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Report 429

Review of the 2010-11 Defence Materiel Organisation Major Projects Report

May 2012
Canberra

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Foreword

The 2010-11 Defence Materiel Organisation (DMO) Major Projects Report (MPR) is the fourth MPR to be produced by DMO and the third to be reviewed and reported on by the Joint Committee of Public Accounts and Audit. The Committee originally supported the production of the MPR to improve the transparency and accountability of the Defence acquisition process.

The Committee is pleased to report that there has been an overall improvement in the preparation and presentation of data in the 2010-11 MPR but notes that there remains a number of outstanding concerns that require further work.

In its review of the 2009-10 MPR, the Committee recommended that DMO address the ongoing issue of the presentation of financial data in base date dollars. After considerable effort, DMO and the Australian National Audit Office (ANAO) have finally produced an acceptable method and format for the presentation of financial data and the Committee has endorsed the move to an out-turned dollar presentation. The Committee has also accepted the proposal to include a 'Project Assurance Statement' regarding the remaining budget for each project instead of more detailed indexation information. However, I acknowledge the different opinions within the Committee on this issue, in particular the views of Senator Mark Bishop as contained within the attached dissenting report. The Committee will continue to monitor the issue of financial reporting, and in particular the reliability of the proposed Project Assurance Statement, and will revisit the issue if needed.

The steady increase in schedule slippage which has been identified over the life of the MPR is of major concern to the Committee, both in terms of timely delivery of capability to the Australian Defence Force and in budgetary terms. The Committee acknowledges that the evidence suggests the majority of the slippage is made up of legacy projects and indicates that initiatives to improve processes are having an effect on minimising slippage. However, to improve transparency and accountability in this area the Committee recommended that a section be included

in future MPRs that specifically provides information on the activities being undertaken to minimise slippage and the tangible results of those initiatives.

Another ongoing issue of concern to the Committee is the inconsistency of internal management systems across projects. This issue affects the reliability of the information in the Project Data Summary Sheets and ultimately lowers the quality of the MPR. Despite some action being taken to improve the consistency of processes and information, the expected improvements have not yet been achieved. Previous evidence to the Committee indicated that the problem dated back to around the year 2000, and that it would take time to resolve. However, after some 12 years, more progress should have been made to address the issue. The Committee expects to see concrete evidence of results and progress reported in the next MPR.

The MPR is now well established and is a useful tool to monitor Defence major acquisitions and capability. Given this, it is timely to consider its future over the longer term, including the exit criteria for projects and the role of parliamentary committees and other stakeholders.

Despite a proposal that projects exit the MPR at the point of Final Materiel Release, the Committee has retained the current exit criteria of Final Operational Capability. Reservations about the proposal included that valuable information might be lost and that the ability to scrutinise Defence projects could be reduced. The Committee will consider the matter further in future reviews.

The Committee is satisfied that the current format of the MPR largely achieves the original goal of the report but also intends to consult with other relevant committees of the Parliament on ways that the scrutiny of defence capability projects could be enhanced. The Committee would also like to gauge how extensively the MPR is being utilised by external stakeholders, and has therefore recommended that DMO include a discussion on the use by, and value of, the MPR to external stakeholders in the 2011-12 MPR.

I believe that the implementation of the Committee's recommendations will contribute greatly to the continuous improvement that has been witnessed throughout the history of the MPR, and thank DMO, the ANAO and my fellow Committee members for their efforts throughout the inquiry process.

Mr Robert Oakeshott MP
Chair



Membership of the Committee

Chair Mr Robert Oakeshott MP

Deputy Chair Mrs Yvette D'Ath MP

Members Hon. Dick Adams MP

Mr Jamie Briggs MP

Ms Gai Brodtmann MP

Mr Darren Cheeseman MP

Mr Josh Frydenberg MP

Ms Deborah O'Neill MP

Ms Laura Smyth MP

Hon. Alexander Somlyay MP

Senator Mark Bishop

Senator Helen Kroger

Senator the Hon. Nick Sherry

Senator Matt Thistlethwaite

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List of abbreviations

ADF	Australian Defence Force
ANAO	Australian National Audit Office
AUC	Assets Under Construction
CEO	Chief Executive Officer
COTS	Commercial-Off-The-Shelf
Defence	Department of Defence
DMO	Defence Materiel Organisation
FIC	Fundamental Inputs to Capability
FMR	Final Materiel Release
FOC	Final Operational Capability
JCPAA	Joint Committee of Public Accounts and Audit
MOTS	Military-Off-The-Shelf
MPR	Major Projects Report
OTS	Off-The-Shelf
PDSSs	Project Data Summary Sheets
RAAF	Royal Australian Air Force



List of recommendations

Recommendation 1

The Joint Committee of Public Accounts and Audit recommends that the Defence Materiel Organisation include in the 2011-12 Major Projects Report a section specifically providing information on the activities being undertaken to minimise schedule slippage and the results of those activities.

Recommendation 2

The Joint Committee of Public Accounts and Audit recommends that the Defence Materiel Organisation and the Australian National Audit Office continue to develop the Major Project Report Guidelines jointly but that the Australian National Audit Office take administrative responsibility for updating the Guidelines and submitting them to the Joint Committee of Public Accounts and Audit annually.

Recommendation 3

The Joint Committee of Public Accounts and Audit recommends that the Defence Materiel Organisation includes a discussion on the use by, and value of, the Major Projects Report by external stakeholders in the 2011-12 Major Projects Report.

Introduction

Background

- 1.1 The 2010-11 Major Projects Report (MPR) is the fourth produced by the Defence Materiel Organisation (DMO) and the Australian National Audit Office (ANAO). The Joint Committee of Public Accounts and Audit (JCPAA) has reviewed the three previous MPRs (2007-08; 2008-09; 2009-10) and reported on two (2007-08; 2009-10).
- 1.2 The MPR came about as a result of a recommendation made in the *Senate Foreign Affairs, Defence and Trade References Committee Report into Materiel Acquisition and Management in Defence* in 2003 that the Department of Defence (Defence) produce an annual report on progress in major defence projects, detailing cost, time and technical performance data for each project.¹
- 1.3 In December 2006 the JCPAA unanimously agreed to recommend that the ANAO receive additional funding to produce such a report. In August 2008 the JCPAA published *Report 411: Progress on equipment acquisition and financial reporting in Defence*. Chapter 5 of that report provided a broad outline of the key features deemed critical for inclusion in the MPR.

¹ Foreign Affairs, Defence and Trade References Committee, *Report into Materiel Acquisition and Management in Defence*, March 2003, pp. xv-xvi.

- 1.4 The aim of the MPR is to provide the Parliament and wider Australian community with accessible, transparent and accurate information about the status of Defence's major acquisition projects, providing a basis for longitudinal analysis of project performance. The report is comprised of a series of Project Data Summary Sheets (PDSSs), an overview and summary by the DMO and an overview and limited assurance review undertaken by the Auditor-General.
- 1.5 The MPR is automatically referred to the JCPAA in accordance with its statutory obligations to examine all reports of the Auditor-General that are tabled in each House of the Parliament.²

Role of the committee

- 1.6 The JCPAA has reviewed the MPR annually to assess the content, accessibility and transparency of the information provided on major projects. The Committee's subsequent report has provided suggestions and recommendations to improve the format and presentation of the data and ensure that the MPR fulfils its original objective to enhance transparency and accountability.
- 1.7 As well as reviewing the MPR, the Committee reviews and endorses the MPR Work Plan annually. The MPR Work Plan includes:
- the criteria for project selection;
 - the roles and responsibilities of DMO in the production and review of the MPR;
 - Guidelines for producing the PDSS;
 - format for the PDSS template; and
 - an indicative program schedule.

Scope and conduct of the review

- 1.8 This report includes discussion on a selection of the ongoing issues highlighted in previous reviews of the MPR and discussion on the future role of the MPR. The Committee considered Government Responses to its

2 *Public Accounts and Audit Committee Act 1951 (Cth)*, 8(1)(c).

previous report, *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report* during the course of the review.

- 1.9 The Committee received two submissions to the inquiry, which are listed at Appendix A.
- 1.10 The Committee held a public hearing on 21 March 2012 in Canberra with representatives from Defence, the DMO and ANAO. Witnesses who appeared before the Committee at this hearing are listed at Appendix B. The Transcript of Evidence received at this hearing is available from the Committee's website at:
http://www.aph.gov.au/Parliamentary_Business/Committees/House_of_Representatives_Committees?url=jcpaa/defenceannual0311/index.htm.

Report structure

- 1.11 Chapter 2 provides an overview of the 2010-11 Major Projects Report including the Auditor-General's assurance audit.
- 1.12 Chapter 3 identifies and examines the ongoing issues identified in the Committee's review of the MPR, both in 2010-11 and previous years. Those issues include the presentation of financial data, project slippage and possible exit criteria for projects from the MPR as well as an overall evaluation of the usefulness of the MPR.

Major Projects Report 2010-11

Introduction

- 2.1 This chapter provides an outline of the 2010-11 MPR, listing the major projects included in the report, the risks these projects face and a summary of the findings with regard to cost, scheduling and capability. It includes a summary of the Auditor-General's conclusion from his review of the MPR. The chapter also provides a summary of the Major Projects Work Plan for 2011-12.
- 2.2 The Major Projects Report is comprised of three parts:
- Part 1: ANAO overview;
 - Part 2: DMO commentary and analysis; and
 - Part 3: Auditor-General's assurance review report; statement by the Chief Executive Officer (CEO) DMO; and the 28 Project Data Summary Sheets (PDSSs).¹
- 2.3 The PDSSs prepared by the DMO have been refined over the years since the first model of the MPR was developed in 2007-08, by the DMO and ANAO and with the support of the JCPAA. Currently the PDSSs provide data covering the following areas:
- project summary;
 - financial performance;
 - schedule performance;

1 Australian National Audit Office (ANAO), *2010-11 Major Projects Report: Defence Materiel Organisation*, Australian National Audit Office, Canberra, p. 29.

- materiel capability performance;
- major risks and issues;
- project maturity;
- lessons learned; and
- project line management.²

2.4 The objective of the MPR is to provide:

- a formal conclusion on the review of the PDSSs by the Auditor-General;
- comprehensive information on the status of projects as reflected in the PDSSs prepared by the DMO;
- ANAO analysis on the three key elements of the MPR: cost, schedule and capability, in particular longitudinal analysis of projects over time; and
- further insights and context by the DMO on issues highlighted during the year (not included in the scope of the review by the ANAO).³

Major projects included in 2010-11

2.5 The 2010-11 MPR reports on 28 major projects, an increase of six projects on the 2009-10 MPR.⁴ The total approved budget for the 28 projects is \$46.1 billion which represents over half of the budget for the DMO's approved major capital investment program.⁵ These projects and their approved budgets appear in Table 2.1

Table 2.1 2010-11 MPR Projects and approved budgets at 30 June 2011

Project	DMO Abbreviation	Approved Budget \$m
Air Warfare Destroyer Build (SEA 4000 Ph 3)	AWD Ships	7 931.8
Airborne Early Warning and Control Aircraft (AIR 5077 Ph 3)	Wedgetail	3 859.5
Multi-Role Helicopter (AIR 9000 Ph 2/4/6)	MRH90 Helicopters	3 753.7
Bridging Air Combat Capability (AIR 5349 Ph 1/2)	Super Hornet	3 578.5
Field Vehicles and Trailers (LAND 121 Ph 3)	Overlander Vehicles	3 263.9
Amphibious Ships (LHD) (JP 2048 Ph 4A/4B)	LHD Ships	3 122.6

2 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 30-31.

3 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 16.

4 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 13.

5 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 13.

New Air Combat Capability (AIR 6000 Ph 2A/2B)	Joint Strike Fighter	2 666.8
Armed Reconnaissance Helicopter (AIR 87 Ph 2)	ARH Tiger Helicopters	2 060.3
F/A-18 Hornet Upgrade (AIR 5376 Ph 2)	Hornet Upgrade	1 917.5
C-17 Globemaster III Heavy Airlifter (AIR 8000 Ph 3)	C-17 Heavy Airlift	1 848.9
Air to Air Refuelling Capability (AIR 5402)	Air to Air Refuel	1 828.5
Guided Missile Frigate Upgrade Implementation (SEA 1390 Ph 2.1)	FFG Upgrade	1 528.9
F/A-18 Hornet Upgrade Structural Refurbishment (AIR 5376 Ph 3.2)	Hornet Refurb	951.3
Bushmaster Protected Mobility Vehicle (LAND 116 Ph 3)	Bushmaster Vehicles	929.8
Next Generation SATCOM Capability (JP 2008 Ph 4)	Next Gen Satellite	880.9
High Frequency Modernisation (JP 2043 Ph 3A)	HF Modernisation	670.8
SM-1 Missile Replacement (SEA 1390 Ph 4B)	SM-2 Missile	612.0
Additional Medium Lift Helicopters (AIR 9000 Ph 5C)	Additional Chinook	584.6
Armidale Class Patrol Boat (SEA 1444 Ph 1)	Armidales	537.2
ANZAC Anti-Ship Missile Defence (SEA 1448 Ph 2B)	ANZAC ASMD 2B	462.0
Collins Replacement Combat System (SEA 1439 Ph 4A)	Collins RCS	450.4
Replacement Heavyweight Torpedo (SEA 1429 Ph 2)	Hw Torpedo	425.4
Collins Class Submarine Reliability and Sustainability (SEA 1439 Ph 3)	Collins R&S	411.4
Indian Ocean Region UHF SATCOM (JP 2008 Ph 5A)	UHF SATCOM	407.2
ANZAC Anti-Ship Missile Defence (SEA 1448 Ph 2A)	ANZAC ASMD 2A	389.5
Follow On Stand Off Weapon (AIR 5418 Ph 1)	Stand Off Weapon	343.3
Artillery Replacement (LAND 17 Ph 1A)	155mm Howitzer	326.1
Battlefield Command Support (LAND 75 Ph 3.4)	Battle Comm. Sys.	325.9
TOTAL		46 068.7

Source Australian National Audit Office, 2010-11 Major Projects Report, p. 15.

2.6 Twenty-two of the projects were reported in the 2009-10 MPR. The following six projects have been added:

- AIR 6000 Phase 2A/B – New Air Combat Capability (Joint Strike Fighter);
- SEA 1390 Phase 4B – SM-1 Missile Replacement (SM-2 Missile);
- AIR 9000 Phase 5C – Additional Chinook Helicopter (Additional Chinook);
- JP 2008 Phase 5A – Indian Ocean UHF SATCOM Capability (UHF SATCOM);
- LAND 17 Phase 1A – Artillery Replacement (155mm Howitzer); and
- LAND 75 Phase 3.4 – Battlefield Command Support System (Battle Comm. Sys).

Risks

2.7 The DMO identified a number of risks facing major projects including:

- employing and maintaining an appropriately skilled workforce;
- multiple integration challenges for projects;
- overestimating by contractors of the technical maturity of proposed equipment solutions and underestimating the level of effort and complexity required to deliver new equipment;
- unavailability of in-service equipment;
- accelerating the maturity of the maintenance operations and supply chains for new equipment to support the transition to in-service use by Australian Defence Force (ADF) units;
- managing the expectations of [DMO] customers on changes to Government approved scope based on contemporary expectations and requirements that may affect project cost and schedule;
- complying with increasingly demanding certification and regulatory requirements; and
- ensuring access to Intellectual Property to enable continued further enhancement and improvement of systems.⁶

Cost

2.8 The ANAO found that there was a net increase of \$7.8 billion in the total approved budget cost of the 28 major projects compared to their approved budget at Second Pass Approval. The \$7.8 billion was comprised of:

- price variation increases of \$7.6 billion;
- real variation increases of \$3.6 billion; and
- foreign exchange rate movement decreases of \$3.4 billion.⁷

2.9 The ANAO indicate that price variation and foreign exchange movements are 'outside the direct control' of the DMO and that the real variation increases:

... primarily reflect changes in the scope of projects, transfers between projects for approved equipment/capability, and budgetary adjustments such as administrative savings decisions.⁸

2.10 The ANAO conclude that none of the 28 major projects included in this report 'have exceeded their approved budgeted cost'.⁹

6 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, pp. 142-143.

7 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 49.

8 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 52.

9 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 51.

Scheduling

- 2.11 The ANAO found that, of the 28 major projects, 14 had experienced schedule slippage amounting to 760 months, a 31 per cent increase.¹⁰ The ANAO identified a number of reasons for the scheduled slippage including:
- technical factors such as design problems;
 - industry capacity and capability;
 - difficulties in integrating different systems to achieve the required capability;
 - emergent work associated with upgrades; and
 - project ability to gain access to the platform.¹¹
- 2.12 The ANAO analysis of the schedule slippage shows that the slippage is greatest for the initial nine projects reported in the 2007-08 MPR, 463 months or 61 per cent.¹² The ANAO indicate that 88 per cent of the total schedule slippage for the projects included in the 2010-11 MPR 'is made up of projects approved prior to the DMO's demerger from the Department of Defence, in July 2005'.¹³
- 2.13 The ANAO found that the DMO received a total of an additional \$295 million in price indexation (up to 30 June 2011) to account for this slippage.¹⁴

Capability

- 2.14 Capability performance falls outside the scope of the ANAO's assurance audit as the data 'concerns forecasting future achievements'.¹⁵ Operational capability, as defined by the ADF, determines when a project has the capacity to be operationally effective and is made up of eight Fundamental Inputs to Capability (FIC):
- organisation;
 - personnel;
 - collective training;
 - materiel systems;
 - supplies;

10 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 62.

11 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 62.

12 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 67.

13 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 69.

14 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 51.

15 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 24.

- facilities;
- support;
- command; and
- management.¹⁶

2.15 Of the 28 major projects in the 2010-11 MPR, DMO consider that 17 projects will deliver their key capability requirements, six projects are at risk but will meet their key capability requirements and three are unlikely to meet their key capability requirements.¹⁷

Australian National Audit Office review

2.16 Although the ANAO conducts an assurance audit of the MPR, it cautions that the level of assurance is more limited than for a regular performance audit.¹⁸ A number of sections of the PDSSs are excluded from the audit review's scope due to their 'inherent uncertainty' as they record future dates and events, risks and issues.¹⁹

2.17 After examining the PDSS data the ANAO concluded that, except for the issue of reporting financial performance in base date dollars (to be discussed in detail in Chapter 3):

... nothing has come to the attention of the ANAO that causes us to believe that the information in the PDSSs, within the scope of our review, has not been prepared, in all material respects, in accordance with the guidelines on completing the PDSSs.²⁰

Major Projects Report Work Plan

2.18 In addition to reviewing the MPR, the Committee considers and endorses the MPR Work Plan annually. The MPR Work Plan includes the list of projects to be added or removed from the MPR and the Guidelines for the PDSSs. The MPR Work Plan for 2011-12, presented to the Committee in September 2011, included:

16 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, pp. 71 and 111.

17 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, pp. 168-170.

18 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 16.

19 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 32.

20 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 17.

- the criteria for project selection and the list of projects selected for the 2011-12 MPR;
- the role and responsibilities of the DMO in the production and review of the DMO 2011-12 MPR;
- the guidelines for producing the PDSSs;
- the PDSS Template; and
- an indicative Program Schedule in support of a mid November 2012 Tabling.

Guidelines for the Project Data Summary Sheets

- 2.19 The DMO in consultation with the ANAO have developed a set of Guidelines for the production of the PDSSs. The Guidelines have been enhanced and refined over previous years to improve both the type and presentation of data to improve transparency and accountability. The Committee has contributed to this process with its annual review of the MPR and final approval process.
- 2.20 The DMO in conjunction with the ANAO has provided the Committee with the revised Guidelines for the 2011-12 MPR. The proposed revisions to the Guidelines include:
- an additional 'Assurance Statement' on the project's budget performance in Section 1;
 - further refinement to financial performance in Section 2;
 - a graphical representation of 'Project Status' at 30 June in Section 4.

Major Projects Work Plan 2011-12

- 2.21 In addition to the 27 'repeat' projects listed in the 2010-11 MPR, the 2011-12 MPR will include the following two 'new' projects:
- Future Naval Aviation Combat system Helicopter – AIR 9000 Phase 8; and
 - Counter Rocket, Artillery and Mortar (C-RAM) – LAND 19 Phase 7A.²¹
- 2.22 One project has been removed from the 2011-12 MPR:
- Hornet Structural Refurbishment – AIR 5376 Phase 3.2.²²

21 Defence Materiel Organisation, *DMO 2011-12 Major Projects Report Guidelines*, p. 3.

22 Defence Materiel Organisation, *DMO 2011-12 Major Projects Report Guidelines*, p. 4.

Committee review

Introduction

- 3.1 Although the Committee observed that there has been overall improvement in the preparation and presentation of data in the 2010-11 MPR, there are a number of ongoing issues that continue to require attention.
- 3.2 The Committee still has concerns over the presentation of financial data and the inconsistency of information across projects.
- 3.3 The ANAO has identified a steady increase in the schedule slippage experienced by the major projects being tracked in the report.¹ This slippage raises a number of issues with regard to budget implications and the overall performance of the DMO.
- 3.4 The MPR is now well established and is a useful tool to monitor Defence major acquisitions and capability. Given this, it is timely to consider its future over the longer term, including the exit criteria for projects and the role of parliamentary committees and other stakeholders.
- 3.5 This chapter covers these issues and, in addition, examines the government response to recommendations from the Committee's previous review of the 2009-10 MPR², particularly with regard to clarity and timeliness.

1 Australian National Audit Office (ANAO), *2010-11 Major Projects Report: Defence Materiel Organisation*, Australian National Audit Office, Canberra, pp. 68-69.

2 Joint Committee of Public Accounts and Audit (JCPAA), *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, April 2011.

- 3.6 This chapter covers the following topics:
- presentation of financial data;
 - business processes;
 - slippage/budget;
 - exit criteria;
 - guidelines;
 - evaluation;
 - timeliness and quality of responses; and
 - MPR identified as a priority audit.

Presentation of financial data

- 3.7 Since the inception of the MPR, the Guidelines have required contract values and project expenditure be reported in 'base date' dollars. This requirement has not been met in the previous MPRs in 2007-08, 2008-09, 2009-10 or the current 2010-11 MPR, resulting in qualified audits for each of these MPRs.
- 3.8 This issue has been the focus of discussion between the Committee, DMO and ANAO in successive years. The DMO has argued that the original proposal for reporting in base date dollars is not workable.³ At one stage the DMO proposed to use Assets Under Construction (AUC) data however, it was unable to implement this approach.⁴ Other suggested reporting methods have included 'constant' dollars and 'out-turned' dollars.⁵

3 Australian National Audit Office (ANAO), *2008-09 Major Projects Report: Defence Materiel Organisation*, Australian National Audit Office, Canberra, pp. 56-58; ANAO, *2009-10 Major Projects Report: Defence Materiel Organisation*, Australian National Audit Office, Canberra, pp. 100-101.

4 Department of Defence – Defence Materiel Organisation, 'A Financial Performance Reporting Proposal for the Defence Materiel Organisation Major Projects Report: A response to Recommendation 7 of the Joint Committee of Public Accounts and Audit Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report', p. 4. (See Appendix C)

5 For a definition of the various dollar types see Department of Defence – Defence Materiel Organisation, 'A Financial Performance Reporting Proposal for the Defence Materiel Organisation Major Projects Report: A response to Recommendation 7 of the Joint Committee of Public Accounts and Audit Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report', p. 2. (See Appendix C)

- 3.9 The Committee's primary concern is for 'project expenditure information to be reported on in a constant manner'.⁶ The Committee seeks accessibility of the information presented and increased transparency through an approach that allows:
- ... for a constant set of expenditure information to be presented, allowing for ease of comparison between years, identification of any project concerns and overall more effective and efficient scrutiny.⁷
- 3.10 In order to reach a final solution, the Committee recommended in its report on the 2009-10 MPR that DMO prepare a report for the Committee examining the possible methods for the presentation of financial information in base date dollars, out-turned dollars and current dollars. Further, the report from DMO should provide a comprehensive proposal for transitioning to the proposed new arrangement. The Committee requested that the ANAO review the final proposal.⁸
- 3.11 The DMO's response to this recommendation proposed that financial information in the PDSSs be presented in out-turned dollars. The DMO argues that presentation of financial information in out-turned dollars:
- allows cost objectivity and is consistent with the historical cost convention;
 - is consistent with the way that Defence and DMO financially manage projects;
 - is consistent with the way that project financial information is reported through other public documents; and
 - allows the JCPAA to readily assess the past cost performance and make judgements about likely cost outcomes.⁹
- 3.12 While supporting the proposal to move to an out-turned dollar presentation, the ANAO initially cautioned that care would need to be taken to ensure that 'sufficient disclosures are maintained to allow

6 JCPAA, *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, p. 35.

7 JCPAA, *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, p. 35.

8 JCPAA, *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, p. 37.

9 Department of Defence - Defence Materiel Organisation, 'A Financial Performance Reporting Proposal for the Defence Materiel Organisation Major Projects Report: A response to Recommendation 7 of the Joint Committee of Public Accounts and Audit *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, p. 13. (See Appendix C)

assessments to be made of project performance against budget'.¹⁰ The ANAO suggested that such disclosures should include:

- budget at first and second pass approval;
- indexation amounts; and
- foreign exchange and real adjustments.¹¹

- 3.13 The ANAO's primary concern was DMO's suggestion to 'report project indexation at an aggregated level, in both the budgetary and expenditure sections of the PDSSs'.¹² In the ANAO's opinion this would reduce the amount of information provided.
- 3.14 After consultation, the DMO and ANAO provided the Committee with an agreed modified proposal for the presentation of financial data consisting of two formats, one for projects that received Government Approval prior to July 2010 and one for projects that received Government Approval after June 2010.¹³
- 3.15 To offer further clarification, the DMO and ANAO proposed that a 'Project Assurance Statement' be made available in the PDSSs that would 'provide an overall assessment of the project's budgetary position'.¹⁴ The Statement would indicate 'whether there is sufficient budget remaining to deliver the materiel element of capability at the agreed Final Materiel Release (FMR) milestone'.¹⁵
- 3.16 At the public hearing on 21 March 2012, the Committee asked the Auditor-General if he was satisfied with the new financial reporting proposal. He told the Committee that he was satisfied and that the suggested Project Assurance Statement was a significant step forward:

... instead of readers having to make their own assessment about how the project is going, and they may still do that, DMO will be

10 Correspondence from Mr Ian McPhee, Auditor-General to Mr Robert Oakeshott, Chair, Joint Committee of Public Accounts and Audit. (See Appendix D)

11 Correspondence from Mr Ian McPhee, Auditor-General to Mr Robert Oakeshott, Chair, Joint Committee of Public Accounts and Audit. (See Appendix D)

12 Correspondence from Mr Ian McPhee, Auditor-General to Mr Robert Oakeshott, Chair, Joint Committee of Public Accounts and Audit. (See Appendix D)

13 Correspondence from Mr Warren King, Chief Executive Officer, Defence Materiel Organisation to Mr Robert Oakeshott, Chair, Joint Committee of Public Accounts and Audit. (See Appendix E)

14 Correspondence from Mr Warren King, Chief Executive Officer, Defence Materiel Organisation to Mr Robert Oakeshott, Chair, Joint Committee of Public Accounts and Audit. (See Appendix E)

15 Correspondence from Mr Warren King, Chief Executive Officer, Defence Materiel Organisation to Mr Robert Oakeshott, Chair, Joint Committee of Public Accounts and Audit. (See Appendix E)

providing an assessment from their perspective as to whether there is sufficient budget to complete this project to expectations.¹⁶

3.17 The Committee observed that, contrary to the Auditor-General's initial request, the proposed format for the presentation of financial data for post June 2010 projects did not contain any indication of price indexation figures. The DMO maintained that indexation was unnecessary to provide the clarity the Committee was looking for.

3.18 In the view of the DMO, indexation could be misleading as the DMO has to create indexation figures and it is therefore 'an artificial artefact of the pricing'.¹⁷ The DMO informed the Committee that predicting indexation figures is complex because of the number of factors involved, including labour and materials:

Sometimes there can be 50 or 60 indexes or just a global government indexation because you cannot break it apart.¹⁸

3.19 On the other hand, the DMO explained that the inclusion of the Project Assurance Statement would provide transparency regarding whether or not a project will be completed 'under the approved budget'.¹⁹ The DMO believe that the relevant information is 'whether we are doing it in the time frame that we said we would do it for government'.²⁰

3.20 With regard to the financial reporting framework, the DMO considers that identifying changes to the actual cost and the scope of a project are the most important information to be disclosed in the MPR.²¹ The DMO believe that the proposed format for financial reporting will:

... make it very clear to the committee what was approved by government, what the cost impacts and budgetary accumulations have been to date, and what in our judgement is our ability to complete that project inside the government approved funding.²²

3.21 To demonstrate the complexity and uncertainties of calculating indexation, the DMO provided the example of the Air Warfare Destroyer Build (SEA 4000 Ph 3) from the current MPR. This project went to contract

16 Mr Ian McPhee, Auditor-General, Australian National Audit Office (ANAO), *Committee Hansard*, Canberra, 21 March 2012, p. 2.

17 Mr Warren King, Chief Executive Officer (CEO), Defence Materiel Organisation (DMO), *Committee Hansard*, Canberra, 21 March 2012, p. 4.

18 Mr King, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 4.

19 Mr King, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 4.

20 Mr King, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 4.

21 Mr King, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 4.

22 Mr King, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 5.

in 2007 before the effects of the global financial crisis began to be felt. The DMO calculated the long-term cost demands for materiel and labour over a 10 year period across the economies of the countries that would contribute to the project, including Australia, Spain, America and Norway. However the DMO explained that the fluctuations caused by the onset of the global financial crisis severely affected the DMO's projections:

Early in the project, the world inflation indexes, just before the global financial crisis, were going very strongly and we were seeing demanding pressure coming in on a number of those indexes, which were outstripping what we had anticipated. Since then, the global financial crisis has had a significant slowing down on the impact of a lot of those indexes – prices for steel and copper, and a lot of copper pipework and labour was coming from overseas – so a lot of that pressure has gone away. Broadly, as reported in [the MPR], we are still operating inside what we projected.²³

- 3.22 While noting this argument, the Committee questioned why the information on indexation could not be made public considering that the DMO had made the calculations for each project. The DMO conceded that providing the information 'would not be impossible but it would be a considerable amount of work'.²⁴ The DMO told the Committee that there is a difference between calculating an estimated indexation figure at the beginning of a project and disaggregating that figure annually as invoices are paid:

The building up of the initial cost model ... – and it could be 60 or 70 indices ... – is only an estimate in terms of the total cost. That total cost is the approval value, not an itemised breakdown of the cost.²⁵

- 3.23 The Committee suggested that perhaps an approximate estimation of the indexation on a project could be publicly disclosed. However, the DMO reiterated that the information is not made public and is not part of the proposal that goes to government:

That information is not normally public. The cost model is normally signed off by the department of finance in terms of how those costs are developed but the breakdown – again, getting back

23 Mr King, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 5.

24 Mr Steve Wearn, Chief Finance Officer, Defence Material Organisation (DMO), *Committee Hansard*, Canberra, 21 March 2012, p. 5.

25 Mr Wearn, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 5.

to that itemisation – is not part of the proposal that goes to government. It is a total cost.²⁶

3.24 Asked again if he supported the DMO proposal, the Auditor-General told the Committee that, after robust discussions with the DMO, the ANAO has been persuaded that the proposal will provide the information required. The Auditor-General admitted that, as budgetary figures are now being presented in out-turned dollars, ‘any indexation figures that would be included would be notional’.²⁷ He also indicated that the ANAO had considered the administrative cost of providing the indexation figures.²⁸

3.25 In summary, the Auditor-General told the Committee that the ANAO accepted the strength of the DMO argument for the proposed financial reporting framework and that the Project Assurance Statement would provide:

... a more comprehensive and valuable statement for the committee to get than an additional notional line on what the indexation figure would be presented in an out-turn basis. I think it is a better figure for the committee to have, because you are interested in the big picture, not the detail, generally speaking.²⁹

Committee comment

3.26 The Committee appreciates the work that the DMO and the ANAO have undertaken to progress the ongoing issue of the presentation of financial data in the MPR, despite this work only occurring after pressure was applied by the Committee.

3.27 The Committee accepts the argument to move to out-turned dollars for the financial performance reporting in the MPR for all new projects. The Committee acknowledges that this method is consistent with the Commonwealth budgetary framework and accounting conventions.

3.28 The Committee therefore endorses the proposed out-turned presentation for future MPRs.

3.29 Further, the Committee accepts the Auditor-General’s recommendation that there is no need for a transitional arrangement for the 2011-12 MPR

26 Mr Wearn, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 5.

27 Mr McPhee, ANAO, *Committee Hansard*, Canberra, 21 March 2012, p. 5.

28 Mr McPhee, ANAO, *Committee Hansard*, Canberra, 21 March 2012, p. 5.

29 Mr McPhee, ANAO, *Committee Hansard*, Canberra, 21 March 2012, p. 6.

showing both base date dollars and out-turned dollars for the 11 projects previously providing information in base date dollars.

- 3.30 Some Members of the Committee remain concerned that the lack of indexation information will hinder appropriate scrutiny. However, the Committee accepts the Auditor-General's assurance that the proposed format for financial reporting for the MPR will provide sufficient information on projects to satisfy transparency and accountability requirements.
- 3.31 The Committee therefore endorses the proposed format, including the inclusion of a Project Assurance Statement for each project.
- 3.32 However, the Committee expects the DMO to work constructively with the ANAO to ensure that Project Assurance Statements provide a level of scrutiny and commentary on a project that the ANAO, and subsequently the Committee, deems appropriate for maintaining transparency and accountability.
- 3.33 In this regard, the Committee will closely monitor the reliability of Project Assurance Statements over time and will revisit the issue if needed.
- 3.34 During the inquiry the Committee was given the impression that the DMO did not actively monitor and manage project budget risks due to indexation effects. This is of concern to the Committee, considering that indexation represents a major budget component.
- 3.35 Nevertheless, the Committee notes that the move to out-turned dollar budgeting puts the onus on the DMO to manage indexation within existing budgets. Therefore, overall the Committee acknowledges that the DMO will be compelled to proactively manage indexation risk and anticipates that the approved new format for financial reporting will be sufficient for the time being.

Business processes

- 3.36 As in previous MPRs, the ANAO found inconsistency of information recorded across projects, however, it acknowledged that the DMO is taking steps to address the issue.³⁰ In particular the ANAO identified

30 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, pp. 84-85.

difficulties resulting from ongoing inconsistency with regard to financial management, risk management and document management systems.³¹

- 3.37 With regard to risk management, the ANAO noted that corporate awareness of the issue had improved. However, the ANAO found that little progress had been made at project level to improve the 'consistency of risk management across the Major Projects'.³²
- 3.38 This is a concern shared by others. In his submission to the review, Mr E.J. Bushell, Air Commodore, RAAF, Retired, informed the Committee that the ongoing poor standard of risk management can be traced to the continuing use of a commercial model of project management. Mr Bushell maintains that the 'primary cause of project risk lies in the operational and technical areas of the project'.³³ He advocates a return to what he calls 'engineering management' to combat the problems and refocus on achieving capability:
- Effective capability management requires that all capability functions – operational, systems and equipment engineering, test and acceptance functions and support requirements, including their associated risks, must come under tight Project and Systems Engineering management, and that commercial management must be constrained to contract management that supports project management objectives.³⁴
- 3.39 The DMO was asked by the Committee to provide further information on progress regarding the rationalisation of its business systems and improvements to risk management training for staff in questions on notice.
- 3.40 The DMO's response focused on risk management only, stating that DMO is working to reduce the number of risk management tools used and is currently developing a risk categorisation framework for dissemination in 2012. DMO has also been undertaking risk management training, including using online learning initiatives.³⁵

31 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 84.

32 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 40.

33 Mr E.J. Bushell, Air Commodore, RAAF, Rtd, *Submission 1*, p. 11.

34 Mr Bushell, *Submission 1*, p. 11.

35 Defence Materiel Organisation, *Submission 3, Answer to Question on Notice, Question 5*.

Committee comment

- 3.41 The Committee is concerned with the continuing inconsistency of information across projects as it affects the reliability of the information in the PDSSs and ultimately lowers the quality of the MPR.
- 3.42 The Committee is concerned that despite some action being taken to improve consistency of information the expected improvements have not yet been achieved. Previous evidence to the Committee indicated that the problem dates back to around 2000 and that it would take time to resolve.³⁶ However, the Committee believes that, after some 12 years, more progress should have been made to address the issue.
- 3.43 The Committee understands that some improvement has been made, and notes the work underway on risk management practices. The Committee is encouraged to by the additional risk management training (in particular the use of online training approaches), and the development of a risk categorisation framework.
- 3.44 However, it was not clear what efforts were being made on financial management or document management systems. As such, the Committee expects to see concrete evidence of results and progress to achieve consistency of information across projects reported in the next MPR.

Slippage/budget

- 3.45 The ANAO found that of the 28 major projects in the 2010-11 MPR, 14 projects have experienced schedule slippage.³⁷ Total slippage across the major projects is 760 months, a 31 per cent increase on the original planned schedule for achieving Final Operational Capability (FOC).³⁸ ANAO analysis shows that the DMO received a total of an additional \$295 million in price indexation (up to 30 June 2011) to account for this slippage.³⁹
- 3.46 Although the ANAO review found that none of the major projects have 'exceeded their approved budgeted cost'⁴⁰, the ANAO indicate that

36 JCPAA, *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, p. 30.

37 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 22.

38 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 22.

39 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 51.

40 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 51.

schedule delays do increase the overall costs as both staffing and administrative resources are 'tied up for longer than planned'.⁴¹

- 3.47 The DMO classify acquisition projects as either Military-Off-The-Shelf (MOTS), Commercial-Off-The-Shelf (COTS), Australianised MOTS, or Developmental.⁴² While the ANAO identified a number of reasons for schedule slippage, it singled out misclassification of projects under this procurement system as Off-The-Shelf (OTS) instead of Developmental as a significant contributor to slippage.⁴³
- 3.48 The Committee asked the DMO to provide additional information on the possible drivers for slippage, what is being done to improve the classification of projects, and the cost impacts of slippage.
- 3.49 DMO listed the possible drivers of slippage as:
- initial optimism;
 - the realisation of emergent risks;
 - platform availability and higher priority operational requirements;
 - stability and clarity of requirements; and
 - technical regulatory compliance.⁴⁴
- 3.50 DMO suggested that the move to the Two Pass Process, Gate Reviews and several other initiatives, are expected to reduce these drivers of slippage.
- 3.51 Regarding the misclassification of projects, the DMO listed several initiatives they are taking to improve outcomes and to be more realistic about project delivery times. In addition to the Gate Reviews, these included:
- the use of Emerging Project Teams – where DMO works with the Defence Capability Development Group to ensure the process for first pass approval is more robust and DMO expertise is engaged earlier in the process;
 - offer Definition Activities – where DMO works with shortlisted tenderers to ensure risks and schedules are more realistic; and
 - the planned use of Implementation Risk Categories –to be introduced in 2012 to assist project teams in the initiation phases with the

41 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 62.

42 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 118.

43 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, pp. 62-63.

44 Defence Materiel Organisation, *Submission 3, Answer to Question on Notice, Question 1*.

classification, early identification, and comprehensive assessment of technical and implementation risks.⁴⁵

- 3.52 Regarding the costs of slippage, the DMO contended that there are several factors which mitigate the costs of slippage, including: that price indexation is factored into project budgets; that contractor caused slippage costs are claimed by DMO through liquidated damages; and that slippage caused by Defence is covered by a project's contingency budget in the first instance.⁴⁶
- 3.53 DMO acknowledged that where 'a project's contingency budget is estimated to be insufficient to cover any additional costs ... then the Project must seek approval for a Real Cost Increase or a reduction in scope.'⁴⁷ DMO's submission shows that only two projects since July 2005 have required real cost increases.
- 3.54 However, DMO also acknowledged that several slippage related costs are not part of the project budget, such as those associated with sustainment of legacy platforms, or needing to lease capability systems from other countries in order to fill temporary capability gaps. Furthermore, additional costs associated with prolongation of DMO workforce are funded through DMO's direct appropriation.⁴⁸

Committee comment

- 3.55 The steady increase in schedule slippage over the life of the MPRs is of major concern to the Committee, both in terms of timely delivery of capability to the ADF and in budgetary terms.
- 3.56 The Committee finds the narrow focus on claiming that project budgets are not exceeded despite significant slippage unhelpful. The Committee acknowledges that there are several factors that minimise the risk of cost blowouts to government above a project's initial budget approval, but it is clear that there are additional cost impacts which are possibly significant.
- 3.57 It is the Committee's understanding that indexation is only factored in to a project's budget for projects commencing after 2010 and that indexation is a separate line item for projects commencing before this date. Therefore, poorly estimated or unmanaged indexation risks for pre-2010 projects

45 Defence Materiel Organisation, *Submission 3*, Answer to Question on Notice, Question 3.

46 Defence Materiel Organisation, *Submission 3*, Answer to Question on Notice, Question 2.

47 Defence Materiel Organisation, *Submission 3*, Answer to Question on Notice, Question 2.

48 Defence Materiel Organisation, *Submission 3*, Answer to Question on Notice, Question 2.

have a real effect on Government expenditure, which is not acknowledged in DMO's submission.

- 3.58 Furthermore, the broader impacts of sustaining legacy platforms, possibility leasing capability, and ongoing administration costs are all 'off project' increases of the total cost to Government. Given the duration of slippage these costs may be significant.
- 3.59 The reality is that projects which take longer to complete cost the Australian taxpayer more, even if the project is technically within budget.
- 3.60 Although DMO now have some mechanisms in place to improve the initial classification of projects and to reduce slippage, the Committee emphasises the importance of focused action in this area.
- 3.61 The Committee believes that the transparency of initial classification decisions could still be improved. Specifically, the Committee wants to see that MOTS and COTS options have been explicitly considered and eliminated for particular reasons before final procurement decisions have been made. The Committee wishes to see this information included in the MPR for all new projects.
- 3.62 The Committee notes the planned 2012 introduction of the Implementation Risk Category process and hopes this supports teams during the initial project planning phases. To complement this and other DMO initiatives the Committee suggests that the DMO consider additional staff training regarding the classification of projects.
- 3.63 The Committee acknowledges that the evidence suggests the majority of the schedule slippage is made up of legacy projects and indicates that initiatives to improve processes are having an effect on minimising slippage. However, the Committee recommends that a section be included in future MPRs that specifically provides explicit information on the activities being undertaken to minimise schedule slippage and the tangible results of these initiatives - so that these can be explicitly monitored and scrutinised over time.

Recommendation 1

The Joint Committee of Public Accounts and Audit recommends that the Defence Materiel Organisation include in the 2011-12 Major Projects Report a section specifically providing information on the activities being undertaken to minimise schedule slippage and the results of those activities.

Exit criteria

- 3.64 In its report on the 2009-10 MPR the Committee recommended that the exit criteria be the point at which both Final Materiel Release (FMR) and Final Operational Capability (FOC) is achieved.⁴⁹ Additionally the Committee asked the DMO to provide a report to the JCPAA on an assessment of the difference in scale, size and incidence of requirements to be completed between FMR and FOC in order that the appropriateness of these exit criteria be further examined.⁵⁰
- 3.65 In its initial response to the Committee, the DMO indicated that it considered that FMR was the 'logical end point to trigger the removal of a project from the MPR' as it is the 'point in time at which the DMO has satisfied its responsibility for acquisition of the materiel element of capability'.⁵¹
- 3.66 The DMO explained that FMR relates to the materiel element of capability, which is only one of the eight Fundamental Inputs to Capability (FIC).⁵² As a project must attain all eight elements of FIC to reach FOC and these elements are managed by various Defence agencies, the DMO argues that FMR is the reasonable point at which to remove a project from the MPR.⁵³

49 JCPAA, *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, p. 20.

50 JCPAA, *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*, p. 20.

51 Department of Defence, 'Government Response to *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*'. (See Appendix F)

52 The Fundamental Inputs to Capability (FIC) are: organisation, personnel, collective training, materiel systems, supplies, facilities, support, command, and management. See ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 111.

53 Department of Defence, 'Government Response to *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report*'. (See Appendix F)

3.67 In an additional response to the Committee the DMO proposed the following approach:

- DMO reports progress to FMR through full disclosure in the PDSSs. The PDSS is then assured by the ANAO:
 - ⇒ the DMO's delivery to FMR is the materiel element of the mature capability, which accounts for approximately 95% (range of 85% - 100%) of the Government approved funding and normally the majority of project schedule.
- Defence (through the relevant Capability Manager) reports progress to FOC 'post-FMR'. This report would not be subject to ANAO assurance. The Defence reports would be an addendum in the MPR, and separate to the PDSS.⁵⁴

3.68 The Committee asked the DMO for an assurance that the proposed reporting format would be simple and explicit and allow stakeholders to compare and contrast information. The DMO assured the Committee that the process would conform to the current format and be transparent:

The detailed PDSSs will be up to FMR. Once FMR is declared, we will then move the projects into an addendum to the report, where we will report the activities from FMR to FOC that is looking at the fundamental inputs to capability, additionally to the materiel components.⁵⁵

3.69 The Committee asked the Auditor-General if he would be able to supply an assurance audit on the proposed new reporting format, particularly for the FOC 'post-FMR' reporting. The Auditor-General explained that as a range of parties would be involved in 'providing support to the provision of the final capability', he would only be able to provide limited assurance:

We can modify our report to make it clear what we are giving assurance around, but I would foreshadow that some of these other functions that have to be provided would be problematic for us to give assurance around.⁵⁶

3.70 The Committee asked the DMO to provide further clarification of the proposed changes to the exit criteria for projects from the MPR in

54 Department of Defence - Defence Materiel Organisation, 'Proposal to establish exit criteria (sic) for projects in the Defence Materiel Organisation Major Projects Report: Additional submission to *'Government Response to the JCPAA Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report'* of 8 November 2011, regarding Recommendations 3 and 4. (See Appendix G)

55 Ms Shireane McKinnie, General Manager Systems, Defence Materiel Organisation (DMO), *Committee Hansard*, Canberra, 21 March 2012, p. 2.

56 Mr McPhee, ANAO, *Committee Hansard*, Canberra, 21 March 2012, p. 2.

questions on notice, including what consultation had been undertaken with Defence and the ANAO on the proposal.

- 3.71 DMO's Question on Notice responses clarify that the Defence Capability Managers have been consulted in the development of the proposal and have raised no objections⁵⁷. However, no information was provided on consultation with the ANAO.
- 3.72 As part of their Question on Notice response the DMO also provided a worked example of the format for the proposed post-FMR report and clarified that in their opinion the achievement of FMR is a single point in time that is auditable.

Committee comment

- 3.73 The Committee has reservations about the proposed changes to exit criteria for projects from the MPR. The Committee wishes to see more detail of any proposed new reporting format; to be assured that the ANAO has been consulted on and is supportive of the proposal; and believes that the practicalities of the proposed change warrant further consideration before making a decision to move away from the current exit criteria arrangements.
- 3.74 The Committee notes that the DMO estimates that delivery to FMR accounts for approximately 95% of the Government approved funding for a project and that a project 'post-FMR' largely becomes the responsibility of the relevant Capability Manger. However, the Committee also notes that evidence from MPRs to date suggests that some projects experience considerable difficulties 'post-FMR', and that the DMO continues to share responsibility for these projects. This indicates to the Committee that schedule slippage and budget could both be affected to some degree, in the 'post-FMR' period. Therefore, although there may be a technically clear distinction between DMO's achievement FMR and subsequent FOC initiatives, in reality the process is more complex and involved.
- 3.75 The Committee is aware that changes to the exit criteria for projects from the MPR have substantial implications for the purpose and aim of the MPR, and hence should be approached with caution.
- 3.76 Therefore, the Committee believes that the type and amount of information provided in any 'post-FMR' reporting format will have to be more carefully considered to maintain visibility of cost and scheduling as well as capability. The Committee also believes that any future 'post-FMR'

57 Defence Materiel Organisation, *Submission 3*, Answer to Question on Notice, Question 6.

reporting format should also be included in the MPR Guidelines endorsed by the Committee, even if separate to the PDSSs, in order to maintain an appropriate level of transparency and accountability.

- 3.77 Therefore the Committee retains its previous opinion and believes that reporting on both FMR and FOC should be included in the MPR and in the PDSSs for the time being.

Guidelines

- 3.78 Historically, the Guidelines for the PDSSs have been developed by the DMO in consultation with the ANAO. The Guidelines are then endorsed by the JCPAA and form a base for the ANAO review of the major projects report.
- 3.79 The Committee considers that the Guidelines are now a stable document, reflecting the requirements of the MPR. The Committee believes that the Guidelines should continue to be developed jointly by the DMO and ANAO. However, as the Guidelines provide the basis for the ANAO audit, the Committee recommends that, in the interests of administrative efficiency, the ANAO should take administrative responsibility for updating the Guidelines and their submission to the JCPAA for endorsement.

Recommendation 2

The Joint Committee of Public Accounts and Audit recommends that the Defence Materiel Organisation and the Australian National Audit Office continue to develop the Major Project Report Guidelines jointly but that the Australian National Audit Office take administrative responsibility for updating the Guidelines and submitting them to the Joint Committee of Public Accounts and Audit annually.

Evaluation

- 3.80 The JCPAA was instrumental in instigating the development of the MPR to provide both the Parliament and the wider Australian community with accessible, transparent and accurate information about the status of

Defence's major acquisition projects. The original aim was to encourage transparency and accountability by providing a basis for longitudinal analysis of project performance.

3.81 The Committee was interested to know if the MPR was useful to the DMO in terms of an overarching project management resource. The DMO notes in the 2010-11 MPR that the Report provides a valuable 'organisational perspective' on major project work and performance for the DMO, as well as enhancing the quality of trend analysis.⁵⁸

3.82 In his opening statement to the public hearing, the CEO of the DMO confirmed the benefit of the MPR to the DMO:

... I hold a firm belief that the major projects report provides my organisation with an ideal opportunity to demonstrate a high level of accountability and transparency to government, parliament and the Australian public on DMO's performance in managing the acquisition of Defence's largest and most technically challenging projects.⁵⁹

3.83 In a question on notice the Committee asked the DMO how the MPR is used by other agencies or groups, and if any evaluation had been done of the use of the MPR by external stakeholders.

3.84 DMO's response reaffirmed the internal value of the MRP, as well as its use by Defence, other parliamentary committees, and potentially the United Kingdom Minister of Defence. DMO noted that to date they have not evaluated the use of the MPR by other Government agencies, and by default other external stakeholders.⁶⁰

Committee comment

3.85 The Committee is pleased to hear that the MPR is providing a useful organisational resource for the DMO and within Defence.

3.86 The Committee is satisfied that the current format of the MPR is largely achieving the original goal for the Report, of increasing the transparency and accountability of major defence procurements. Therefore, it is now timely to consider the future direction of parliamentary scrutiny of the MPR.

58 ANAO, *2010-11 Major Projects Report: Defence Materiel Organisation*, p. 95.

59 Mr King, DMO, *Committee Hansard*, Canberra, 21 March 2012, p. 1.

60 Defence Materiel Organisation, *Submission 3*, Answer to Question on Notice, Question 4.

- 3.87 As part of this consideration, the Committee intends to consult broadly with other relevant parliamentary committees, and potentially other users of the report, regarding their use of the MPR. This consultation will focus on how the various parliamentary committees can work more effectively together to sustain, and indeed improve, the scrutiny of the MPR and related defence capability development projects.
- 3.88 Despite the Committee considering the future parliamentary scrutiny of the MPR, the Committee stresses that the MPR is and will continue to be a critical resource into the future. There are further improvements still to be made to the report itself, as well as improvements on the issues the report exposes.
- 3.89 To assist it in its deliberations the Committee is interested in gauging how extensively the MPR is utilised by external stakeholders. Therefore, the Committee recommends that the DMO include a discussion on the use by, and value of, the MPR by external stakeholders, such as private companies or industry associations, in the 2011-12 MPR.

Recommendation 3

The Joint Committee of Public Accounts and Audit recommends that the Defence Materiel Organisation includes a discussion on the use by, and value of, the Major Projects Report by external stakeholders in the 2011-12 Major Projects Report.

Timeliness and quality of responses

- 3.90 In order to streamline the MPR process, the Committee recommended that the DMO provide the proposed MPR Work Plan, including the MPR Guidelines, to the Committee by 31 August each year for its endorsement.
- 3.91 The Committee also requested the response to recommendation 7 for *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report* by 31 August 2012.
- 3.92 The DMO was unable to meet these deadlines.
- 3.93 Additionally, the 2010-11 MPR which was expected to be tabled in November 2011, was not tabled in the Parliament until December 2011, after the Parliamentary sitting period had finished.

- 3.94 As well as issues with the timeliness of providing responses and information to the Committee, there has been some difficulty with the clarity and quality of information.
- 3.95 The initial Government response to the Committee's recommendations for *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report* included a number of anomalies, compelling the Committee to seek clarification on several ambiguous and incomplete answers.
- 3.96 Furthermore, the responses to the Committee's Questions on Notice were delivered several weeks late, hindering the Committee's inquiry.

Committee comment

- 3.97 The Committee is disappointed at the repeated failure by the DMO and the Government to provide timely and complete responses to its reports and requests. These delays and incomplete responses have hindered the inquiry and ultimately also hinder improvements to the quality of the MPR.
- 3.98 The Committee set the proposed deadlines for the receipt of information from the DMO in an attempt to ensure that the MPR process would proceed in a timely manner. The suggested deadlines would have afforded the Committee more time to scrutinise the information and provide a more considered response, or allowed additional discussion of the issues as needed.
- 3.99 In the case of the questions on notice following the public hearing, the Committee understands that it set a tight timeframe for the responses. However, this was unavoidable given the previous delays by the DMO which resulted in issues remaining unresolved during the year.
- 3.100 Regarding the quality of responses, the Committee believes that the initial Government response could have been clearer, more precise and more complete. In future, the Committee expects the DMO and the Government to provide considered, relevant, and appropriately detailed responses to Committee recommendations and requests, in order to minimise the need for subsequent clarification.
- 3.101 Finally, if there is continued evidence that DMO may not be respecting the Parliament and its committees the JCPAA will look on this extremely unfavourably.

MPR identified as a priority audit

- 3.102 Under the recent amendments to the *Auditor-General's Act 1997*, the Committee may identify an assurance audit as a priority for the Auditor-General. The provision allows the Auditor-General to use the information gathering process under the Act rather than relying on the agreement of the entity being audited. In effect, this circumvents delays and provides for a quicker auditing process.
- 3.103 Considering the importance of the MPR and the tight timeframe that it operates in, the Committee has identified future MPRs as priority assurance reviews to the Auditor-General.

Robert Oakeshott MP
Committee Chair
May 2012



Dissenting Report—Senator Mark Bishop

I wish to express dissent with the Committee's position as expressed at paragraphs 3.30 – 3.35 concerning the provision of information on indexation of project funding, and the reversal of the ANAO's previously expressed position.

The role of the Committee in scrutinising Defence accounts on behalf of the Parliament and the taxpayer, as assisted by ANAO, is to monitor the Defence procurement program for the delivery of important capability on budget, in light of a disastrous history of over expenditure. Not to mention extremely late delivery, getting worse, thereby dramatically reducing ADF capability.

In monitoring costs the Committee, through the Major Projects Review (MPR) conducted by ANAO, has traditionally received information on timelines, as well as original project cost as approved by government together with any approved changes in scope, and the effect of price escalation and foreign exchange movements as separate factors beyond the control of Defence and DMO.

Identification of both these latter variables has enabled the Committee to judge not just the overall performance of Defence and DMO in delivering Defence capability, but financial and project management in particular. The MPR report has to date provided detail on both those variables, but now, as agreed by DMO and ANAO, and accepted by the Committee, the indexation figure will no longer be provided for post 2010 projects. I don't accept that position for the following reasons.

As agreed by the Committee and many other critics over recent years, the largest single failing of the Defence procurement system is inadequate project specification and over optimism on part of Defence and industry, leading to cost blow outs and enormous delays. The result of that is that governments are effectively misled, resulting in additional disciplines and processes, and new measures of ensuring transparency and accountability, such as the JCPAA work and this MPR review process.

Within the funding process, 'the Government decision provides a limit on project expenditure apart from variations for price indexation, foreign exchange adjustments and other subsequent approval decisions'.¹ Within that project price, provision is also made for contingencies, which are unforeseen but inevitable, particularly in the case of large and complex projects. It's understood that caps are placed on both contingency and price indexation as a discipline in managing funds, but also imposing pressure for more accurate project specification and cost estimating from the outset. The Committee has no information of the level of contingency funding or the effectiveness of that discipline, but it has to date been provided with the detail of price indexation and foreign exchange variations within each project which have proven very informative and useful.

It's now asserted by DMO that it's no longer possible to report on price indexation, with the rationale that 'that information is not normally public' and that such itemisation 'is not part of the proposal that goes to government',² asserting also, rather presumptuously, that the Committee doesn't need to know. Putting aside this unfortunate attitude to which I object, if in fact there has been a change in budget practice by allowing global project funding, I believe it's a retrograde step at a time when transparency and accountability should be maintained not reduced.

Especially given that the total budget for price indexation last year was \$1.16 billion – no small amount to be hidden away.

Furthermore, given that such reporting has been possible to date, the Committee might well ask what has happened to make it administratively impossible as alleged. Indeed the advice of the Auditor General to the Committee was that in exchange for agreement to the use of out turn prices, which is logical, other 'sufficient disclosures' should be maintained to allow assessments to be made of project performance against budget' - including indexation amounts. Acceptance by the Auditor General of the DMO line is therefore somewhat disappointing, particularly given the tenacity which ANAO has shown over recent years in flushing out the inefficiency and waste within Defence procurement. In fact without ANAO there would be no MPR, little scrutiny at all, and the Parliament and the taxpayer would be blind.

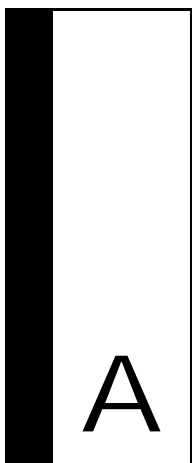
Simply put I believe that the current reporting on financial and output timeliness by DMO and Defence need to be retained. Noting too, that the government has also tightened up by placing a limitation on indexation for post 2010 projects whereby it ceases at the agreed delivery date, thus imposing a welcome added disincentive for time over runs and extra unbudgeted cost.

1 DMO response to Recommendation No. 7 JCPAA Report 422, paragraph 15.

2 JCPAA Report 429, paragraph 3.23.

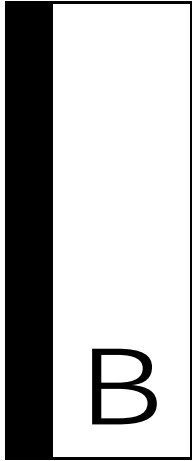
Notwithstanding the administrative task in reporting price indexation fluctuations, it's essential knowledge, just as contingency costs and exchange rate variations are. Together with approved project costs as contracted, they form a total picture by which the Committee and the Parliament can make judgements on the adequacy of performance of the bureaucracy involving hundreds of billions of dollars into the future, no different to any other area of administration.

The Committee should continue to gather accurate estimates for all expenditure, with all variables and risks identified and monitored. While such estimates might begin as notional, they are negotiated in contracts presumably, and inevitably become funds expended and must be acquitted. As a minimum I believe the Committee ought to expect to be informed of all estimates and expenditure of price indexation over the life of all MPR projects. The Committee's acceptance of the proposal for the DMO to simply provide an assurance that any one project will be completed within budget, in part defeats the Committee's purpose, and effectively removes an important area of transparency and accountability as a fundamental principle.



Appendix A – Submissions

- 1 Mr E J Bushell
- 2 Australian National Audit Office



Appendix B – Witnesses

Wednesday, 21 March 2012 - Canberra

Australian National Audit Office

Mr Ian McPhee, Auditor-General

Ms Michelle Page, Senior Director

Mr Michael White, Executive Director, Assurance Audit Services Group

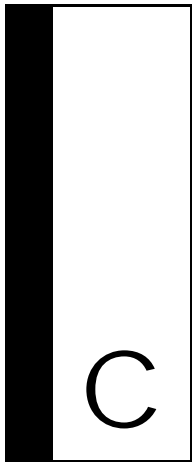
Department of Defence

VADM Peter Jones, Chief Capability Development Group

Mr. Warren King, Chief Executive Officer, Defence Materiel Organisation

Ms. Shireane McKinnie, General Manager, Defence Materiel Organisation

Mr Steve Wearn, Chief Finance Officer



Appendix C –
A Financial Performance Reporting Proposal
for the Defence Materiel Organisation Major
Projects Report: A response to
Recommendation 7 of the Joint Committee
of Public Accounts and Audit *Report 422:
Review of the 2009-10 Defence Materiel
Organisation Major Projects Report*



Australian Government

Department of Defence
Defence Materiel Organisation

A FINANCIAL PERFORMANCE REPORTING PROPOSAL FOR THE DEFENCE MATERIEL ORGANISATION MAJOR PROJECTS REPORT

A response to Recommendation 7 of the Joint Committee of Public Accounts and Audit
Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report

EXECUTIVE SUMMARY

1. In August 2006, the Joint Committee of Public Accounts and Audit (JCPAA) supported the development and submission to Parliament of an annual report – the Major Projects Report (MPR) – on major capital equipment projects. The guidelines for producing the MPR included a requirement for contract values and project expenditure to be shown in *current* dollar and *base date* terms¹. However, Defence has managed its internal budgets in *out-turned*² dollars since 2009-10 and from 2010-11 the Defence Materiel Organisation (DMO) followed suit and now manages project budgets in out-turned dollars. Consequently, the 2010-11 MPR disclosed project budgets in *out-turned* and, where possible, *base date* terms.
2. Since the inaugural MPR was tabled in November 2008, the Auditor-General has qualified its assurance of project financial data due to a “departure from the guidelines” in relation to disclosures, in *base date* terms, of: prime contract progress payments (2007-08 and 2008-09); and prime contract details and other project expenditures (2009-10 and 2010-11).
3. The DMO has consistently held the view that the *base date* dollar requirement provides limited value as a measurement of project performance and that it would be time consuming and costly to implement the systemic changes that would enable all projects to fully comply with this requirement. That is, there is no added benefit for Defence or the DMO in amending financial reporting systems to report solely for the MPR *base date* dollar calculations. The *base date* figures are only calculated for the MPR and are not used in other financial publications (including: Portfolio Budget Statements, Portfolio Additional Estimates Statements or Annual Report).
4. Fortunately, and recognising the difficulties encountered since 2007-08, the JCPAA, in Recommendation 7 of the JCPAA’s Report 422: Review of the 2009-10 Major Projects Report provided the DMO with an opportunity to review and provide a submission to adjust the MPR financial performance reporting.

Brief Description of the Financial Reporting Options

5. In essence, there are three options for reporting project cost performance and budget that could be considered by the JCPAA. They are:

¹ In the 2007-08 and 2008-09 Major Projects Reports, the *base date* value requirement only applied to the prime contract details provided in Table 2.7. The “*base date*” was taken as the date of contract signature unless otherwise specified in the contract. For the later MPRs, the term “*base date*” has not been defined and has been variously taken to mean prime contract signature date, Government Approval date and Government Second Pass Approval date.

² Method used to present forward looking cost estimates for Government consideration.

- a. In *base date* terms - removing price effects (indexation and exchange) from expenditure;
 - In simple terms, *base date* dollars attempts to ‘track’ all expenditures back to a particular point in time (i.e. considering financial management with the benefit of hindsight and knowledge of price indexation, foreign exchange rate fluctuations that have occurred), and recognising that a dollar in this financial year is normally worth less than a dollar last year.
- b. In *current dollar* terms - applying known price effects (indexation and exchange) up to the current period to the current approved budget; or
 - Current day dollars would present expenditure in the current financial year. That is, a dollar today is worth the value of a dollar today as we have catered for price indices and adjusted budgets accordingly. Although, the MPR does not escalate past actual historical expenditure to current year figures.
- c. In *out-turned* dollars - apply known and expected price effects (indexation and exchange) over the life of the project. This is the methodology currently used by Government when approving Budget Measures or any New Policy Proposals, including Defence’s major capital acquisitions.
 - Out-turned dollars methodology recognises that the dollar is worth less over time. Out-turning a project budget takes into account the planned increases in overall Defence spending due to inflationary pressures. This also provides greater surety to Government regarding expenditure estimated in the ‘outer-years’.

Preferred Method

6. Noting that Defence and the DMO receive major acquisition approvals in out-turned dollars and subsequently report progress against budget in out-turned dollars, the preferred option is to also present the MPR financial reporting in this manner. The major benefit of this change would be that all remaining financial data in the Project Data Summary Sheets can be sourced from, and subsequently verified with, existing financial management and reporting systems currently used in the DMO. There would be no need to manipulate project cost.

7. DMO is of the view that this presentation will assist the JCPAA to assess the likely cost outcome for projects. The out-turned budget presentation is consistent with the Commonwealth budget framework and historical cost accounting conventions. Furthermore, this presentation is a cost effective means of reporting budget and expenditure in like terms across all projects.

Comparison Year

8. Recommendation 7 of the JCPAA Report 422 also requests a “comprehensive proposal for transition towards the proposed new arrangement”. As a comparison arrangement for the 2011-12 MPR only, DMO proposes that the *base date* column in Tables 2.1 and 2.2 of the PDSS be retained in the PDSS for the 14 projects that were able to provide *base date* data in the 2010-11 MPR, but removed from the PDSS for the remaining projects.

9. For style purposes, DMO also proposes to combine the table headings for 2.1 and 2.2 as ‘Table 2.1 Project Budget and Expenditure History’ and re-number the subsequent tables of section 2 appropriately.

**A FINANCIAL PERFORMANCE REPORTING PROPOSAL FOR THE DEFENCE
MATERIEL ORGANISATION MAJOR PROJECTS REPORT**

**A response to Recommendation 7 of the Joint Committee of Public Accounts and Audit
Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report**

Background

1. In August 2006, the Joint Committee of Public Accounts and Audit (JCPAA) supported the development and submission to Parliament of an annual report on major capital equipment projects. The content of this report was jointly proposed by the Defence Materiel Organisation (DMO) and Australian National Audit Office (ANAO) and accepted by the JCPAA in September 2007. The 'pilot' report, tabled in November 2008, was developed with the intention of providing information that was not only timely, but useful in improving transparency and accountability surrounding major Defence acquisition projects.
2. The initial guidelines for producing the Major Projects Report (MPR) included, inter alia, a requirement to disclose in the Project Data Summary Sheets (PDSS):
 - a. in Table 2.1, project budget approval history, including variations for price indexation, foreign currency exchange rate variations and real cost increases and decreases³ in *current* terms;
 - b. in Table 2.3, project budget, expenditure and remaining budget as at the end of the financial year being reported in *current* terms; and
 - c. in Table 2.7, prime acquisition contract(s) price and progress payments to be "expressed in *base date* terms".
3. The initial guidelines and PDSS template were followed for the 2007-08 and 2008-09 MPRs. The Auditor-General's review of the first MPR was qualified due to the "uncertainty in relation to the reported information on prime contract expenditure at *base date* price" presented in Table 2.7. In the second MPR of 2008-09, the Auditor-General's review was again qualified because "contract *base date* figures" were not provided for three projects in Table 2.6 – Prime Acquisition Contractor(s) Real Price Increases and Capital Equipment Quantities Required and for 11 of 15 projects in Table 2.7 – Prime Acquisition Contractor(s) Price and Progress Payments.
4. Up until 2008-09, the generic term '*base date* dollars' referred to the value of a contract at signature and this requirement was included in order to present contract costs in real⁴ terms at the time of contract signature. However, since the inaugural MPR, in which projects attempted to present *base date* dollars for the prime contracts only, the Auditor-General has provided a qualified opinion on each MPR due to non-compliance with the requirement to report project (as opposed to contract) expenditure in *base date* dollars.
5. For the 2009-10 MPR the JCPAA endorsed a revised template which was intended to improve the presentation of the financial data. The revision attempted to combine tables 2.1

³ Defence Materiel Organisation – Major Projects Report 2007-08 ANAO Report No. 9 2008-09, p. 96

⁴ excluding the effect of inflation and exchange variation from the date of signature

(budget history), 2.2 (project expenditure history) and 2.3 (remaining budget) with table 2.7 (prime contract(s) data). This resulted in an implied requirement to report all project budget and expenditure data in both *current* and *base date* terms. The Auditor-General's review of the 2009-10 MPR was again qualified due to the departure from the guidelines, specifically a failure to report contract details in *base date* terms (in the new Table 2.3) for the Collins and Hornet projects, and a failure to report all or some project expenditure in *base date* terms for 19 of the 22 projects in the revised Table 2.2. This situation has endured and, despite only being required to report *base date* data for 11 of 28 projects in the 2010-11 MPR, the Auditor-General's review again provides a qualified conclusion based on a lack of disclosure, by three of those 11 projects, of *base date* information.

6. DMO's response to the qualification in the 2009-10 and 2010-11 reports reaffirmed that the qualification does not imply deficiencies in DMO's management of the projects or non-compliance with any accounting standards. The *base date* requirement is unique to the MPR report and, apart from variable price contracts, it requires the development of data by no defined methodology. The DMO has consistently maintained (since the 2007-08 MPR 'pilot' program and through successive MPRs) that this requirement is time consuming, costly and provides very limited value in relation to project management outcomes. Likewise, there is no justifiable benefit to amending the DMO's financial reporting systems to present this information purely for the MPR.

7. Consequently, Recommendation 7 of the JCPAA's *Report 422: Review of the 2009-10 Major Projects Report* provides the DMO with an opportunity to review and provide recommendations to adjust the financial performance reporting methodology for the 2011-12 MPR Program. Recommendation 7 states:

The committee recommends that the Defence Materiel Organisation present the findings of its examination of the presentation of financial data on all possible methods for project expenditure information (Eg. Base date dollars, outturned dollars and current dollars) to the Joint Committee of Public Accounts and Audit (JCPAA) as soon as it is completed and no later than 31 August 2011.

This examination should include a:

(1) preferred method, and

(2) comprehensive proposal for transition towards the proposed new arrangement. In

addition, the proposed examination should be reviewed by the Australian National Audit Office before it is submitted to the JCPAA for consideration and recommendation prior to inclusion in the MPR.

8. In addressing this recommendation, the DMO, in consultation with ANAO, has developed this paper to propose a revised MPR financial performance presentation which is congruent with the DMO's existing financial management framework, policy, reporting and supporting systems. Other options previously considered included Assets Under Construction (AUC) and statistical information analysis. However, for AUC this option was rejected because it captured only a proportion of the projects overall expenditure and related to the building of tangible assets. For the statistical analysis option, this was also rejected due to the concerns with the potential volatility of using averages for varying levels of expenditure throughout the year, and the potential for the relevant individual indices being materially different from any broad-based

indice. This paper describes the three approaches suggested in Recommendation 7 as options for presenting the Project Data Summary Sheets (PDSS) financial information and seeks the JCPAA's endorsement of the out-turned budget presentation as the preferred method.

9. **Scope.** This paper will argue that:

- a. the financial information presented in the PDSSs of the MPR should assist the JCPAA to assess whether there is risk that the DMO would not deliver the materiel equipment required by Government within budget;
- b. the key measures that need to be considered in this assessment are the project's budget, its expenditure to date and what is yet to be acquired with its remaining budget;
- c. the difficulty in comparing these measures stem from price effects (inflation) and foreign exchange rates during the life of the project;
- d. the out-turned budget presentation is consistent with the Commonwealth budget framework, the Department of Finance and Deregulation's costing principles, financial accounting standards and the way that DMO manages project finances;
- e. the out-turned budget presentation is a simple and objective method for presenting project financial information which allows the JCPAA to assess the likely cost performance of projects by including the effect of inflation in both the actual and budget amounts;
- f. a comparison or transition year would enable DMO and the ANAO to agree new criteria for the ANAO review of PDSS financial information and for the ANAO to develop an appropriate strategy for future MPR reviews;
- g. for only those materially significant variable price contracts that are managed in *base date* terms, it would be appropriate for those projects to report expenditure in *base date* dollars, in the 2011-12 MPR, in a separate 'Prime Contract Details' table; and
- h. the requirement for reporting financial data in *base date* terms should be removed from future MPRs.

JCPAA Assessment

10. Through the MPR, the JCPAA should be able to gain insight into a project's progress and assess whether Defence projects remain on-track and, in particular, whether the DMO is able to deliver the materiel elements of capability specified by Government on-time, within budget and to the required standard. In forming a view as to whether a project is likely to experience future cost pressure prior to completion, the JCPAA may wish to consider the following questions:

- a. does the expenditure on the project to date seem reasonable considering the total project budget and what has been achieved to date by the project?
- b. What is the likely cost for the project to be completed, in particular,
 - i. what expenditure obligations exist?
 - ii. what assumptions have been made about future price escalation?

- c. most importantly, does the project have sufficient remaining budget to deliver the required scope?

11. The MPR should provide relevant and reliable information to answer these questions. In particular, the MPR should provide the JCPAA with:

- a. assurance that project cost and budget information is accurate and that project approval, budget and cost records are maintained appropriately by DMO;
- b. visibility of how much of a project's budget has been spent which can be aligned with the project's progress in delivering equipment;
- c. a view on the likely cost to complete the project taking into account future expenditure plans, contractual commitments and estimated price escalation; and
- d. an appreciation of the financial risk faced by the project based on the above performance information.

Kinnaird Review – Cost Estimating

12. The approved value for a project can be expressed legitimately in 'real' or 'nominal' terms (i.e. excluding or including the effects of inflation). Through the two-pass approval process for major projects which was established following the Kinnaird Review, Government approves the scope and estimated cost for each project following consideration of the project approval submission. The Cabinet Handbook requires that the cost estimates for second-pass consideration are presented in out-turned dollars.

13. Before June 2010, post-approval expenditure budgets for DMO acquisition projects were priced in 'current' year dollars. At budget milestones, project budgets were updated based on prevailing indices and were updated to the new budget year price basis with each new financial year. Up to the 2009-10 MPR, the total budget in the PDSSs were expressed in 'current prices' which reflected the prevailing DMO and Defence budget management approach at the time.

14. In July 2010, DMO commenced financially managing all its budgets (including Acquisition Program budgets) on an out-turned price basis. The reason for this change was to ensure consistency with Defence and Commonwealth budgets which are managed on an out-turned basis. An exercise was undertaken during May and June 2010 to identify those projects that had been transferred to DMO with approved prices expressed in current year prices and to out-turn their remaining budgets. In the 2010-11 MPR, the total budget was expressed in out-turned dollars to reflect the change to out-turned budgeting.

Defence and DMO Funding Model.

15. Once a project is approved by Government, the Government decision provides a limit on project expenditure apart from variations for price indexation, foreign exchange adjustments and other subsequent approval decisions. The funding for the project however, flows through the normal Defence budget process and the subsequent annual payment to DMO by Defence for the estimated project expenditure that has occurred that year. In summary, the Government project approval decision is a governance measure, not a funding mechanism.

MPR Financial Information

16. The financial information in the PDSSs shows the budget and expenditure positions as at 30 June each year. This information enables judgements to be made about project cost performance as described above. Given the variables, there will be uncertainty as to whether the project's deliverables will be achieved at or below approved cost until close to project completion; however, a level of confidence can be achieved by considering the current approved project value (i.e. Total Budget in the PDSS), the expenditure incurred by the project to date (i.e. Total Expenditure in the PDSS), the difference between the Budget and Expenditure (i.e. Remaining Budget in the PDSS), and then evaluating whether the project can be completed with the Remaining Budget.

17. A simple comparison of these measures has the potential to be misleading because of the effect of inflation and foreign exchange movements. The financial information in the PDSS can be expressed in several ways, including:

- a. In *base date* terms - removing price effects (indexation and exchange) from expenditure;
- b. In *current* dollar terms - applying known price effects (indexation and exchange) up to the current period to the approved budget; or
- c. In *out-turned* dollars - apply known and expected price effects (indexation and exchange) over the life of the project.

18. The method used must provide a satisfactory outcome to enable the JCPAA to determine whether a project is likely to be completed within approved cost using a 'like-for-like' comparison between budgeted and expended amounts with regard to the effect of inflation.

An example

19. To illustrate how the three approaches would be applied, a simple example is used. A project with a planned spend spread of eight years is approved by Government in Year 1 with a total cost estimate of \$169 in current dollars at the time of approval. If inflation is estimated to be five per cent per annum (effective from year 2 onwards), this would produce an out-turned project cost estimate of \$200 – Table 1 refers. Once approved by Government, this becomes the project Budget.

Table 1. Sample Project Estimated Cost and Spend Spread.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Total
Estimate	\$10	\$19	\$27	\$35	\$33	\$24	\$15	\$7	\$169
Out-turned	\$10	\$20	\$30	\$40	\$40	\$30	\$20	\$10	\$200

20. Table 2 below shows the budget and actual amounts after year 4 that would apply under each method.

Table 2. Financial Performance at end Year 4

Year	Expenditure (Base date)	Expenditure* (Current)	Expenditure* (Out-turned)
1	\$10	\$10	\$10
2	\$19	\$20	\$20
3	\$27	\$30	\$30
4 (present year)	\$35	\$40	\$40
Total	\$91	\$100	\$100
Original Budget	\$169	\$191	\$200
Remaining Budget	\$78	\$91	\$100

*for simplicity, it is assumed that pre-approval estimates for cost and inflation were accurate and did eventuate.

Base date dollar presentation

21. In *base date* terms, we would compare project expenditure to the original Government approval by manipulating the actual expenditure records to account for the effects of inflation. In short, we would report that the project's expenditure to date was equivalent to \$91 in *base date* dollars and we would compare this to a manipulated Government project approval value of \$169 (the Government would have approved a \$200 out-turned amount) and as such we can determine that the remaining budget is \$78 in *base date* terms. Budget, expenditure and remaining budget are all compared in like terms, albeit some have been calculated.

Advantages.

- In addition to the 'in like terms' comparison for a project's finances, *base date* analysis attempts to compare cumulative project costs with a calculated project approval that is exclusive of inflation and foreign exchange.

Disadvantages.

- The *base date* presentation requires a single *base date* to be determined and agreement on which indices should be used in the 'de-escalation' to the *base date*. The use of multiple *base dates*, or differing indexes, would introduce discrepancies that reduce the utility of the resulting *base date* values in any analysis.
- The *base date* values in one project can only be used in the analysis of the financial performance of that particular project because the various projects were approved at different times. That is the *base date* values for older projects (HF Mod) would not be 'in like terms' with *base date* values of a newer project (SATCOM).
- DMO financial management and information systems are not designed to produce project financial data in *base date* terms.

22. The key problem with *base date* dollars, which stems from the first dot point above, is the arbitrary nature that is introduced when the price escalation component has to be selected because the purchasing arrangements for the project are not all through variable price contracts. This introduces a level of subjectivity, and likely inaccuracy, which undermines the certainty and confidence that can be placed upon the calculated values when making judgements. Furthermore, the *base date* presentation of project approval presents the project budget as it may have been at a particular point in time without regard for changes in economic relativities and the impact of subsequent Government decisions. Comparing costs adjusted to *base date* dollars

becomes less relevant when the original Government approval has been varied for subsequent decisions by Government.

23. In the 2010-11 MPR the materially significant price contracts that feature in the project have been examined to determine what payments were due to contractual price variation (indexation). These payments were then excluded from the actual expenditure calculations against the contract(s) to produce the '*base date*' value of expenditure against the contract. This is a reasonable determination. However, the average percentage by which the significant contract(s) actual and base price expenditures differed was applied to other expenditures in order to determine a "*base date dollar*" value for those other expenditures. This is where the subjectivity and likely inaccuracy is introduced. For example, a single firm price prime contract produces a percentage of zero, i.e. other expenditure is not de-escalated, multiple variable price contracts produce an average percentage, i.e. other expenditure is 'de-escalated' at a rate different to all contract expenditures.

24. Given the divergence between approval and contract signature dates and the varying contract dates, durations and percentages it is unlikely that the resultant *base date* dollars could be considered accurately representative of the financial status of any of those projects.

Current dollars presentation

25. Under the current dollar presentation, project actual expenditure to date is presented without modification and the project budget for the current years is updated to the prevailing price and foreign exchange rates. The unspent project budget in future years is updated using current year inflation and exchange rates.

26. In the simplified example above, the actual expenditure after 4 years was \$100, the project budget has received supplementation of \$22, so far, applying the historical 5% inflation to remaining budget in each of Years 2 to 4 and the remaining budget would be \$91 in *current* terms. In the MPR context, *current* dollar values have been used in the Cost Performance analysis of the first three MPRs.

Advantages.

- A broad cross-project cost performance analysis can be performed, because all projects' financial data are price adjusted to a common price basis. Current dollar analysis introduces the realities of what has happened since project approval. This lends a 'layman' understanding to the remaining budget figures which are presented in today's terms.
- Actual expenditures are readily available in DMO's current financial reporting systems.

Disadvantages.

- The current dollar presentation does not align with current Defence and DMO budgeting policy. Remaining budgets in *current* dollars are no longer readily available in DMO's financial reporting systems.
- All future inflation and exchange rates are assumed to remain constant with the current budget year.

Out-turned budget presentation

27. An alternative presentation for project cost and budget information in the PDSS is to present the actual costs as they are without manipulating them and compare them to the original Government approved budget, which is an out-turned amount. That is, both the actual and budget amounts include inflation and therefore, no arbitrary manipulation of financial information is required. In the example above, after year 4, the project expenditure to date would be reported as \$100 and the remaining budget would be reported as \$100, which added together reflect the Government project approval value.

Advantages.

- In addition to the ‘in like terms’ comparison for an individual project’s finances, this method gives a sense of what the project is likely to cost at the end of the project, i.e. in future dollar terms. This method introduces allowances for price variation and budget policy out to the forecast end of the project.
- A key issue for assessing project cost risk and a significant advantage of the out-turned budget presentation over *base date* dollars is the immediate visibility at reporting date of a potential ‘cost to complete’ pressure. It highlights the difference between a project’s known funding and the cost to complete.
- DMO’s current financial budgeting and reporting systems align with the requirement to present estimates in out-turned dollars. Project budget and actual expenditure methodologies will not need to be adjusted.
- Consistency with accounting standards for reporting historical costs.
- Consistency with current methods for recording and reporting project budgets in public documents such as the Defence Annual Report, Portfolio Budget Statements and Portfolio Additional Estimates Standards, all of which are presented in out-turned dollars.

Disadvantages.

- This is a change from the previous way of reporting the MPR.

28. The chart below represents graphically the difference between stating financial data (budget and expenditure) in *out-turned*, *current* and *base date* terms over the life of the project. Ultimately, it demonstrates that all methods allow an analysis of a project's cost performance through a comparison of the project's budget and expenditure 'in like terms'. It also highlights the reducing impact of indexation with the passage of time or as projects approach completion.

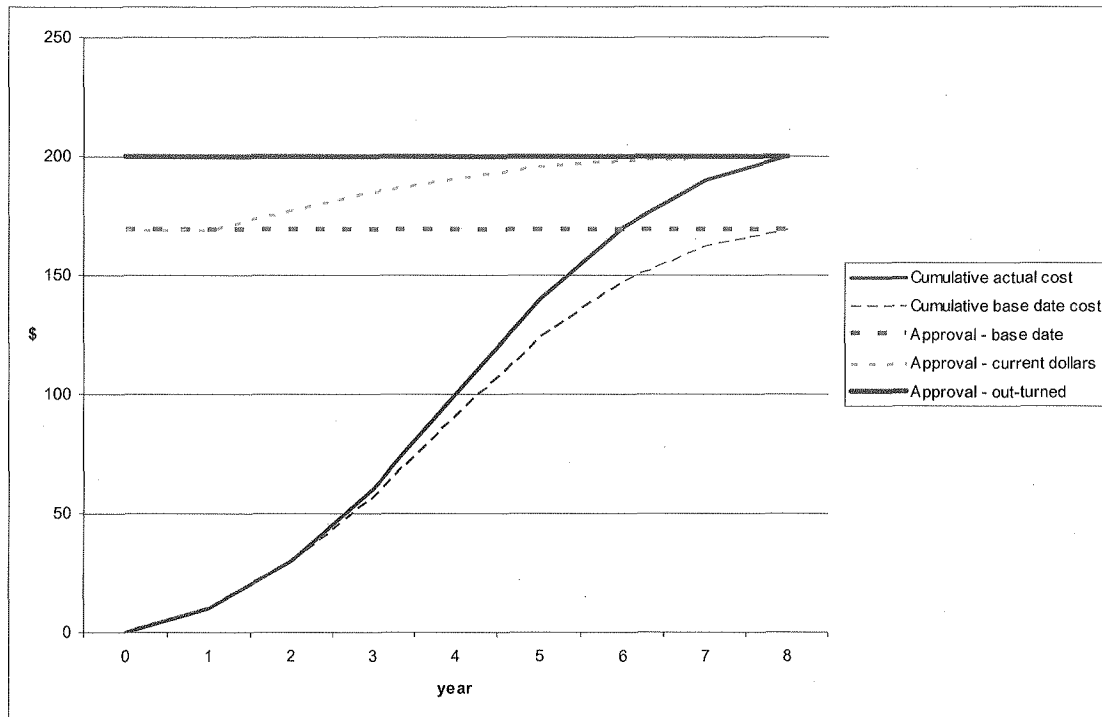


Chart 1. Demonstration of price effects for project budget and actual expenditure

The preferred method

29. Of the three methods for presenting PDSS financial information described above, the out-turned budget presentation is consistent with the Defence and Commonwealth budget framework and offers an objective and simple view of how a project is tracking within its approved budget. Furthermore, the JCPAA may wish to link the cost to complete view with the capability delivery (schedule) view. This is a paramount consideration and establishes clear visibility of financial and capability risk. The strengths of this approach and the limitations of the others, particularly *base date* dollars, are as follows:

- a. **Consistency with accounting standards for reporting historical costs.** Historical cost is the basis of presenting financial transactions in financial statements. This means that actual cost information is presented without manipulation. Under this method project cost information is presented as it is in other Commonwealth Budget documentation. No adjustment is made based on applying an arbitrary, de-escalation rate.
- b. **Consistency with the current method for recording and reporting project budgets.** Project approval amounts reported in all public documents, such as the Defence Annual Report, Portfolio Budget Statements and Portfolio Additional

Estimates Statements, are presented in out-turned dollars. All budgets in DMO are now managed in out-turned dollars and remaining budgets have been out-turned. When a project transfers from Defence to DMO, the approved price for the project (ie the agreed DMO element of the project approval) is also in out-turned dollars.

- c. **Objectivity.** The approved Government out-turned budget and the subsequent expenditure do not require potentially inaccurate adjustment to arrive at legitimately comparable figures. Budget is stated up front and incorporates a consideration of price movement, and can be compared with ordinarily price affected expenditure as it occurs.
- d. **Simplicity and ease of making judgements about likely project cost performance.** As demonstrated by the example above, the out-turned budget presentation provides a clear view as to whether a project is likely to be completed within its approved budget.

Transition proposal to remove base date information

30. The current presentation of data includes actual expenditure and out-turned budget as well as the same data in *base date* terms (where possible and required) all included in Tables 2.1 and 2.2. An example of the current presentation is at Annex A.

31. For style purposes, DMO proposes to combine the table headings for 2.1 and 2.2 as 'Table 2.1 Project Budget and Expenditure History' and re-number the subsequent tables of section 2 appropriately.

32. As a transitional arrangement for the 2011-12 MPR that would be discontinued for subsequent reports, DMO proposes to retain the *base date* column for the 14 projects that were able to provide *base date* data for the 2010-11 MPR. An example of the proposed Section 2 tables for the 14 projects is presented at Annex B.

33. The DMO proposes the *base date* column be removed from Tables 2.1 in the PDSS template for the remaining projects. An example of how this would look is in annex C.

Conclusion

34. The financial information presented in the PDSSs of the MPR should assist the JCPAA to assess whether each project is likely to deliver the equipment required by Government within its approved budget. The key measures that need to be considered in doing this are the project's estimated cost, its expenditure to date and what is yet to be spent. These data should be presented in like terms.

35. The current approach to making these measures comparable does not require reporting of financial data in *base date* terms, which has proven problematic to implement. Additionally, there is no Commonwealth approved policy and method for determination of a *base date* and calculation of *base date* dollars, and the transference of contractual indexation rates on to other project expenditure introduces a significant margin of error since a significant portion of project actual costs do not come from variable price contracts.

36. DMO has proposed that the actual expenditure and out-turned budget presentation is the preferred approach as:

- a. allows cost objectivity and is consistent with the historical cost convention,
- b. it is consistent with the way that Defence and DMO financially manage projects,
- c. it is consistent with the way that project financial information is reported through other public documents, and
- d. it allows the JCPAA to readily assess the past cost performance and make judgements about likely cost outcomes.

37. A comparison year would enable DMO and the ANAO to develop an appropriate review strategy for future MPRs. It would also assist the JCPAA and the MPR reader in the transition from *base date* dollar to out-turned reporting. In that regard, it would be appropriate for projects that can reliably report contract expenditure information in *base date* terms to do so in the 2011-12 MPR via a separate table. Those projects would report the expenditure under the prime contract or where there is no prime contract but more than one materially significant contract, up to five contracts. 'Materially significant contracts' being those with a value equivalent to at least 10 per cent of total project value and being at least \$10 million in value.

Recommendations

38. It is recommended that the JCPAA agree that:

- a. table headings 'Table 2.1 Project Budget History' and 'Table 2.2 Project Expenditure History' of the PDSS template be combined to become 'Table 2.1 Project Budget and Expenditure History' as a heading for the first table in Section 2 (subsequent tables to be re-numbered accordingly);
- b. for the 2011-12 MPR, the requirement to report expenditure in *base date* terms, only apply to the 14 projects that were able to provide *base date* dollar information in 2010-11 and, for these 14 projects, the *base date* column be retained in Table 2.1;
- c. for the remaining projects, the *base date* column be removed from Table 2.1; and
- d. for the 2012-13 MPR and future MPRs, the requirement to report project budgets and expenditures in *base date* terms be removed.

Annexes:

- A. Financial performance schedule used in 2010-11 PDSS
- B. Proposed Financial Performance Schedule for Projects Required to Report Base Date dollars in 2011-12 MPR
- C. Proposed Financial Performance Schedule for Projects Not Required to Report Base Date Dollars in 2011-12 MPR

FINANCIAL PERFORMANCE SCHEDULE USED IN 2010-11 PDSS

Section 2 – Financial Performance

Date	Description	Base date \$m	Current \$m	Contractor	Notes
2.1 Project Budget History					
Nov 03	Original Approved	3.1	3.1		1
Aug 04	Real Variation – Budgetary Adjustments	(0.1)	(0.1)		2
Sep 04	Real Variation – Scope	4.8	4.8		3
Nov 05	Real Variation – Scope	29.6	29.6		4
Government Second Pass Approval					
Jun 07	Approval	2,920.8	2,920.8		
Oct 08	Real Variation – Transfer	9.4	9.4		5
		2,964.5		2,964.5	
Jun 10	Price Indexation			428.4	
Jun 10	Exchange Variation			(264.9)	
Jun 10	Total Budget	2,967.6	3,131.0		
2.2 Project Expenditure History					
Prior to Jun10		868.2	952.1	BAE Systems	
		53.98	59.2	Other	
		922.18		1,011.3	
FY to Jun 11		303.0	344.3	BAE Systems	
		9.06	10.3	Other	6
		312.06		354.6	
Jun 11	Total Expenditure	1,234.24		1,365.9	
Jun 11	Remaining Budget	1,733.36		1,765.1	
Notes					
1	This project's original DMO budget amount is that prior to achieving Second Pass Government approval.				
2	Administration savings harvest.				
3	To fund a risk reduction activity for the Project to obtain design data and develop designs to meet Australian essential requirements.				
4	First Pass approval.				
5	Transfer of funding for technical studies from DSTO.				
6	Other expenditure comprises: Operating Expenditure, Offer Definition, Consultants, Foreign Military Sales, Contractor Support and Minor Capital expenditure not attributable to the Prime contract.				

2.3 In-year Budget Expenditure Variance

Estimate \$m	Actual \$m	Variance \$m	Variance Factor	Explanation
			FMS	
			Overseas Industry	
			Local Industry	
			Brought Forward	
			Cost Savings	
			FOREX Variation	
			Commonwealth Delays	
500.7	500.0	(0.7)	Total Variance	

2.4 Details of Project Major Contracts

Contractor	Signature Date	Price (Base) at		Type (Price Basis)	Form of Contract	Notes
		Signature	30 Jun 11			
BAE Systems	Oct 07	2,268.1	2,287.7	Firm	ASDEFCON	1
Notes						
1 Contract Price at Revision 35						
Contractor	Quantities as at		Scope	Notes		
	Signature	30 Jun 11				
BAE Systems	2	2	LHD ships and integrated support systems			
Major equipment received and quantities to 30 Jun 11						
Detailed Design Review achieved. Construction of main hull sections underway.						

**PROPOSED FINANCIAL PERFORMANCE SCHEDULE FOR PROJECTS REQUIRED TO REPORT
BASE DATE DOLLARS IN 2011-12 MPR PDSS**

Section 2 – Financial Performance

2.1 Project Budget and Expenditure History

Date	Description	\$m (base date)	\$m (out-turned)		Contractor	Notes
Nov 03	Original Approved	3.1	3.1	3.1		1
	Real Variation – Budgetary					2
Aug 04	Adjustments	(0.1)	(0.1)			
Sep 04	Real Variation – Scope	4.8	4.8			3
Nov 05	Real Variation – Scope	29.6	29.6			4
	Government Second Pass Approval					
Jun 07	Approval	2,920.8	2,920.8			
Oct 08	Real Variation – Transfer	9.4	9.4			5
		2,964.5		2,964.5		
Jun 10	Price Indexation			428.4		
Jun 10	Exchange Variation			(264.9)		
Jun 10	Total Budget	2,967.6		3,131.0		
Prior to Jun10	Expenditure	(868.2)	(952.1)		BAE Systems	
		(53.98)	(59.2)		Other	
		(922.18)		(1,011.3)		
FY to Jun 11		(303.0)	(344.3)		BAE Systems	
		(9.06)	(10.3)		Other	
		(312.06)		(354.6)		
Jun 11	Total Expenditure	(1,234.24)		(1,365.9)		6
Jun 11	Remaining Budget	1,733.36		1,765.1		

Notes

1	This project's original DMO budget amount is that prior to achieving Second Pass Government approval.
2	Administration savings harvest.
3	To fund a risk reduction activity for the Project to obtain design data and develop designs to meet Australian essential requirements.
4	First Pass approval.
5	Transfer of funding for technical studies from DSTO.
6	Other expenditure comprises: Operating Expenditure, Offer Definition, Consultants, Foreign Military Sales, Contractor Support and Minor Capital expenditure not attributable to the Prime contract.

2.2 In-year Budget Expenditure Variance

Estimate \$m	Actual \$m	Variance \$m	Variance Factor	Explanation
			FMS	
			Overseas Industry	
			Local Industry	
			Brought Forward	
			Cost Savings	
			FOREX Variation	
			Commonwealth Delays	
500.7	500.0	(0.7)	Total Variance	

2.3 Details of Project Major Contracts

Contractor	Signature Date	Price (Base) at		Type (Price Basis)	Form of Contract	Notes
		Signature	30 Jun 11			
BAE Systems	Oct 07	2,268.1	2,287.7	Firm	ASDEFCON	1
Notes						
1	Contract Price at Revision 35					
Contractor	Quantities as at		Scope	Notes		
	Signature	30 Jun 11				
BAE Systems	2	2	LHD ships and integrated support systems			
Major equipment received and quantities to 30 Jun 11						
Detailed Design Review achieved. Construction of main hull sections underway.						

Note: DMO suggests changes to numbering and labelling of tables.

PROPOSED FINANCIAL PERFORMANCE SCHEDULE FOR PROJECTS NOT REQUIRED TO REPORT BASE DATE DOLLARS IN 2011-12 MPR PDSS

Section 2 – Financial Performance

2.1 Project Budget and Expenditure History

Date	Description	\$m (out-turned)	Contractor	Notes
Nov 03	Original Approved	3.1		1
	Real Variation –			2
Aug 04	Budgetary Adjustments	(0.1)		
Sep 04	Real Variation – Scope	4.8		3
Nov 05	Real Variation – Scope	29.6		4
	Government Second Pass Approval			
Jun 07		2,920.8		
Oct 08	Real Variation – Transfer	9.4		5
		2,964.5		
Jun 10	Price Indexation	428.4		
Jun 10	Exchange Variation	(264.9)		
Jun 10	Total Budget	3,131.0		
Prior to Jun10	Expenditure	(952.1)	BAE Systems	
		(59.2)	Other	
		(1,011.3)		
FY to Jun 11		(344.3)	BAE Systems	
		(10.3)	Other	6
		(354.6)		
Jun 11	Total Expenditure	(1,365.9)		
Jun 11	Remaining Budget	1,733.36		
		1,765.1		

Notes

1	This project's original DMO budget amount is that prior to achieving Second Pass Government approval.
2	Administration savings harvest.
3	To fund a risk reduction activity for the Project to obtain design data and develop designs to meet Australian essential requirements.
4	First Pass approval.
5	Transfer of funding for technical studies from DSTO.
6	Other expenditure comprises: Operating Expenditure, Offer Definition, Consultants, Foreign Military Sales, Contractor Support and Minor Capital expenditure not attributable to the Prime contract.

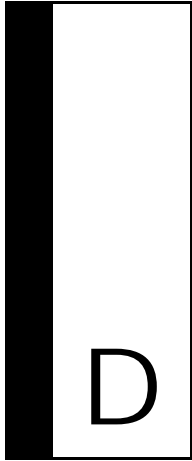
2.2 In-year Budget Expenditure Variance

Estimate \$m	Actual \$m	Variance \$m	Variance Factor	Explanation
			FMS	
			Overseas Industry	
			Local Industry	
			Brought Forward	
			Cost Savings	
			FOREX Variation	
			Commonwealth Delays	
500.7	500.0	(0.7)	Total Variance	

2.3 Details of Project Major Contracts

Contractor	Signature Date	Price (Base) at		Type (Price Basis)	Form of Contract	Notes
		Signature	30 Jun 11			
BAE Systems	Oct 07	2,268.1	2,287.7	Firm	ASDEFCON	1
Notes						
1	Contract Price at Revision 35					
Contractor	Quantities as at		Scope	Notes		
	Signature	30 Jun 11				
BAE Systems	2	2	LHD ships and integrated support systems			
Major equipment received and quantities to 30 Jun 11						
Detailed Design Review achieved. Construction of main hull sections underway.						

Note: In addition to removal of Base Date column, DMO also suggests changes to numbering and labelling of tables.



Appendix D –
Correspondence from the Mr Ian McPhee,
Auditor-General to Mr Robert Oakeshott,
Chair, Joint Committee of Public Accounts
and Audit



23 January 2012

Mr Robert Oakeshott MP
Chair
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Mr Oakeshott

Major Projects Report – Presentation of Financial Data for 2011–12

The Defence Materiel Organisation (DMO) has provided the Australian National Audit Office (ANAO) with an updated draft proposal on the presentation of financial data for the Major Projects in the light of recommendation 7 of the Committee's Report 422 *Review of the 2009–10 Defence Materiel Organisation Major Projects Report*.

By way of background, presentation of financial information for projects in 'base date dollars' has been a requirement of the Guidelines since the inception of the Major Projects Report (MPR), and also the subject of considerable debate and discussion. While it has been generally understood that presenting information in base date dollars is not ideal for all projects, it has been well aligned to the contract management for others.

For example, the Fast Frigate Guided (FFG) upgrade project which received second pass approval in June 1999, has not maintained records or systems that readily support the provision of financial data in the base date dollar format. Conversely, some current projects such as AWD Ships and LHD Ships have contracts specifying base dates, with contract payments made and recorded on this basis. However, for the MPR's up until 2010–11, a common financial presentation, that provided all of the data required by the Committee, providing a consistent format for all projects in the MPR has not been available.

From 1 July 2010, the DMO transitioned to a budgetary framework whereby the financial information is presented on an 'out-turned' basis, and has proposed that the MPR for 2011–12 adopt this framework. Being conscious of the move to the out-turned budgetary framework and its alignment with the requirements of the Commonwealth's budgetary framework, including Defence's, there are clear benefits in the budgeting information in the MPR being transitioned to an out-turned presentation, provided sufficient disclosures are maintained to allow assessments to be made of project performance against budget. With adequate reflection of those disclosures previously considered desirable, i.e. budget at first and second pass approval, indexation amounts, foreign exchange and real adjustments, it is possible to provide the Committee with a consistent format for all projects. This should also facilitate the efficient compilation and review of the Project Data Summary Sheets (PDSSs).

Based on the submission provided by the DMO, but allowing for the above, the ANAO has developed a template for the Committee's consideration (Attachment A). This template is

based on the DMO proposal but highlights the additional disclosures (in light type) the Committee may wish to consider. Further explanation of the ANAO proposal is set out hereunder.

- *Disclosure of both First and Second Pass Approval*

Our understanding is that the Committee's interests lie in gaining a full picture of a project's budget and expenditure over time, not just those areas of the DMO's responsibility. In order to fully disclose a project's budget and expenditure, both first and second pass approvals (where existing) would need to be included, and as they are formal government milestones, this allows for consistent reporting across the various publicly available documents. We understand this aligns with the DMO's approach.

- *Disclosure of itemised indexation amounts for budget and expenditure*

While we appreciate the benefits for the DMO and Defence moving to an out-turned dollar presentation, the proposal by the DMO is to report project indexation at an aggregated level, in both the budgetary and expenditure sections of the PDSSs. This will lead to issues of comparability, and in essence is a reduction in information for the 14 projects in the 2010–11 MPR, which have successfully provided base date dollar information. However, if appropriate disaggregation of the presented amounts is maintained, this should be overcome. We have been advised by the DMO that this is in alignment with the new management processes implemented to support reporting in out-turned dollars.

- *Foreign Exchange and Real Adjustments*

The DMO proposal makes no suggestion of changes to the previous presentation of these two areas of significance in a project's budget and expenditure presentation, and the ANAO concurs with this position.

- *Other Additional Disclosures*

To enhance the financial presentation further, the ANAO also recommends the Committee consider additional descriptors as presented within the table at Attachment A. These descriptors are designed to assist the reader in the review of the financial information presented within each PDSS.

If the Committee agrees with the proposal to remove the requirement for base date dollars, the ANAO would suggest consideration of the amendments included at Attachment A. These amendments will allow for one consistent presentation of the financial information included within the PDSSs, provide the same level of data as under the base date dollar regime, and improve the readability of the MPR across all projects.

Additionally, as the 2010–11 MPR included 14 projects reporting in both base date and out-turned dollar formats, it may be worth considering whether the DMO's proposal for a transitional year is necessary, as it will provide no more information for readers than that reported in the previous year.

It is also important to recognise that the introduction of out-turned dollar reporting will, in all likelihood, raise some issues for those projects that currently manage in base date dollars, i.e. those projects with variable price contracts. However, we understand that the DMO is providing project managers with tools to assist with this transition.

On a separate issue, the Committee will recall that the recent amendments to the *Auditor-General Act 1997*, following your inquiry, provided that the Committee may identify an assurance review as a priority. A review so identified is a priority assurance review (subsection 19A(5)). The main consequences of the Committee identifying a review as a priority review is that it allows the Auditor-General to use the information gathering process under the Act rather than relying on the agreement of the entity being audited (section 31).

While the DMO has always provided high levels of cooperation to allow our review of the MPR and access has never been a problem, this is an issue the Committee may wish to consider given its influential role leading to the development of the MPR, and its ongoing interest.

If the Committee was to agree to our review of the MPR being a priority review, this would result in a consequential change in our current agreement with the DMO pursuant to section 20 of the Act.

We would be happy to discuss these matters with you or your staff. The relevant ANAO contact officer is Mr Michael White who can be contacted on 02 6203 7393.

Yours sincerely

A handwritten signature in black ink, appearing to read 'I. McPhee', with a long horizontal flourish extending to the left.

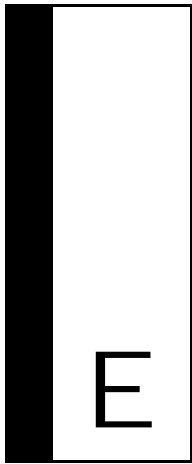
Ian McPhee
Auditor-General

Section 2 - Financial Performance

Date	Description	ANAO PROPOSED out-turned dollars \$m 2011-12 Format	Contractor	Notes
2.1 Project Budget History				
Nov-03	Original Approved	3.1		1
Sep-04	Real Variation – Scope	4.8		2,3
Nov-05	Real Variation – Scope	29.6		4
Jun-07	Government Second Pass Approval	2,920.8		
Oct-08	Real Variation – Transfer	9.3		5
	Total Nominal Budget	2,967.6		
Jun-10	Price Indexation to 30 June 2010	350.0		
Jun-12	Price Indexation (out-turned)	[80.8]		6
Jun-12	Exchange Variation	-273.4		
	Total Indexation & Exchange Adjustments	157.4		
Jun-12	Total Budget	3,125.0		
2.2 Project Expenditure History				
Prior to Jul 11	Prime Contract Payments	952.1	BAE Systems	
	Other Contract Payments / Internal Expenses	59.2	Other	7
		1,011.3		
FY to Jun 12	Prime Contract Payments	541.1	BAE Systems	
	Other Contract Payments / Internal Expenses	16.4	Other	8
		557.5		
Jun-12	Total Expenditure	1,568.8		
Jun-12	Remaining Budget	1,556.2		
	Remaining Budget attributable to:			
	Remaining Indexation	[71.3]		
	Remaining Nominal Budget	[1,484.9]		
Notes				
1	This project's original DMO budget amount is that prior to achieving Second Pass Government approval.			
2	In the 2009-10 MPR, an amount of 0.1m was reported as a Real Variation due to a Budgetary Adjustment for an Administration savings harvest. It should have been rounded to 0.0m and is therefore no longer being reported.			
3	To fund a risk reduction activity for the Project to obtain design data and develop designs to meet Australian essential requirements.			
4	First Pass approval.			
5	Transfer of funding for technical studies from DSTO.			
6	Up until July 2010, indexation was applied to project budgets on a periodic basis. The cumulative impact of this approach was \$350m. In addition to this amount, the impact on the project budget as a result of out-turning was a further \$78.4m having been applied to the remaining life of the project. The out-turned calculation is adjusted annually to reflect actual movements in the index.			
7	For base date calculations against "Other" expenditure, calculations have been made using a proportional adjustment. This proportional adjustment involves the average between base date calculation of the disclosed major contract(s) and their constant price and applying to the "Other" expenditure.			
8	Other expenditure comprises: Operating Expenditure, Offer Definition, Consultants, Foreign Military Sales, Contractor Support and Minor Capital expenditure not attributable to the Prime contract. For base date calculations against "Other" expenditure, calculations have been made using a proportional adjustment. This proportional adjustment involves the average between base date calculation of the disclosed major contract(s) and their constant price and applying to the "Other" expenditure.			

Notes:

1. Out-turning indexation is the allowance within the budget for price increases that apply from 2010-11 until the project's estimated completion date.
2. Numbers in "[]" are not actual numbers and do not represent the result of calculations performed by the ANAO. These figures would differ in a real world scenario.



Appendix E –
Correspondence from Mr Warren King,
Chief Executive Office, Defence Materiel
Organisation to Mr Robert Oakeshott, Chair,
Joint Committee of Public Accounts and
Audit



Australian Government
Department of Defence
Defence Materiel Organisation

Chief Executive Officer
R2-5-C074
Russell Offices
CANBERRA ACT 2600
Ph: (02) 6265 3742
FX: (02) 6266 7641

CEO DMO/OUT/2012/78

Mr Rob Oakeshott MP
Chair
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Mr Oakeshott,

**PRESENTATION OF FINANCIAL DATA FOR THE DEFENCE MATERIEL
ORGANISATION MAJOR PROJECTS REPORT**

1. At the private briefing to the Joint Committee of Public Accounts and Audit on Wednesday 8 February 2012, the Auditor-General and I undertook to provide you with an agreed position on the financial disclosures section of the Major Projects Report (MPR).
2. The Auditor-General and I have reviewed the proposed formats as presented in our separate papers to the Committee and, having also noted the guidance of the Committee provided on 8 February 2012, are pleased to advise that we have arrived at an agreed format for the financial performance presentation. This format does not differ greatly from that previously presented to the Committee, but establishes the construct of 'out-turned' budgets and recognises the availability of the financial data from the current DMO financial management systems.
3. The agreed format is contained at Attachments A and B. Attachment A covers those projects who received Government Approval prior to July 2010 (when projects were approved in constant dollars). Attachment B addresses the post June 2010 approved projects (when projects were approved in out-turned dollars). I recommend these templates to the Committee and suggest that they be implemented for the 2011-12 MPR (i.e. as at 30 June 2012). I understand that the Auditor-General will also be recommending these templates to the Committee.
4. I therefore respectfully request the Committee's consideration and approval of the templates at Attachment A and B.
5. On a related issue, the Auditor-General and I have agreed that the DMO should provide an assurance statement for each project as to whether there is sufficient budget remaining to deliver the materiel element of capability at the agreed Final Materiel Release (FMR) milestone. In this regard, we have provided a 'Project Assurance Statement' which is intended to provide an overall assessment of the project's budgetary position, obviating the need for the reader of the

PDSS to make their own assessment of a project's budgetary performance (as applies with present arrangements).

6. It is suggested that the 'Project Assurance Statement' will be disclosed within the construct of the MPR Project Data Summary Sheet (PDSS) under Section 1.2 'Current Status – Project Cost'. The agreed format, and 'Project Assurance Statement' contained therein, is provided at Attachment C for the Committees consideration and, if appropriate, approval.

7. I look forward to discussing this proposal with you at the 21 March 2012 Public Hearing.

Yours sincerely,



Warren King
CEO DMO

14 March 2012

Attachment:

- A. Agreed Financial Performance Presentation for pre July 2010 projects.
- B. Agreed Financial Performance Presentation for post June 2010 projects.
- C. Agreed 'Project Assurance Statement' for PDSS Section 1.2 – Project Cost.

DMO-ANAO AGREED FINANCIAL PERFORMANCE PRESENTATION FOR PRE JULY 2010 PROJECTS

Section 2 – Financial Performance

2.1 Project Budget (out-turned) and Expenditure History

Date	Description	\$m	Notes
Project Budget			
Nov 03	Original Approved	3.1	1
Aug 04	Real Variation – Budgetary Adjustments	(0.1)	2
Sep 04	Real Variation – Scope	4.8	3
Nov 05	Real Variation – Scope	29.6	4
Jun 07	Government Second Pass Approval	2,920.8	
Oct 08	Real Variation – Transfer	9.4	5
		2,967.6	
Jun 12	Price Indexation	428.4	6
Jun 12	Exchange Variation	(264.9)	
Jun 12	Total Budget	3,131.1	
Project Expenditure			
Prior to Jul 11	Contract Expenditure - BAE Systems	(952.1)	7
	Other Contract Payments / Internal Expenses	(59.2)	
		(1,011.3)	
FY to Jun 12	Contract Expenditure - BAE Systems	(344.3)	7
	Other Contract Payments / Internal Expenses	(10.3)	
		(354.6)	
Jun 12	Total Expenditure	(1,365.9)	
Jun 12	Remaining Budget	1,765.2	
Notes			
1	This project's original budget amount is that prior to achieving Second Pass Government approval.		
2	Administration savings harvest.		
3	To fund a risk reduction activity for the Project to obtain design data and develop designs to meet Australian essential requirements.		
4	First Pass approval.		
5	Transfer of funding for technical studies from DSTO.		
6	Up to July 2010, indexation was applied to project budgets on a periodic basis, with the objective of maintaining the real purchasing power of the original budget value approved by Government. The cumulative impact of this approach was \$350m. Post July 2010, all DMO projects have been managed in 'out-turned' dollars which takes into consideration the future value of the dollar. The impact on the project budget as a result of out-turning was a further \$78.4m having been applied to the project until the forecast delivery in accordance with the dates agreed in the Materiel Acquisition Agreement and noted in Section 3.3 of the PDSS.		
7	Other payments and expenses comprises: Operating Expenditure, Offer Definition, Consultants, Foreign Military Sales, Contractor Support and Minor Capital expenditure not attributable to the Prime contract.		

2.2 In-year Budget Expenditure Variance

Estimate \$m	Actual \$m	Variance \$m	Variance Factor	Explanation
			FMS	
			Overseas Industry	
		0.6	Local Industry	
			Brought Forward	
			Cost Savings	
			FOREX Variation	
			Commonwealth Delays	
354.0	354.6	0.6	Total Variance	

2.3 Details of Project Major Contracts

Contractor	Signature Date	Price at		Type (Price Basis)	Form of Contract	Notes
		Signature	30 Jun 11			
BAE Systems	Oct 07	2,268.1	2,287.7	Firm	ASDEFCON	1
Notes						
1	Contract Price at Revision 35					
Contractor	Quantities at at		Scope	Notes		
	Signature	30 Jun 11				
BAE Systems	2	2	LHD ships and integrated support systems			
Major equipment received and quantities to 30 Jun 11						
Detailed Design Review achieved. Construction of main hull sections underway.						

DMO-ANAO AGREED FINANCIAL PERFORMANCE PRESENTATION FOR POST JUNE 2010 PROJECTS

Section 2 – Financial Performance

2.1 Project Budget (out-turned) and Expenditure History

Date	Description	\$m	Notes
	Project Budget		
Nov 03	Original Approved	3.1	1
Aug 04	Real Variation – Budgetary Adjustments	(0.1)	2
Sep 04	Real Variation – Scope	4.8	3
Nov 05	Real Variation – Scope	29.6	4
Jun 07	Government Second Pass Approval	3,349.2	5
Oct 08	Real Variation – Transfer	9.4	6
		3,396.0	
Jun 12	Exchange Variation	(264.9)	
Jun 12	Total Budget	3,131.1	
	Project Expenditure		
Prior to Jul 11	Contract Expenditure - BAE Systems	(952.1)	7
	Other Contract Payments / Internal Expenses	(59.2)	
		(1,011.3)	
FY to Jun 12	Contract Expenditure - BAE Systems	(344.3)	7
	Other Contract Payments / Internal Expenses	(10.3)	
		(354.6)	
Jun 12	Total Expenditure	(1,365.9)	
Jun 12	Remaining Budget	1,765.2	

Notes

1	This project's original budget amount is that prior to achieving Second Pass Government approval.
2	Administration savings harvest.
3	To fund a risk reduction activity for the Project to obtain design data and develop designs to meet Australian essential requirements.
4	First Pass approval.
5	Government has approved an 'out-turned' budget that recognises the estimated future value of the dollar from the approval date until the forecast delivery date in accordance with the dates agreed in the Materiel Acquisition Agreement and noted in Section 3.3 of the PDSS.
6	Transfer of funding for technical studies from DSTO.
7	Other payments and expenses comprises: Operating Expenditure, Offer Definition, Consultants, Foreign Military Sales, Contractor Support and Minor Capital expenditure not attributable to the Prime contract.

2.2 In-year Budget Expenditure Variance

Estimate \$m	Actual \$m	Variance \$m	Variance Factor	Explanation
			FMS	
		0.6	Overseas Industry	
			Local Industry	
			Brought Forward	
			Cost Savings	
			FOREX Variation	
			Commonwealth Delays	
354.0	354.6	0.6	Total Variance	

2.3 Details of Project Major Contracts

Contractor	Signature Date	Price as at		Type (Price Basis)	Form of Contract	Notes
		Signature	30 Jun 11			
BAE Systems	Oct 07	2,268.1	2,287.7	Firm	ASDEFCON	1
Notes						
1	Contract Price at Revision 35					
Contractor	Quantities as at		Scope			
	Signature	30 Jun 11				
BAE Systems	2	2	LHD ships and integrated support systems			
Major equipment received and quantities to 30 Jun 11						
Detailed Design Review achieved. Construction of main hull sections underway.						

DMO-ANAO AGREED 'PROJECT ASSURANCE STATEMENT' FOR PROJECT DATA SUMMARY SHEET SECTION 1.2 – PROJECT COST

1.2 Current Status

Cost Performance

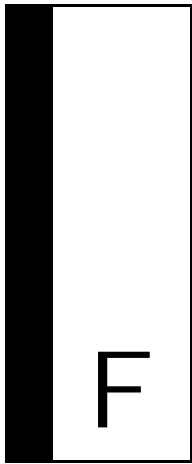
Noting the budget remaining for completion of the project, together with the estimated future expenditure and current known risks, the DMO considers that there is sufficient budget remaining for this project.

Schedule Performance

Thirteen aircraft have been accepted with six aircraft based with the Army's 5th Aviation Regiment in Townsville, three aircraft based with Navy's 808 Squadron in Nowra and four aircraft with the Army Aviation Training Centre in Oakey. These first thirteen aircraft will require an in-service retrofit (at Contractor expense) to bring them up to the full Phase 2/4/6 capability baseline. The first fully compliant Phase 2/4/6 aircraft are due for delivery in the second half of 2011.

Materiel Capability Performance

Following achievement of In-Service Date (ISD) with agreed partial achievement of the contracted MRH capabilities, there has been significant work by both Industry and the project to define and implement a series of capability block enhancements to bring the MRH90 to contracted standards. This includes a retrofit program, at no additional cost to the Commonwealth, to progressively bring all aircraft up to the contracted standard.



Appendix F –
Department of Defence, 'Government
Response to Report 422: Review of the
2009-10 Defence Materiel Organisation
Major Projects Report'



COPY

Stephen Smith MP
Minister for Defence

Original sent from PH

0 9 NOV 2011

Mr Robert Oakeshott MP
Chair
Joint Committee on Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Rob

Dear Mr Oakeshott

I write concerning the 422nd Report of the Joint Committee on Public Accounts and Audit - *Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report.*

I enclose a copy of Defence's Government Response to the Report's recommendations and a minute from the Secretary of the Department of Defence, Mr Duncan Lewis AO DSC CSC to Mr David Brunoro, Committee Secretary, which advises that the Report's recommendations are administrative in nature.

Yours sincerely

Best wishes

Stephen Smith

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT
REPORT 422: REVIEW OF THE 2009-10 DEFENCE MATERIEL
ORGANISATION MAJOR PROJECTS REPORT

RECOMMENDATIONS FOR DEFENCE

Major Projects Report Work Program

Recommendation 1

That the Major Projects Report (MPR) Work Plan (which contains the MPR Guidelines) be provided to the Joint Committee of Public Accounts and Audit (JCPAA) concurrently with the list of proposed projects for inclusion and exclusion in the following year's MPR, not later than 31 August each year.

Response: Agree (administrative)

The JCPAA's requirement that it be consulted by no later than 31 August each year provides sufficient lead time to: undertake preparations for the following year's MPR Program; develop the proposed list of DMO projects for MPR inclusion in the following year (in accordance with the JCPAA endorsed project entry criteria); and provide a draft 'DMO MPR Work Plan' that will detail key management aspects planned for the following year's MPR Program.

After Parliamentary Tabling of the DMO MPR each November, the DMO and ANAO will be able to review the previous year's MPR Program and incorporate identified improvements into a redrafted DMO MPR Work Plan. The DMO and ANAO would then seek JCPAA endorsement of the revised DMO MPR Work Plan at the JCPAA Committee Hearing in February/March of the next year.

Recommendation 2

That Projects of Concern (PoC) not be specifically included in the selection criteria for projects to be reported on in the MPR, but where projects reported on in the MPR are also PoC, that they continue to be identified as such.

Response: Agree (administrative)

The DMO MPR places a strong emphasis on longitudinal analysis on all projects selected as per the endorsed JCPAA selection criteria. The DMO believes that the current JCPAA endorsed selection criteria provide a robust mechanism for project selection that ensures an appropriate level of transparency and reporting over the DMO's largest acquisition projects.

Projects reported in the DMO MPR that are also a PoC will continue to be identified as such.

Recommendation 3

That the exit criteria for projects reported on in the Major Projects Report be the point at which both Final Materiel Release and Final Operational Capability (as currently defined by the Defence Materiel Organisation and Department of Defence respectively) is achieved.

Response: Agree in Principle (administrative)

In January 2010, the Defence Committee endorsed the concept of Initial Materiel Release (IMR) and Final Materiel Release (FMR) milestones. The IMR-FMR construct is designed to clearly define the points at which the DMO is to meet its responsibilities for the acquisition of materiel supplies – the materiel element of capability. The materiel element of capability is but one element of a number of Fundamental Inputs to Capability (FIC). The Capability Manager is responsible for integrating the FICs to achieve a capability state that can be operationally deployed by the Capability Manager. Other FICs that are managed by various Defence Agencies would typically include, but are not limited to, operator training (Capability Manager), facilities and infrastructure (Defence Support Group), IT infrastructure (Chief Information Officer Group) - achievement of all FICs would then provide the trigger point for Capability Manager endorsement of either an Initial Operational Capability (IOC) state or Final Operational Capability (FOC) state.

The DMO MPR provides a valuable insight to the DMO's management performance on the materiel element of capability from Government Second Pass Approval to achievement of FMR. The DMO considers achievement of FMR (the point in time at which the DMO has satisfied its responsibility for acquisition of the materiel element of capability) as the logical end point to trigger the removal of a project from the MPR.

Recommendation 4

That in determining whether the exit criteria is appropriate for future Major Projects Reports (MPRs), that the Defence Materiel Organisation's assessment of the difference in scale, size and incidence of requirements to be completed between Final Materiel Release and Final Operational Capability be provided to the Joint Committee of Public Accounts and Audit as soon as possible to allow for the implementation of any changes to occur for the 2011-12 MPR. In conducting its analysis, the DMO should consult with the three services, the Department of Defence, the Australian National Audit Office and industry representatives.

Response: Agree (administrative)

To formally establish the IMR and FMR milestones, all DMO projects are required to transition to a new Materiel Acquisition Agreement (MAA) for joint signature by Chief Capability Development Group, Chief Executive Officer Defence Materiel Organisation and the relevant Capability Manager by December 2011. Notwithstanding, the 28 DMO projects involved in the 2010-11 MPR Program have, as a priority, transitioned to the new MAA.

Consequently, for the 2010-11 MPR, DMO will be in a position to introduce additional analysis which will aim to identify the schedule lead-times, and scale, size and incidence of requirements between DMO project achievement of FMR (delivery of the materiel element of capability) and the Capability Manager's planned endorsement of FOC (upon successful delivery of all FIC).

For the 2011-12 MPR Program, the DMO will seek to engage with Capability Development Group and Capability Managers to analyse post FMR delivery of FIC requirements needed to achieve an endorsed FOC state.

Recommendation 5

That once projects have met the exit criteria, they be removed from the Major Projects Report (MPR) and for each project which has been removed, the lessons learned at both the project level and the whole-of-organisation level are included as a separate section in the following MPR.

Response: Agree (administrative)

The DMO introduced analysis of project lessons learned in the 2008-09 MPR and further strengthened this analysis in the 2009-10 MPR. Project lessons learned are analysed to identify systemic issues and the measures being taken by DMO to address these systemic issues to foster ongoing business improvement. For future DMO MPRs, as projects are removed from the MPR Program, the project and enterprise level lessons learned will continue to be reported in an annex to the DMO MPR.

Auditor-General's Review

Recommendation 6

That the Defence Materiel Organisation include in the format of a comparison table, for the listed eleven projects included in the Major Projects Report, columns appearing side by side showing base date dollars, out-turned dollars and current dollars for expenditure information.

Response: Agree (administrative)

The Project Data Summary Sheet (PDSS) template, endorsed by the JCPAA (at the 28 February 2011 Hearing) for the 2010-11 DMO MPR Program, provides the structure to inform a comparison between base date dollar, out-turned dollar and current day dollar expenditures for the eleven projects identified in the 2010-11 MPR Work Plan.

Recommendation 7

That the Defence Materiel Organisation present the findings of its examination of the presentation of financial data on all possible methods for project expenditure information (Eg. base date dollars, out-turned dollars and current dollars) to the Joint Committee of Public Accounts and Audit (JCPAA) as soon as it is completed and no later than 31 August 2011.

This examination should include a: (1) preferred method, and (2) comprehensive proposal for transition towards the proposed new arrangement. In addition, the proposed examination should be reviewed by the Australian National Audit Office before it is submitted to the JCPAA for consideration and recommendation prior to inclusion in the MPR.

Response: Agree (administrative)

The DMO has developed a proposal which details the revised methodology for Financial Performance Reporting, in the construct of the PDSS, for implementation in the 2011-12 DMO MPR Program. The DMO proposal will be circulated for consultation with the ANAO and will be ready for JCPAA consideration prior to the next JCPAA Hearing.

In order to effectively establish and maintain a sustainable approach to reporting project financial performance (via the revised PDSS Financial Performance Reporting methodology), the DMO proposal will address the following key considerations:

- Consistency with other published documents, including: Portfolio Budget Statements; Portfolio Additional Estimates Statements; and the Defence Annual Report.
- Consistency with the accepted method for managing project budgets in accordance with the Commonwealth's budgeting framework.
- Ensuring all financial data produced in the PDSS at the transactional level is verifiable with Defence and DMO's existing financial management systems.

In addressing the above considerations, the DMO proposal will present at least three financial performance reporting methodologies and will advise the preferred methodology for implementation in the 2011-12 DMO MPR Program.

Recommendation 8

That the way that Measures of Effectiveness data is presented in the Major Projects Report not be changed until a thorough analysis outlining the reasons for and implications of the change has been undertaken and presented to the Joint Committee of Public Accounts and Audit for consideration and endorsement.

Response: Agree in Principle (administrative)

Since the DMO Prescription in July 2005, acquisition and sustainment support to capability has been managed through the DMO agreements framework. The principal agreement for all DMO acquisition projects is the MAA, signed between the DMO and Capability Development Group (CDG). The MAA defines the acquisition services to be delivered by DMO to Defence for all major and minor equipment acquisition projects and defines each DMO project in terms of budget, scope and schedule. The former Measures of Effectiveness (MOEs) construct under the original MAA framework assessed the likelihood of delivering the defined materiel element of the capability.

As part of the Mortimer reforms, the MAA framework has been further developed and strengthened by two key initiatives: including the relevant Capability Manager as a signatory to the MAA, along with the DMO and CDG; and introducing the new milestones of IMR and FMR as replacements for MOEs. The introduction of IMR and FMR milestones has a threefold effect: it provides greater clarity of responsibilities between the DMO, CDG and Capability Managers; sets the two key milestones for delivering the materiel elements of capability to the Capability Manager; and provides for a very direct and more effective measurement of DMO performance.

In accordance with the direction provided by the Defence Committee on 21 January 2010, all DMO projects are to transition to the new MAA framework by December 2011. As at 30 June 2011, all 28 DMO MPR projects had transitioned to the new MAA template. Consequently, these projects have ceased to formally report against the former MOE construct and have commenced reporting on their performance in delivering the materiel element of capability to Capability Managers to the required scope approved by Government in order to satisfy achievement of IMR and FMR.

Consequently, for the 2010-11 MPR, DMO will provide additional analysis which will aim to explain the introduction of IMR and FMR milestones under the strengthened MAA framework.

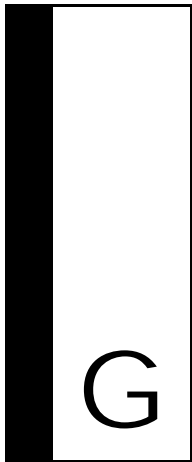
Recommendation 9

In line with the previous Committee's recommendation, that the Defence Materiel Organisation in conjunction with the Australian National Audit Office develop a standardised graphical representation of each project's cost and schedule variance for inclusion in the Project Data Summary Sheets for the 2011-12 Major Projects Report Guidelines.

Response: Agree (administrative)

Fundamental to the achievement of the DMO business is the use of standardised financial management and schedule management systems. These systems already produce data metrics to track the progress and performance of projects (which underpins DMO's monthly reporting process), and will readily provide the data required to produce a graphical representation of project performance against cost and schedule, and variances between planned and actual performance.

DMO believes that this additional disclosure will add significant value to future DMO MPRs by providing the reader with an easy to understand and consolidated reference point detailing each project's cost and schedule performance.



Appendix G –
Proposal to establish exit criteria (sic) for
projects in the Defence Materiel
Organisation Major Projects Report:
Additional submission to *'Government
Response to the JCPAA Report 422: Review
of the 2009-10 Defence Materiel
Organisation Major Projects Report'*
of 8 November 2011, regarding
Recommendations 3 and 4



**PROPOSAL TO ESTABLISH EXIT CRITERIA FOR PROJECTS IN THE
DEFENCE MATERIEL ORGANISATION MAJOR PROJECTS REPORT**

**Additional submission to ‘Government Response to the JCPAA Report 422:
Review of the 2009-10 Defence Materiel Organisation Major Projects Report’ of
8 November 2011, regarding Recommendations 3 and 4.**

1. This proposal seeks to provide the Joint Committee of Public Accounts and Audit (JCPAA) with the Defence Materiel Organisation’s (DMO) recommendation to establish a formal set of ‘Exit Criteria’ for the Major Projects Report (MPR) Program. This proposal is in addition to the previous 8 November 2011 ‘Government Response to the JCPAA Report 422: Review of the 2009-10 Defence Materiel Organisation Major Projects Report’, specifically to address Recommendations three and four.
2. Recommendation 3 stated:
‘That the exit criteria for projects reported on in the Major Projects Report be the point at which both Final Materiel Release and Final Operational Capability (as currently defined by the Defence Materiel Organisation and Department of Defence respectively) is achieved’.
3. Recommendation 4 stated:
‘That in determining whether the exit criteria is appropriate for future Major Projects Reports (MPRs), that the Defence Materiel Organisation’s assessment of the difference in scale, size and incidence of requirements to be completed between Final Materiel Release and Final Operational Capability be provided to the Joint Committee of Public Accounts and Audit as soon as possible to allow for the implementation of any changes to occur for the 2011-12 MPR. In conducting its analysis, the DMO should consult with the three services, the Department of Defence, the Australian National Audit Office and industry representatives’.
4. Analysis of MPR projects showed an average of about 95% of budget expended up to Final Materiel Release (FMR) and up to about 5% to achieve Final Operational Capability (FOC). The time to achieve FOC from FMR ranged from 0 to 52 months. Looking to future projects analysis of projects approved in the last 24 months shows that this trend is continuing with the DMO delivery of the ‘materiel element of capability’ representing 97% of budget on average.
5. To ensure continued transparency and assurance over those project elements that have the largest materiality while providing the committee visibility to delivery of final capability the following approach is recommended:
 - a. DMO reports progress to FMR through full disclosure in the Project Data Summary Sheets (PDSS). The PDSS is then assured by the Australian National Audit Office (ANAO).
 - i. The DMO’s delivery to FMR is the materiel element of the mature capability, which accounts for approximately 95% (range of 85% -

100%) of the Government approved funding and normally the majority of project schedule.

- b. Defence (through the relevant Capability Manager) reports progress to FOC 'post-FMR'. This report would not be subject to ANAO assurance. The Defence reports would be an addendum in the MPR, and separate to the PDSS.

6. In summary, this recommendation would achieve several improvements. A project would remain visible in the MPR until both FMR and FOC have been achieved. Projects would be removed from the PDSS after achievement of FMR but would be reported in the Addendum to the MPR until FOC is achieved. The ANAO would continue to assure DMO performance to FMR; the period in which the majority of cost and schedule risks could arise. This approach also provides additional flexibility to add new projects for assurance by the ANAO within the agreed limit of thirty projects.