the costs for Government consideration. In the event that a developmental program has no analogous system against which costs can be assessed, in keeping with the Kinnaird model, Finance usually recommends that a staged approach is adopted to develop the capability, with multiple Second Pass approval points. This approach allows Defence to build up certainty in the costs required to deliver a capability requirement and retire risks before approaching for Government for final Second Pass approval.

First Pass quality costs are typically supported by active industry engagement through market surveys, targeted cost information collection activities and studies.

Second Pass Analysis

When considering Second Pass proposals, Finance assesses the basis of refined costs brought forward for Government consideration, and provides the Minister for Finance with advice relating to project costs and risks. In addition, Finance reviews the available funding provision within the Defence Capability Plan to assess whether the proposals can be delivered within the existing Defence funding guidance, and without placing additional pressure on the wider Government Budget. The costs for the major cost elements of a Second Pass proposal should be based on an executable offer, supported by responses from industry to Requests for Tender and similar, executable arrangements.

Other than the Two Pass process, Defence capability acquisitions are normally only approved as Rapid Acquisitions (RA), or New Policy Proposals (NPP), following approval from the Prime Minister. The RA process is designed to meet urgent, unforeseen operational needs, whereas the NPP process is designed to work in with the Budget process. In these cases, Finance assesses each proposal on its merits, and applies the same principles to the analysis of costs and risks as if the acquisition were an ordinary Second Pass procurement proposal. Procurement proposals that are brought forward under the RA or NPP method are typically for equipment that is already in service elsewhere, and for which costs are well known.

Initiatives to Improve the Defence Procurement Process

Finance would like to acknowledge the work undertaken by Defence to improve its procurement processes, including the introduction of an internal Gate Review Assurance Board (to review projects at specified points in a project's life cycle) and the introduction of a process to manage projects of concern.

Further, Finance understands that Defence has recently undertaken a review of its accountability and governance frameworks, and we await positive outcomes resulting from this review.

Budget Group Organisational Structure

