

27 June 2006

Mr Russell Chafer
Committee Secretary
Joint Committee on Public Accounts and Audit
R1 108 Parliament House
Canberra ACT 2600

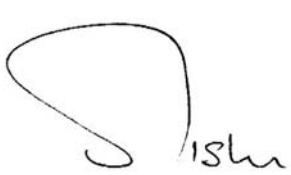
Dear Mr Chafer

Thank you for the invitation to provide a submission to the Joint Committee on Public Accounts and Audit's inquiry into the Financial Reporting and Equipment Acquisition at the Department of Defence and the Defence Materiel Organisation.

Attached is the Raytheon Australia paper which addresses two of the four terms of the inquiry's references.

Should you have any questions regarding the Raytheon Australia submission, please do not hesitate to contact my office.

Yours sincerely



Ron Fisher
Managing Director

**SUBMISSION TO THE JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT
INQUIRY INTO FINANCIAL REPORTING AND EQUIPMENT ACQUISITION AT THE
DEPARTMENT OF DEFENCE AND THE DEFENCE MATERIEL ORGANISATION****Terms of Reference**

The Joint Committee of Public Accounts and Audit shall inquire into and report on progress in implementing systematic reforms in the areas of financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation (DMO), as identified in ANAO financial and performance audits, the *Defence Procurement Review 2003* (Kinnaird Review) and the Senate Foreign Affairs, Defence and Trade Reference Committee's 2003 Report on the Inquiry into Materiel Acquisition and Management in Defence, including the following:

- Progress in implementing Defence's financial remediation plans, relative to international best practice in these areas and recommend any further measures that can be adopted.
- Progress in implementing the Kinnaird Reforms, relative to international best practice in these areas and recommend any further measures that can be adopted.
- Review Australia's relative achievements in procurement and financial reform relative to international best practice in these areas of Defence administration; and
- Assess progress in Defence's adoption of international business accounting standards relative to international best practice in this area of Defence administration.

Introduction

Decisions on the future force structure for the Australian Defence Force (ADF) and the ability of the Department of Defence and the Defence Materiel Organisation (DMO) to acquire and field new capabilities have been the subject of considerable debate over the last decade. There has been justifiable criticism of a number of major defence capital equipment acquisition projects that have either failed to deliver the desired capability or have done so late and/or over budget. This has occurred despite a number of major reviews and subsequent reorganisations within the department and its acquisition organisation.

Raytheon Australia believes that the *Defence Procurement Review 2003* was a watershed in this ongoing process. By looking across the whole process, rather than focussing on a particular phase, it not only identified the major problems, but laid out a comprehensive program of reform. It is to the Government's credit that it decided to implement the review team's recommendations. The success of the reform process is critical to the future capability of the ADF and therefore to the nation's security.

In addition to reviewing progress of this reform process the terms of reference for this inquiry also cover the internal financial reforms that the Department of Defence has embarked upon, including the change to accrual accounting. These are areas that are

much more difficult for those outside the department to provide meaningful commentary on. We have little direct insight into what is actually being done and rely on reports by the Australian National Audit Office (ANAO) and general commentary in the media.

Raytheon Australia therefore has not responded to the two specific terms of reference dealing with the financial remediation program and the change in accounting standards. However, there is a general observation that the company feels should be made with respect to the implementation of these initiatives.

While reporting of these programs has exposed some serious issues with respect to the management of elements of Defence's assets there appears to be an overly pedantic approach being taken to relatively unimportant issues, seemingly for the sake of accounting purity, which are requiring a disproportionate effort to correct. To expend greater resources than the potential savings is inconsistent with sensible business practice and a more pragmatic approach should be adopted. This would not only save money, but allow managers within the department and the ADF to deal more effectively with current issues and planning the way forward.

What is needed is a sound understanding of Defence's asset base, its serviceability, disposition and, within sensible parameters, its value. It appears to many outside the department that the means (accounting system and valuation data) are being confused with the ends, which surely should be the efficient and effective management of Defence assets.

Raytheon Australia

In order to provide context for the comments that follow, it is desirable for the Committee to appreciate Raytheon Australia's position in the defence market.

The company is a wholly owned subsidiary of Raytheon Company, the fourth largest defence company in the United States. Our core business in Australia is Mission Systems Integration, which we are in the process of expanding into Mission Support.

Raytheon has had a presence in Australia since the mid-1950s and has been a major supplier of weapons, sensors, command, control and communications systems to the Australian Defence Force (ADF).

As a result of the Government's *Defence and Industry Strategic Policy Statement* in 1998, Raytheon Company decided to invest further in Australia and establish a local capability. Since then Raytheon Australia has grown to a workforce of over 1,100, all of whom are Australians, with operations in all mainland States and Territories, and annual turnover for indigenous business (not including product sales from the US) of \$390 million in 2005.

This is dynamic growth in anyone's language, but particularly so in the Australian defence market. We are involved in a number of major programs in which we are responsible for systems integration, including:

- Air Warfare Destroyers (AWDs),
- replacement combat system on the Collins Class submarines,
- simulators for the upgraded F/A-18 Hornets;
- electronic warfare training aircraft operated out of HMAS Albatross in Nowra, and
- electronic warfare emulator pod, which is to be fitted to the BAE Hawk aircraft.

We also provide avionics support for the Royal Australian Air Force (RAAF) Maritime Patrol Group and the Aircraft Research and Development Unit at RAAF Edinburgh; and the Strike And Reconnaissance Group at RAAF Amberley; in service support for the Royal Australian Navy (RAN) Submarine Group at HMAS Stirling; as well as technical support for the joint facility at Pine Gap and the Tidbinbilla Deep Space Communications Complex outside Canberra.

Finally, we have a geospatial imagery business that takes telemetry data directly from a constellation of orbiting satellites through a dish and terminal equipment in Adelaide to provide imagery and other value-added products much faster than through satellite operators in Europe and the U.S. These satellites have a potential complimentary role in wide area surveillance of our maritime approaches.

DISCUSSION

As mentioned above, Raytheon Australia does not intend to make specific comment on the first and fourth terms of reference. Therefore, only the second and third issues are addressed.

Progress in implementing the Kinnaird Reforms, relative to international best practice in these areas and recommend any further measures that can be adopted.

As noted above, Raytheon Australia believes the success of the Kinnaird reform process is critical to the future capability of the ADF and therefore to the nation's security.

All of the recommendations of the Kinnaird Review have been acted upon and, with the exception of making the DMO an Executive Agency and, possibly, making the Capability Managers responsible and accountable for reporting on the development of defence capability. The following administrative arrangements have been put in place:

- Process now exists for strategic reviews, although judging by the number of public versions published to date these have not occurred annually (recommendation 1).
- A three-star position has been created to head the capability development organisation and LTGEN David Hurley was appointed as the first incumbent (recommendation 2). It is too early to say whether LTGEN Hurley is fully "responsible and accountable for managing capability definition and assessment" or

whether his appointment ends up being for the recommended five year minimum term¹ to “ensure a coherent, cohesive, holistic and disciplined approach.”²

- The two-pass government approval process has been embedded in the Cabinet and Defence processes for major acquisitions (recommendation 3). However, it is not possible to determine from outside the system whether the Government is being provided with “comprehensive analyses of technology, cost (prime and whole-of-life) and schedule risks subjected to external verification”³ as called for in the Kinnaird Review.
- It is not evident outside Defence that the Capability Managers (Service Chiefs) have been given the “authority and responsibility to report, and be accountable for reporting, on the development of defence capability”⁴ (recommendation 4).
- A Strategic Advisory Board for the DMO has been created and the members appointed (recommendation 5).
- The DMO is now a Prescribed Agency (recommendation 6). Although the review recommended the DMO become an Executive Agency⁵ the Government decided that Prescribed Agency status was more appropriate.
- The CEO DMO, Dr Stephen Gumley has implemented a program to professionalise project managers, and other staff, within the DMO (recommendation 7). It is yet to be seen whether military officers appointed as project managers have minimum tenures of five years in these positions as recommended in the Kinnaird Review.⁶
- It is not possible, nor should it be, for those outside Defence to know whether the CEO DMO is being consulted on military postings to the DMO, or whether he has the “authority to accept only those ADF personnel who possess the requisite skills and experience.”⁷

Raytheon Australia strongly supports the initiatives Dr Gumley has taken to professionalise program management within the DMO and to recruit senior program managers with relevant experience in industry. Not only will this improve the performance of the DMO, but it should also assist in improving the relationship between the DMO and industry.

Other very positive initiatives that Dr Gumley has taken have been to refocus his staff on the high priority issues, to shift from trying to manage the work being done to managing the contract, to standardise the way in which they do business and the tools they use, and to benchmark their performance with a view to improvement in all facets of their work.

¹ LTGEN Hurley’s initial appointment as Chief Capability Development Group is for three years
² Defence Procurement Review 2003, p.11
³ Ibid, p.20
⁴ Ibid, p.29
⁵ Ibid, p.38
⁶ Ibid, p.40
⁷ Ibid, p.41

The significance of Dr Gumley's reform agenda goes beyond the initiatives themselves to changing the culture and behaviour within the DMO. Changing the culture within the organisation is as important, if not more so, to improving the overall performance of the defence acquisition function as the initiatives themselves. Culture change takes time, and is a journey rather than a destination, but industry is very pleased that the journey has begun.

Problems in the acquisition of defence capital equipment have not been the responsibility of the DMO (or its antecedents) alone. Industry has to shoulder a significant portion of the blame and Raytheon Australia believes that this has been recognised with most companies undertaking their own programs to improve performance through skills, processes, tools and culture change.

Raytheon Australia had already decided to seek to achieve best practice for business reasons and the company was very pleased to find that many of our initiatives paralleled those of Dr Gumley. For example, Raytheon Australia was the first organisation in Australian defence industry to sign a strategic agreement with the Australian Institute of Project Management to professionalise and certify all our program managers to recognised Australian and international standards - a process largely completed last year. We have also invested heavily in tools and processes in key skill areas, such as being the first organisation in the Australian defence industry to reach the sought after level 3 rating in risk management and in quality management under the world's best practice model, "CMMI".

Also we have drawn upon the processes developed by our parent company that are being proved in the United States on the DD(X) destroyer program, the LPD-17 amphibious ship program, and the CVN-78 new generation aircraft carrier program. While we still have a way to go in reaching the level of maturity in them that our parent company has achieved, we are well advanced by Australian standards and have made huge improvements in our performance. For example, we have just delivered the first elements of the new combat systems for the Collins Class submarines within both schedule and budget.

Dr Gumley has established performance against contracted schedule as his primary concern and goal. Raytheon Australia supports this objective and the efforts to improve our performance will ensure that we achieve it, as long as the overall schedule established through the capability development process is realistic. Too often schedules are compressed and important preliminary work, such as defining requirements, is rushed and incomplete. This then flows on to the design and engineering phases, and really can be a case of more haste less speed.

Where a project appears in the Defence Capability Plan (DCP) is not based upon industry advice as to the necessary lead time for capability definition studies, design activity, production, and test and evaluation activities. It is largely a "wet blanket over the head" exercise by public servants and military officers with no commercial or industry experience. Hence the starting point is often flawed and this is before any potential delays due to slippage in studies and decision points.

Although greater and more effective industry involvement in the capability development process has been something of a mantra over the last decade, and was emphasised again in the Kinnaird Review, it has proved difficult to achieve. The most promising mechanism, established as a result of the 1998 *Defence and Industry Strategic Policy Statement*, was the Capability Development Advisory Forum (CDAF). However, the failure of the CDAF to achieve its objective of providing industry input to the capability development process was due primarily to the failure of companies to contribute meaningful advice in the presence of their competitors. Instead the CDAF became a vehicle for industry to gain information from Defence. These failings were recognised and the CDAF was revamped in late-2005 with industry membership raised to CEO level in an attempt to meet the forum's original objectives.

Further contributing factors to unrealistic schedules are inadequately articulated, and over-stated, requirements, and poorly understood risks associated with the technical solutions and acquisition strategies (the Seasprite helicopter program is a prime example). These need to be addressed as early as possible in the capability process and certainly well before the competition point.

Dr Gumley has told industry that companies responding to tenders should provide realistic schedules, that companies bidding non-compliant schedules can still win the contract. Companies simply do not believe this to be the case, and therefore respond that the schedule can be met and hope to negotiate some flexibility into the contract if they win. The correct response to the problem is for Defence, with industry involvement, to develop a realistic schedule in the first place. This was recognised by the Kinnaird Review which also recognised that the problem has its roots in the pre-approval process.

The two-stage approval process has been a step forward with the Government reportedly provided with much better information as a basis for their decision-making. However, the transition has placed enormous demands upon the revamped Capability Development Group (CDG) under LTGEN Hurley and this should be recognised. Once a steady state has been reached the process should be manageable, but in the intervening period CDG staff are struggling to provide the analysis and other information the process requires. The result has been that project approvals are falling behind schedule. This is accepted, but what should then follow is an appropriate adjustment to the acquisition schedule to avoid further compression that has so often beset projects in the past.

One change that the Kinnaird Review advocated that does not seem to have been implemented, other than in a nominal sense, was for an enhanced role for the Capability Managers (principally the Chiefs of the three Services) in monitoring and reporting on the development of defence capabilities. This is somewhat difficult to judge from outside the defence organisation, but interaction with staff within the respective Service headquarters does not suggest that the Service Chiefs are fulfilling the role the Kinnaird Review envisaged.

In part this is possibly the result of inadequate staffing following the 1996 Defence Efficiency Review, which reduced the size of the Service headquarters to 100. Possibly more significant though, is the balance of influence within the Department of

Defence between the central players and the Chiefs of Service.

As the professional heads of their Service, and the experts in the employment of the capabilities being developed, the Service Chiefs are uniquely placed to evaluate all aspects of particular capabilities, including most importantly the people aspects. However, successive Defence reviews have weakened their role in the capability development process, with the central players taking increasingly dominant roles. Regrettably this seems to be viewed as a zero sum game within the Department with the objective being to avoid the Service Chiefs exercising undue influence, rather than using their expertise and experience constructively.

In summary, Raytheon Australia believes that the organisational and administrative changes recommended by the Kinnaird Review have largely been put in place. What is not yet clear is whether the associated cultural and behavioural changes are proceeding apace. It is the latter changes that ultimately will determine whether the process overall produces better outcomes.

Review Australia's relative achievements in procurement and financial reform relative to international best practice in these areas of Defence administration.

This issue really requires dedicated study, perhaps more appropriately by an academic institution. However, Raytheon Australia's parent, Raytheon Company, is the fourth largest defence company in the United States and has other subsidiaries in the United Kingdom and Canada. We therefore have some specific understanding of the defence market environments in those countries, plus through observation a general awareness of practices in other countries, including those in Australia's region.

It is important to note that the Department of Defence has, by and large, taken a pragmatic and realistic view of which major capital equipment acquisition programs could be executed by Australian defence industry and which should be done overseas, either through direct commercial sale or the United States Foreign Military Sales (FMS) process.

As far as acquisition is concerned though, the company believes that Australia is close to best practice in many aspects of its acquisition practices. For example, in the United States many major defence contracts are still based upon cost plus, or time and material regimes. We moved away from these forms of contracts some time ago, although as noted under the previous term of reference, we could improve the practice here by demonstrating greater awareness and understanding of the risk profiles of individual projects, or phases of projects, and adjusting the contract strategy accordingly. Too many developmental projects are contracted against fixed prices, to the detriment of both the Commonwealth and companies (although having some protection against unexpected cost escalation the Commonwealth ends up paying more than might be necessary because companies have to factor the additional risk into their price).

By our observation Australia leads the world, at least for those countries with no clearly identifiable threat, in its planning processes for structuring the ADF. The processes behind Australia's strategic and force structure planning, developed over the last thirty years, are acknowledged world-wide for their intellectual rigour and have been adapted by a number of countries.

The DCP is another area where Australia leads the world. By laying out its medium-term capital equipment acquisition plan, together with indications of the broad cost it is willing to pay in each case, the Government provides the best planning baseline for industry anywhere in the world.

Notwithstanding the improvements suggested earlier in this submission, the relationship between Defence/DMO and industry is as healthy here as anywhere in the world. By and large Defence and DMO officials are open and willing to engage with companies while maintaining strong ethical standards. Our competitive tendering processes are also as robust and fair as any in the world.

Negotiated terms and agreements are generally reasonable for major acquisition contracts, although, depending on which side of the contract you are on, perceptions sometimes differ. By and large the very poor contracting models highlighted through controversial projects are a thing of the past; with projects contracted in more recent years appear to be working much better.

An area where Australia does not compare so well is in managing technical risk associated with new capabilities. Too often Defence specifies unique technical solutions to meet ADF requirements, seemingly without sufficient consideration of the impact upon the project's risk profile and the associated overall cost. This is an area where greater discipline is required.

Australia does face unique challenges in terms of space and distance, low force-space ratios, and different environmental conditions to those experienced in the northern hemisphere, where most equipment is designed and produced. These differences need to be considered when acquiring new capabilities, but changes to existing systems or platform designs should be rigorously tested, and the technical implications thoroughly understood, before they are approved.