



Australian Government
Department of Defence

Mr Simon Lewis PSM
Acting Secretary

SEC/OUT/2012/209

Senator Alan Eggleston
Chair
Standing Committee on Foreign Affairs,
Defence and Trade
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Senator Eggleston,

I refer to your letter to the Chief Executive Officer of the Defence Materiel Organisation, Mr Warren King, dated 10 May 2012, and the letter from myself and the Acting Chief of the Defence Force, dated 1 June, in relation to the provision of a further submission to the Inquiry into Defence Procurement.

Mr King has prepared the attached submission which I am forwarding on behalf of Defence.

Please note that neither Mr King nor the Defence Materiel Organisation itself is properly able to address all issues that you have raised. Accordingly, I have addressed the advantages and disadvantages of the former Force Development and Analysis (FDA) Division in this letter.

The former FDA Division previously provided a level of independent contestability within Defence for major capital equipment projects. Overall it had a positive contribution to force structure development.

Since the Kinnaird Review, the role of independent analysis and contestability has been undertaken by Capability Investment and Resources (CIR) Division within Capability Development Group. CIR Division is larger than the old FDA with a higher work rate and output. It analyses the projects from their inception and provides objective critique at each capability development milestone. This advice is provided independently of the Chief of the Capability Development Group. What is clear is that the work of CIR in producing agendum for these milestones has repeatedly tested assumptions and materially improved the quality of submissions going forward for Government consideration.

Importantly, CIR Division then has a role in stewarding the proposal through to Government consideration. This latter role ensures that the contestability is grounded in the realities of obtaining central agency and Government approval. It should be noted that the

level of central agency scrutiny of Defence projects is far greater than in the days of FDA. Additional scrutiny is also provided by DMO, in terms of achievability of delivery (cost, schedule and risk) and DSTO in terms of technical risk. In addition to this work, CIR Division has staff seconded to activities such as Force Structure Reviews and White Paper development. CIR Division is also responsible to CCDG for the management of the Defence Capability Plan from a financial perspective.

As part of the Business Process Reforms and the Capability Development Improvement Program, there are a number of refinements underway to strengthen CIR Division. Efforts are underway to further professionalise the staff of the Division and a number are attending for the first time the year-long Capability Technology Management Course at the Australian Defence Force Academy.

Mr King has addressed the remainder of the issues that you have raised and I commend his submission to you. Please note that in future all requests for information should be directed to the Secretary and the Chief of the Defence Force for a response, not to different parts of the Defence Organisation.

Yours sincerely

S. Lewis

7 June 2012

Enclosures:

1. DMO SUBMISSION TO THE INQUIRY INTO DEFENCE PROCUREMENT

SSCFADT INQUIRY INTO PROCUREMENT PROCEDURES

Submission by the

Chief Executive Officer of the Defence Materiel Organisation (CEO DMO)

1. The Defence Materiel Agency (DMO) delivers equipment within the scope, cost and schedule approved by Government. Procurement varies from developmental / leading edge systems with significant capability, cost, and schedule risks through to off-the-shelf buys which require the management of integration with the remainder of the fleet and the management of systems upgrades through-life. DMO then manages support of the equipment to the level agreed with Capability Managers. All of these activities involve some level of risk which is measured, mitigated and managed.
2. The 2012-13 DMO budget of \$9.1b represents about 40% of Defence's Departmental budget and 0.6% of estimated GDP. The Budget includes \$3.4b for acquisition and \$4.7b for sustainment activity. DMO manages over 268 capital projects (188 major projects (average size of \$400m) and 80 minor projects (average size \$8m)) and supports \$45b of assets, almost 42% of the Government's non-financial assets.
3. Every working day DMO will spend about \$38m, over \$84,000 per working minute. DMO estimates that over 50% of its acquisition and sustainment funding (some \$4b) will be spent in Australia. About 3 000 SMEs in the Australian defence industry benefit from this expenditure.
4. Recent studies show that DMO manages some of the most complex projects and supports some of the most complex systems in Australia.
5. On average, projects are delivered under budget (using 98% of available funding). Since DMO formed in 2000 the average schedule slippage has decreased from over 50% to around 30% in 2007 and number of projects delivered on time has doubled.
6. DMO currently expects to employ a workforce of almost 7,400 in the next financial year, with an average spend of \$1.23m per employee. This is comparable with the United Kingdom's Defence Equipment and Sustainment organisation (DE&S) and the Canadian Materiel Group. The following table shows the workforce and budget numbers from public sources for the three agencies. While no comparison is ever on a completely like for like basis, it provides a picture of the relative sizes of the organisations.

	Workforce	Spend pa \$A	\$A pa / employee
DMO	7,400	\$9.1b	\$1.23m
DE&S – UK	20,000	\$21.1b	\$1.06m
Materiel Group - CAN	4,100	\$4.5b	\$1.10m

Values are in 2012-13 PBS prices and exchange rates

7. On 10 May 2012 the Chair of the Senate Standing Committee on Foreign Affairs, Defence and Trade invited the CEO DMO to make a submission to the committee's inquiry into the procurement procedures for Defence capital projects.

8. DMO input has been included in the Defence submissions already provided to the Inquiry. It has also co-ordinated site visits in both Australia and overseas to ensure that the Inquiry members have information on procurement procedures employed by DMO. In addition, in October 2011 DMO appeared before the Inquiry to respond to issues being considered.

9. While the committee raised a number of matters that it sought comment on, this paper focuses on those areas where it can add most value.

Independent Advice

10. While DMO is a Prescribed Agency under the *Financial Management and Accountability Act 1997* (the FMA Act), it remains an integral and integrated part of the Department of Defence. The CEO remains accountable to the Secretary under the *Public Service Act 1999* and to the Secretary and Chief of Defence Force (CDF) under the *Defence Act 1903*.

11. The CEO DMO provides independent advice on cost, schedule and risk of equipment acquisition to the Secretary and CDF and to the Minister on all projects progressing through the approval process. This advice is provided to support Defence to deliver the best advice possible to the Government in support of equipment acquisition decisions. DMO does not provide advice on the capability that should be acquired, that is rightly advice that should come from Defence itself.

12. The 2003 Defence Review into Defence Procurement (the Kinnaird Review) recommended a strengthened two-pass approval system:

- : incorporating rigour and discipline;
- : based on mandatory endorsement of key decisions by relevant stakeholders;
- : subject to external scrutiny applied to significant aspects of the proposals being forwarded to government;
- : providing the Government with robust proposals;
- : characterised by a higher proportion of project funds being spent on early analysis to provide better and more relevant information to government and to ensure that projects are less likely to develop problems during the acquisition phase; and
- : including rigorous analysis of technology, and cost (prime and whole-of-life) and schedule risks, including external scrutiny and verification.

13. The Kinnaird Review report was specific in the advice that was expected. It noted that there should be mandatory review and external verification of information going to Government. Specifically it noted:

The external evaluation and verification of all proposals is essential. Importantly, government needs to be assured that adequate scrutiny is undertaken by Finance, the CFO and DMO on costings; by the DMO on acquisition strategy, risk mitigation and schedule; by Defence's Corporate Support and Infrastructure Group (CSIG) on facilities issues; and by DSTO on technology feasibility, maturity, and overall technical risk. Apart from the involvement of Finance, Defence also need to consult appropriately with other central agencies.¹

The head of the DMO would report to government on detailed issues including tendering and contractual matters related to acquiring and supporting equipment.²

14. In 2008 Mr Mortimer, in his report of the Review of Defence Acquisition and Sustainment, noted:

Prior to seeking entry into the DCP, or first or second pass approval, formal agreement should be documented on the cost, schedule and capability requirements of projects.

To ensure clear accountability for the information put forward, agreement and sign-off should occur at the level of:

- : Chief of Capability Development Group, as coordinator of the capability proposal, for the capability options and cost, schedule and risk information provided by Defence Groups.*
- : Capability Manager (usually a Service Chief) for acknowledgement of the capability options; and*
- : Chief Executive Officer of DMO for cost, schedule and risk for military equipment as well as for the development of an equipment acquisition strategy for the capability throughout the process.³*

15. On the matter of providing expert commercial advice he went on to note that

"DMO is in a unique position to advise Defence and Government on important aspects of defence acquisitions.

Aside from being the principal centre of expertise available on many aspects of defence acquisitions, DMO is responsible for delivering military equipment to the ADF according to the cost, schedule and specifications agreed by Government. To be properly held to account for doing so, DMO needs to be able to provide independent advice to Government on matters within its remit.

At the point of DCP entry, and first and second pass approval, DMO should provide advice to Government on:

- : project cost, schedule and risk;*
- : acquisition strategy, tendering, negotiation and contracts;*

¹ Defence Procurement Review 2003, pp.17

² Ibid., pp. 25

³ Defence Procurement and Sustainment Review, pp 22

- : *industry capacity; and*
- : *in-service equipment sustainment.*

DMO should not provide advice to Government on military capability. This is rightly the exclusive responsibility of Defence.

DMO advice to Government should be conveyed in two ways. First, DMO should provide written advice (coordination comments in submissions to Cabinet) on major capital investment submissions in the same way as other agencies do now. Second, the Chief Executive Officer of DMO should be a permanently invited adviser to all Government committees considering defence equipment acquisitions to answer the Government's questions on these matters.⁴

16. The Government decided that it would ensure that DMO presents its independent advice on cost, schedule and risk of equipment acquisition in NSC submissions, and that DMO presents an acquisition strategy within the submission. The CEO DMO advises on cost, risk, schedule and acquisition strategy for the military equipment aspects of major capability submissions.

Gate Reviews

17. Gate Reviews are a key assurance process which ensures DMO is able to provide high quality and reliable advice to Defence and Government regarding the health and outlook of Major Capital Projects.

18. Over the life of a project there is a need for an appropriately balanced assurance approach with a mix of management and stakeholder review. Gate Reviews do not usurp the requirement for stakeholder engagement meetings, whose purpose is fundamentally different. Nor do they replace other forms of assurance sponsored by Capability Development Group as specified in the Defence Capability Development Handbook.

19. A Gate Review provides the opportunity for senior management to confirm that a project is ready to proceed to the next stage, before any further significant commitment of resources. It will confirm that all critical objectives for the associated milestone have been met, the project business case remains valid and the project is on track to deliver the capability that Government approved.

20. Gate Reviews are undertaken by DMO appointed Gate Review Boards. Each Review Board is specifically constituted to ensure there are both senior DMO executives actively involved in every review and external independent members are appointed to each Board. Board membership normally consists of DMO staff in management roles, DMO staff in independent advisory roles and non DMO External Board Members.

21. DMO is finding Gate Reviews to be successful. This is the result of a range of factors:

- : The careful constitution of each Board, including domain expertise;
- : Conducting reviews in the lead up to key project decision points.

⁴ Defence Procurement and Sustainment Review, pp 27

- : The accountability of the Chair for the conduct of a robust review and the provision of sound recommendations;
- : Conducting thorough preliminary analysis and preparation prior to each review;
- : Conducting reviews in a helpful and constructive manner;
- : Supporting the full and frank disclosure of issues;
- : The presence of key stakeholders to contribute to the resolution of issues; and
- : The authority of the Senior Executive to direct implementation of the recommendations;
- : Based on the findings of the Board, the Chair provides guidance to the project and make a recommendation, to the relevant Senior Executive, regarding the readiness of the project for progression to the next stage in the project life cycle.

22. Gate Reviews provide an opportunity to identify best practice and opportunities for improvement, across all DMO Divisions and Major Programs, as projects are executed. A lessons-learned watchlist has been developed to validate suspected systemic issues with DMO major projects. During each Gate Review the project is assessed against the watchlist to establish whether or not each item was observed.

Ministerial Directive

23. The DMO Business Model agreed by Government established a direct relationship between the CEO DMO and the responsible Minister because the relationship was not well articulated in the *Financial Management and Accountability Act 1997* (FMA Act). Specifically the Business Model stated:

- : *The CEO would be accountable directly to the Minister for the efficient delivery of outputs as agreed in the budget process. These outputs would include equipment acquisition and modification, and fleet sustainment.*
- : *CDF and Secretary would be accountable to the Minister for coordinating the wider aspects of capability – people, facilities and training – with DMO outputs, as part of the total Defence budget, to ensure that wider Government capability decisions are delivered. CDF and Secretary would also be accountable for advice to the Minister on the capability and financial implications of any failure by DMO to deliver agreed outputs.*

24. While a Minister of State can seek advice from any departmental officer, the Ministerial Directive makes clear the relationship expected between the Minister and the CEO DMO.

25. The current Ministerial Directive was issued to the former CEO DMO, Dr Gumley, from the then Minister for Defence on 28 July 2008. While it has not been updated for some time, DMO still operates within the principles established by the Directive. The Directive establishes the accountability of the CEO DMO to the Minister to achieve the following results:

- a. timely, accurate and considered advice in your role as principal adviser to me on equipment acquisition and fleet sustainment;
- b. efficient and effective acquisition and through-life support of materiel for Defence capabilities;
- c. sound management of financial and other resources, operating within the budget and meeting statutory requirements for preparing financial statements;
- d. appropriately skilled and experienced workforce whilst providing a working environment that attracts and retains people;
- e. high quality governance and management, implementing agreed reform initiatives and embedding continuous improvement within business processes;
- f. savings and efficiencies for re-investment in priority areas in Defence; and
- g. appropriate representation of Australia internationally in your role of National Armaments Director.

26. Given the recent appointments to the Secretary and CEO DMO positions it may be appropriate to review the current Directive and update it as necessary.

Materiel Acquisition Agreements (MAAs)

27. The Materiel Acquisition Agreements (MAAs) were developed as part of the implementation of the 2003 Kinnaird Review. The Government agreed that purchaser-provider arrangements would be established for DMO to ensure that DMO remained an integral part of Defence, with clearly articulated outputs linked to Defence outcomes.

28. The establishment and maintenance of the agreements has introduced considerable discipline in the tasking of the agency and the associated resource requirements. The purchaser-provider arrangements cover both the acquisition and in-service support elements of DMO's business (Materiel Acquisition and Sustainment Agreements respectively).

29. The Mortimer Review report noted that:

"gaps sometimes arise between what a project delivers and the expectations of the Capability Manager at the point of acceptance into service. There can be a number of reasons for this; some are the same as for changing the scope of a project, for example changed technical regulations, others reflect inadequate communication and the differing expectations of key personnel that change during the life of a project."

"Irrespective of the cause, the Review believes that the recommendations already made on the role of Capability Managers and use of MAAs should reduce the divergence of expectations that sometimes arises between the point of project approval and acceptance into service. As a principle, DMO should be held to account for delivering equipment and services as set out

in the MAA. DMO can only be held accountable for those aspects within its control.”⁵

30. In response to the Mortimer Review, the Government decided to introduce Project Directives to manage all fundamental inputs to capability (FICs) throughout the acquisition stage. Every project receiving Government approval from March 2010 will have a Joint Project Directive from the Secretary and CDF. This Directive sets the baseline parameters (cost, schedule and scope) and accountabilities for the delivery of the project.

31. Project Directives do not replace the MAAs which specifically detail DMO responsibilities in the acquisition of military equipment. MAAs for major capital investment projects, which are funded under the Defence Capability Plan (DCP), are signed between Capability Development Group (CDG), the relevant Capability Manager (CM) and DMO.

32. MAAs specify: Project Approval, Project History, Price, Project Deliverables, Project Event and Delivery Schedule, Cardinal Milestones (including Initial Materiel Release and Final Materiel Release), Customer Furnished Supplies, Asset Ownership, Project Risks and Special Terms and Conditions.

33. The MAA only covers approved work to be done by DMO as part of the project approval for each project stage e.g. Pre-First Pass, First Pass, Second Pass etc. MAAs do not cover FIC elements that are delivered by other groups such as Defence Support Group (DSG) or Chief Information Officer Group (CIOG).

34. Following project approval, MAAs must include details of Initial Materiel Release (IMR) and Final Materiel Release (FMR) and any intervening Materiel Releases. These are the key DMO project milestones.

35. While DMO is not responsible for delivery of Initial Operational Capability (IOC) and Final Operational Capability (FOC), DMO's materiel deliverables contribute to achieving these project milestones. IOC and FOC should be recorded in the Project Event and Delivery Schedule within the MAA as they provide valuable situational context.

36. An MAA operates for the duration of the project stage, and is amended only by agreement to reflect changes as required. An amendment is required where there are any changes to scope, capability, schedule or price of the MAA. These changes must fall within the parameters of the original Project Approval, or have received the appropriate Government approval, and be formally agreed between DMO and Defence and reflected in an amended MAA. This amended agreement must be signed by all parties to the MAA.

37. In summary, the benefits from the development and maintenance of MAAs include:

- : clarity in accountability for outputs (reinforced at the higher level by Project Directives);
- : increased discipline in identifying the resourcing required by DMO to plan and manage delivery of the outputs expected of it;

⁵ Defence Procurement and Sustainment Review, pp 44

- : clarity in the inputs needed from third parties including contractors and Defence; and
- : clarity in the expected outputs allowing measurement of DMO's performance.

38. The major disadvantage is the increased overhead in establishing and maintaining the agreements.

39. While not a focus within the acquisition side of DMO's business, DMO's major customers, the Capability Managers, have indicated that the Materiel Sustainment Agreements (MSAs) have given them much greater insight into the support of their capabilities and the areas where they can best manage their requirements. Because all MSAs have been costed since 2004 there is much more visibility of fixed and variable costs to allow better decision making by the Capability Managers.

Test and Evaluation (T&E) Advice

40. Verification and Validation (V&V) is integral to DMO's systems engineering processes utilised within the lifecycle of capability in Defence. The V&V program is not done in isolation but instead in collaboration with the Service's Technical Support Network and Operation T&E organisations, to ensure program transparency and to assist in the transition of the materiel system into operational service.

41. The purpose of V&V program is to ensure that materiel system design satisfies its immediate requirements and that the implementation of the materiel system aligns with the intended purpose. Additionally the V&V program identifies and quantifies, at the earliest possible time, areas of programmatic and technical risk within the relevant program. Consequently the program risks identified by the V&V program are fed into the project assurance framework and are a necessary input into the respective Project Management Stakeholder Groups and Gate Reviews.

Way Ahead

42. DMO was formed in July 2000 through the amalgamation of the Defence Acquisition Organisation and Support Command Australia. The combined workforce of the two organisations was over 11,000 staff⁶.

43. By the time functions were redistributed DMO retained approximately 7,000 to 8,000 personnel with about 20% being military staff. It is presumed that the staffing level at the time was considered appropriate for the task.

44. As part of the Kinnaird reforms, DMO became a prescribed agency in 2005. At the same time the warehousing and distribution functions returned to Defence – reducing DMO's workforce to about 6,300.

45. An examination of our performance between 2003-04 and our forecast position at the end of this financial year indicates that the DMO output (measured in real dollars by taking inflation and currency fluctuations into

⁶ 1998-99 Defence Annual Report pp 185, 233 and 268

account) grew by about 35%, but DMO's workforce only grew by just under 20%. With budget reductions in 2012-13, the number of staff as a proportion of budget will rise. DMO and Defence are examining future staff requirements to ensure that staff numbers match expected work levels.

46. DMO has improved its performance in delivering within budget, against scope and schedule management has improved. Data on this was provided in the earlier Defence submissions to the inquiry. Since those submissions we have continued to analyse project performance. Analysis of over 300 completed projects shows that projects have largely managed within budget since the 1980s – utilising about 98% of available funding.

47. Based on the data available, the rate of improvement in cost management has increased since 2000 – while it is difficult to find strong causal links this seems to be in line with improvement in project definition and changes to the management of scope change. The data is presented in the graphs in Attachment 1.

48. DMO will continue to focus on improving its performance. It is important that DMO does this from the perspective of:

- : Working with managed urgency - still managing risks through appropriate checks and balances while focussing on delivering quicker outcomes.
- : Maintaining a strong customer focus
- : Applying business acumen to all transactions
- : Ensuring that the organisation is structured to best deliver its outputs
- : Undertaking more contractor-managed work.

Annex:

A . Variation in Project Cost Management over Time

VARIATION IN PROJECT COST MANAGEMENT OVER TIME

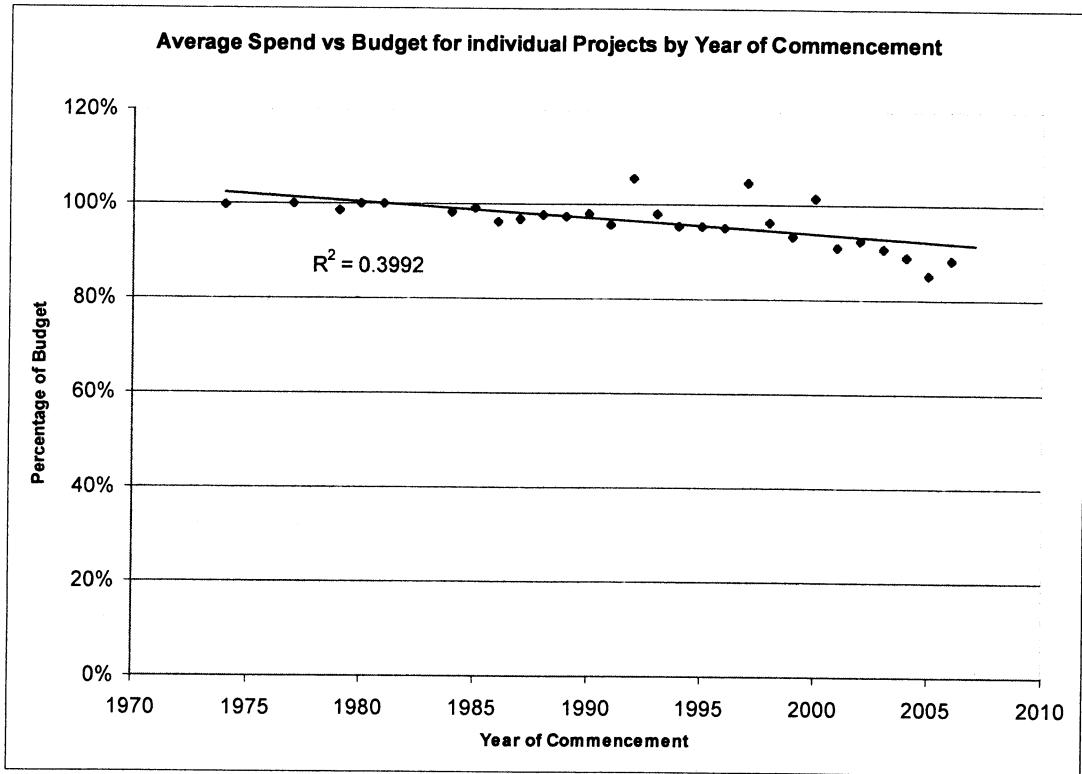


Figure 1: Spend as a Percentage of Available Budget – Average for Individual Projects

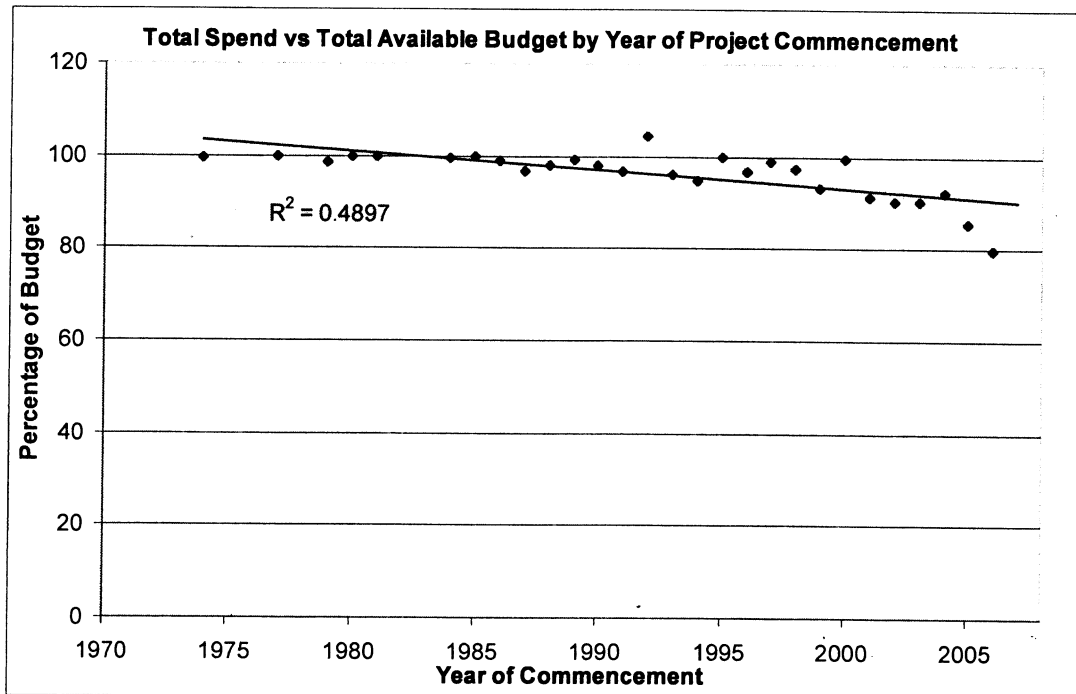


Figure 2: Annual Total Spend as a Percentage of Total Available Budget

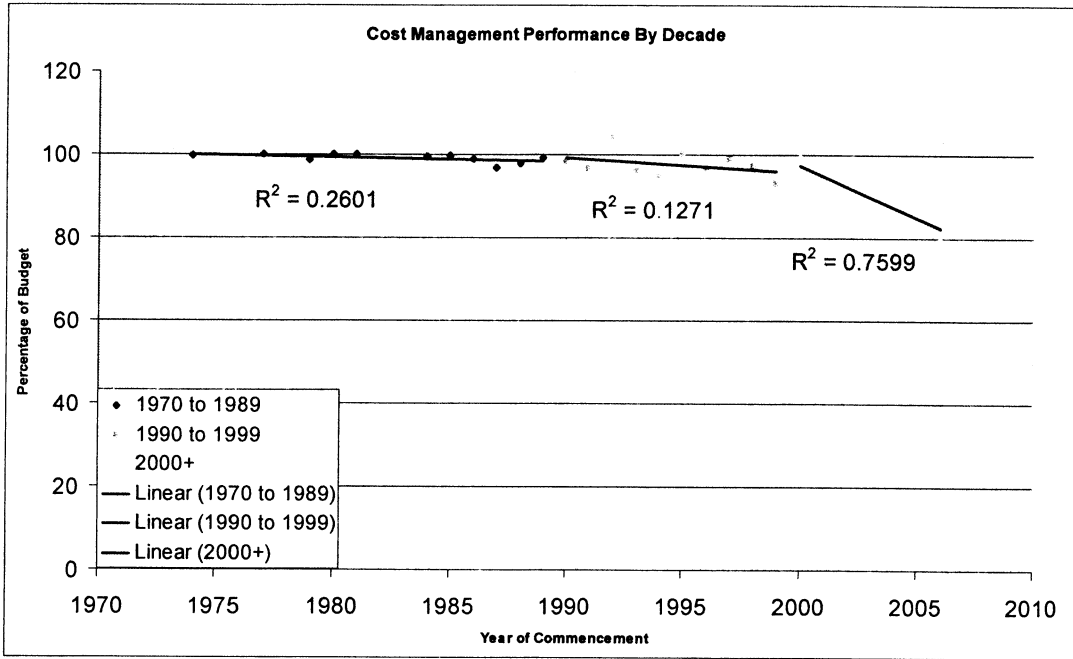


Figure 3: Annual Total Spend as a Percentage of Total Available Budget – All Projects