

Chapter 14

Defence's relationship with defence industry

14.1 The committee's main focus has been on the shortcomings in Defence's performance in its major acquisition projects. Industry, however, is not without fault. Both industry and Defence have not always fulfilled 'all their obligations and commitments on delivering projects on time and often to budget'.¹ Thus, there is scope for Defence to work more effectively with industry and to assist industry to improve its performance. Breakdowns in the relationships between Defence and industry on several major projects in recent years have highlighted the tension that can exist between the parties and its potential to derail a project. In this chapter, the committee considers the relationship between Defence and industry as partners in Australia's capability development.

Partnership—Defence and industry

14.2 Mr Ben White, Australian Business Defence Industry Unit, believed that delivering defence capability must be a partnership between the government, Defence and industry, and advocated greater industry engagement as a true partner—at all levels and stages of the capability development and acquisition process.²

14.3 Witnesses identified opportunities for improvement in the relationships between industry and the CDG.³ According to the Defence Teaming Centre, industry 'needs to work with the CDG to establish a full and complete understanding of their capability requirement to effectively bid and fulfil the end user capability requirement'. It suggested that through improved consultation, the CDG could use industry expertise to gain a better understanding of current and future enhancements in technology and capability for consideration within current project procurement requirements.⁴ Furthermore, the Defence Teaming Centre informed the committee that industry feedback indicated that 'a more direct relationship with the end user and customer would create a more accepting level of technical risk by the customer'. It explained that 'industry can provide the advice, information and technical expertise for a greater awareness of the capability and the risks'.⁵ It stated:

Industry recognises a greater need to negotiate directly with the customer during the procurement process rather than contracted external parties to

1 *Committee Hansard*, in camera.

2 *Committee Hansard*, 11 August 2011, p. 2.

3 According to the Defence Teaming Centre, industry consultation suggested the CDG's role should be enhanced to establish a better relationship with industry. *Submission 16*, p. 3.

4 *Submission 16*, p. 3.

5 *Submission 16*, p. 3.

fully understand the capability requirements and negotiate innovative concepts within the contract.⁶

14.4 While BAE Systems acknowledged the recent improvements in the six-monthly online DCP updates, it noted that it was only a one-way transmission of information from Defence to industry.⁷ BAE Systems suggested that 'meaningful discussion between industry and Defence early in the capability development process would improve the knowledge of both parties and lead to higher quality outcomes'.⁸ The importance of early engagement was one of industry's dominant messages.

Early engagement

14.5 Defence's level of engagement with industry in the early stages of the procurement process can have significant implications for a project's success, viability and value for money over the long-term. Additionally, DMO's relationship with industry and DMO's ability to negotiate effectively on behalf of the Commonwealth is also an important factor in establishing a positive working relationship between the different parties involved in defence projects and achieving value for money.

14.6 As noted early in this report, 80 per cent of problems with projects occur in the first 20 per cent of the project's life.⁹ Both industry representatives and observers stressed the importance of industry's early involvement in the capability development process to ensure that requirements are realistic and cost-effective.¹⁰ The Australian Business Defence Industry Unit argued that 'real partnership between Defence and industry early in the development of capability concepts and then throughout the lifecycle of systems can only lead to better capability, better technology and lower life-cycle costs'. In its view, the Commonwealth's focus on:

...Value for money and market-based competition in key capability means that industry gets involved too late to bring the best and most cost-effective solution to the table. Early industry involvement can lower Defence risk and can be done in ways that maintain Value for Money objectives and market-based competition.¹¹

14.7 According to the Unit, early industry engagement should occur before formal approaches to market and Defence should be willing to build ongoing formal and informal relationships with industry. It argued that the Capability Development

6 *Submission 16*, p. 2.

7 BAE Systems, *Submission 12*, p. 4.

8 BAE Systems, *Submission 12*, p. 4.

9 Australian Business Defence Industry Unit, *Submission 6*, p. 5; Andrew Davies and Mark Thomson, *Submission 8*, p. [2]; Australian Industry Group Defence Council, *Submission 10*, p. [4]; Australian Industry Defence Network, *Submission 19*, p. 3.

10 Australian Business Defence Industry Unit, *Submission 6*, p. 5.

11 *Submission 6*, p. 5.

Advisory Forum (CDAF) and environmental working groups should be used to achieve this early industry engagement.¹²

14.8 Mr Willox, Australian Industry Group Defence Council, stated succinctly that one of industry's key bugbears was to get itself involved much more and much earlier in the CDG.¹³ In his view, if industry 'is not involved earlier on then there are blow-outs'. He stated getting industry involved sooner reduces the risk and industry is at least able to say 'what is doable, what is possible, what is realistic and what is not'.¹⁴ The Australian Industry Defence Network also argued that there is potential for Defence to develop a stronger relationship with industry by encouraging earlier industry involvement in Defence reviews and reports.¹⁵

14.9 Dr Davies and Dr Thomson were among the many other witnesses who argued in favour of the involvement of industry in the early stages of capability development to ensure that planning is informed by a clear understanding of what is available, technologically and commercially. It cited the proposal in the 2009 White Paper and subsequent DCP to replace the Navy's current patrol boats, mine hunters and hydrographic ships with a single class of vessels (SEA 1180) as a demonstration of the risk of 'planning in an information vacuum'.¹⁶ It should be noted that DSTO stated in its submission that it supported Navy in the Needs Phase to assess the feasibility of the multi-role vessel to perform a variety of different tasks.¹⁷ Even so, as noted in chapter 3, Dr Thomson observed that the multi-role vessel:

...is going to be all things to all people. If you talk to people who actually build boats for a living, you might actually temper your aspirations...¹⁸

14.10 The major primes similarly highlighted the benefits to be gained from earlier industry involvement in the capability development and procurement process.¹⁹ One industry representative voiced the widely held view amongst his peers that primes should be involved at the earliest point in time—that they should 'be there as independent expert witnesses, almost':

...to give guidance on what the possibilities are: to suggest methods of minimising the risk; and even to put scaling on cost for initial acquisition and scaling on cost for sustainment.²⁰

12 Australian Business Defence Industry Unit, *Submission 6*, p. 5.

13 *Committee Hansard*, 11 August 2011, p. 5.

14 *Committee Hansard*, 11 August 2011, p. 5.

15 Australian Industry Defence Network, *Submission 19*, p. 3.

16 Andrew Davies and Mark Thomson, *Submission 8*, p. 2.

17 Defence Science and Technology Organisation, *Submission 31*, p. 3.

18 Mark Thomson, *Committee Hansard*, 12 August 2011, p. 11.

19 *Committee Hansard*, in camera

20 *Committee Hansard*, in camera.

14.11 One industry representative also noted that the prime contractors could, based on their global experience, reach back to their parent company and draw on a much broader knowledge base.²¹ Industry representatives suggested that there is no real impediment for industry to engage with Defence prior to first pass.²²

14.12 During the committee's visit to South Australia and Western Australia, industry representatives reinforced this message. They informed the committee that early industry involvement and close collaboration between Defence and industry during the early stages of a project was critical to its success, and that a lack of consultation can lead to significant mistakes being made during the initial phase of a project.

14.13 Additionally, several industry representatives observed that Defence's decision to postpone industry involvement in projects until later stages often puts unnecessary pressure on industry to deliver a project. In some cases, industry had been engaged only as a long-foreseen capability gap began to emerge, and was placed under significant pressure to deliver the new capability as fast as possible. A few witnesses were concerned about indications that the SEA 1000 may repeat this situation, where an obvious capability gap could loom as the Collins Class approaches the end of its life of type.²³ Noting that the boats are to be built in Adelaide, the danger is that by the time decisions are made and industry engaged, there would be significant pressure on industry to deliver the submarines quickly to maintain Australia's submarine capability as the Collins Class submarines are decommissioned.

14.14 Defence's Capability Development Handbook recognises that early engagement with industry can 'provide projects with useful information about the products available in the marketplace'. It can also give an:

...indication of their expected whole-of-life costs, any innovative options that might be available for addressing the capability gap and insights into the nature of the marketplace required for the development of an acquisition strategy.²⁴

14.15 Indeed, pre-first pass solicitation activities, such as a Request for Information, may be undertaken with the assistance of DMO as the subject matter expert.²⁵

21 *Committee Hansard*, in camera.

22 *Committee Hansard*, in camera.

23 See for example, *Submission 9*, pp. 1–2; *Submission 14*, pp. 1–2; and *Submission 15*, pp. 1–2 and 7.

24 Department of Defence, Department of Defence, *Defence Capability Development Handbook*, August 2011, paragraph 3.3.44.

25 Department of Defence, Department of Defence, *Defence Capability Development Handbook*, August 2011, paragraph 3.3.45.

Probity concerns

14.16 The early engagement of industry, however, can involve integrity issues. In this regard, Defence cited probity matters as the primary barrier to earlier industry involvement in the capability development process.²⁶ It was concerned with specific companies gaining a competitive advantage through being consulted during the early stages of a project. For example, Air Marshal Harvey explained that the problem was 'to make sure that we treat everybody equally. We cannot show favouritism. If someone comes in and says, 'We have the solution,' we cannot shape our proposed way ahead to match that company'. He stressed that Defence 'cannot be seen to have one company have input and influence that others cannot'.²⁷ Moreover, in Mr King's view, sometimes a certain element of industry shapes CDG too much—'They might have got in there very effectively lobbying for their approach and their solution'.²⁸

14.17 While there was overwhelming support from industry for its early involvement in the capability development process, some representatives recognised the concerns about conflicts of interest. An industry representative from one of the prime contractors acknowledged that:

Probity is an important issue, but we should not be seen as marketing product that we sell or as marketing skills that we have. We should be there representing the capabilities necessary to build the particular thing we are talking about...²⁹

14.18 Consistent with this view, industry more broadly argued that it was possible to achieve the commercial type of interaction where industry is able to provide advice at the front end without undermining the integrity of the process. During its visit to South Australia and Western Australia, both industry and Defence representatives suggested to the committee that probity concerns, while legitimate, were not insurmountable. In their view, such problems could easily be overcome by open and transparent consultation at the strategic stages before specific concepts were proposed. Indeed, some industry representatives commented positively on developments in recent years where industry has been able to have an increased level of involvement in the procurement process.³⁰ Protecting its intellectual property when providing early comments, however, remains an issue for industry.

26 Dr Ian Sare, Defence Science and Technology Organisation, *Committee Hansard*, 5 October 2011, p. 24.

27 *Committee Hansard*, 5 October 2011, p. 24.

28 *Committee Hansard*, 7 October 2011, p. 50.

29 *Committee Hansard*, in camera.

30 *Committee Hansard*, in camera.

Capability Development Advisory Forum and environmental working groups

14.19 A number of witnesses referred in favourable terms to the successful work of the CDAF and its three accompanying environmental working groups—air, land and sea—as a means of bringing Defence and industry together early in the acquisition process. Until recently, however, they had been 'in abeyance'.³¹

14.20 Air Marshal Harvey indicated that the CDG was reinvigorating the forum and the environmental working groups to ensure that both Defence and industry have a better understanding of project feasibility options and risks earlier in the process.³² For example at a recent meeting of the maritime working group, Defence stepped through the whole content of the DCP. Air Marshal Harvey also mentioned that Defence have specific workshops associated with projects where Defence holds one-on-one meetings with industry.³³

14.21 In August 2011, Mr Priestnall, Australian Industry and Defence Network, indicated that work had started at the higher level of requirements development by the CDAF, but also, more importantly, in the environmental working groups that report up to Forum. He explained:

These have been reinvigorated within the last six [months], except for the land one, which stayed in existence. There are also the maritime, air and other ones. In the case of the maritime one, 150 people attended a forum where we talked about ideas.³⁴

14.22 The Australian Industry Group Defence Council also welcomed the decision to revive the Forum and the environmental working groups and advocated stronger industry engagement at the meetings.³⁵ Mr O'Callaghan stated:

...in years gone by the Capability Development Advisory Forum and its underlying environmental working groups...worked quite effectively because it provided companies in a collegiate sense to sit around a table with the Capability Development Group and identify in advance for those capabilities downstream risks associated with major design and integration activities. They could bring in the key players from key companies, likely to be involved but not at that point in any conflict situation, early in the piece to identify for the benefit of the Capability Development Group those elements associated with risk, complexity and schedule, which ought to be identified at that point.³⁶

31 *Submission 10*, p. 8.

32 *Committee Hansard*, 7 October 2011, p. 2.

33 *Committee Hansard*, 5 October 2011, p. 15.

34 *Committee Hansard*, 11 August 2011, p. 8. See also *Submission 10*, p. 8.

35 *Committee Hansard*, 11 August 2011, p. 7.

36 *Committee Hansard*, 11 August 2011, p. 7.

14.23 He suggested that the Forum needs to provide clear guidance to the working groups and not to bite off too much work. In his view, they need to be specific about the outcomes they are seeking and need to focus clearly on 'ameliorating those potential issues related to risk and complexity'.³⁷

14.24 Mr White, Australian Business Defence Industry Unit, also acknowledged the importance of early engagement of industry through environmental working groups, project working groups and similar meetings. He indicated that the process was just starting and time would be needed before any assessments could be made. Even so, in his assessment, 'It is looking very good at the moment. The couple of meetings that we have had have shown good signs'.³⁸ He drew attention, however, to the work currently being done in DMO on the Acquisition and Support Implementation Strategy as a possible model:

...whereby, for example, there may be scope to downselect a number of prime contractors in the requirements phase of a project so that capability definition can be done in concert between Defence and industry in an open environment, while meeting some of those requirements for competition.³⁹

14.25 BAE Systems noted that in the past the CDAF and its environmental working groups 'were not vehicles for close engagement but rather a means for Defence to inform industry of its requirements and intentions'.⁴⁰ The RSL also noted the tendency for Defence to use the environmental working groups to brief industry on projects but that 'resulted in a one-way communication process, with industry representatives understandably reluctant to discuss in open forum their intention and perspectives on individual projects'.⁴¹

Committee view

14.26 Despite Defence's acknowledgement of industry's role, industry representatives referred to the need for greater and earlier industry involvement in capability development. In this regard, the committee welcomes the reinvigoration of the CDAF and the environmental working groups. They provide an ideal opportunity to involve senior defence industry representatives early in the capability development phase without compromising the integrity of an acquisition process.

14.27 The committee also notes industry's observation about the importance of industry having a direct relationship with the end user—capability managers. The committee's proposed model presented in the following chapter addresses this concern.

37 *Committee Hansard*, 11 August 2011, p. 7.

38 *Committee Hansard*, 11 August 2011, p. 6.

39 *Committee Hansard*, 11 August 2011, p. 6.

40 *Submission 12*, p. 3.

41 *Submission 5*, p. [2].

Recommendation

14.28 The committee recommends that Defence:

- continue to collaborate with industry to reinvigorate the Capability Development Advisory Forum and the associated environmental working groups as a means of engaging industry early in the capability development process. The committee recommends further that Defence ensure that such engagement with industry is a genuine two-way exchange of ideas and of information; and
- continue to support training programs such as Skilling Australia's Defence Industry (SADI).

Recommendation

14.29 Given the reach back capacity of primes and their ability to tap into research and development of US and European headquarters, the committee recommends that industry consultation start at the earliest Defence White Paper and DCP stage.

Defence Materiel Organisation's negotiations with industry

14.30 The Coles Report on Collins Class sustainment referred to the monopsonistic relationship between industry and the various parts of Defence. Mr Coles could not help but gain the impression of 'highly-charged, difficult and often hostile relationships between the parties'.⁴² The report was particularly critical of the relationship between DMO and ASC, noting that it had previously been described as 'damaging'.⁴³ Similarly, the AWD project recently suffered from strained relationships between DMO and its industry partners, evident in the difficulties experienced by BAE Systems at the Williamstown shipyard in Melbourne. In the past, some projects that ended badly such as the Super Seasprite, also demonstrated a breakdown in the relationship between Defence and the contractor.

14.31 Some witnesses raised the nature of the working relationship between DMO and industry as a key area of concern. They held that the relationship was often difficult or unproductive which could lead to project failures.⁴⁴ The Defence Teaming Centre was critical of DMO's attitude. In its view, the DMO 'appears to have an adversarial approach to Australia's defence industry' by implying that industry is trying to 'gouge' Defence and 'not deliver'. It stated that the industry does not experience this adversarial approach when dealing with other areas of Defence such as

42 John Coles, *Collins Class Sustainment Review—Phase 1 Report*, 4 November 2011, p. 9.

43 John Coles, *Collins Class Sustainment Review—Phase 1 Report*, 4 November 2011, p. 10.

44 Returned and Services League of Australia, *Submission 5*, p. 2; Australian Industry Group Defence Council, *Submission 10*, p. 2; MOTIVEPOWER stated that 'in general DMO and Defence do not understand the commercial pressures on companies seeking to be Defence suppliers'. *Submission 29*, p. 2.

the DSG.⁴⁵ In the Defence Teaming Centre's view, DMO's perception that industry does not work in the best interest of the customer needs addressing and should be reversed to create a win/win culture for all parties in the procurement process.⁴⁶ It suggested that:

The DMO needs to develop a more commercial engagement culture that offers the 'carrot' more than the 'stick'.⁴⁷

14.32 The RSL also referred to the adversarial relationship between DMO and industry which was 'antithetical to the development of a transformational culture of integrated endeavour...essential if true reform is to be achieved'. It noted that capability managers, DMO and industry must together engage in the 'end to end analysis' of a capability 'to identify all opportunities for reform and hence efficiency'.⁴⁸

14.33 Trust between Defence and industry is fundamental to a good working relationship. But according to Mr Mansell, Australian Business Defence Industry Unit, 'that trust is diminishing'. For example, he said that industry needs to know whether there is going to be a tender out on time...But if it is a moving feast then, after a while, industry will say no.⁴⁹ The Australian Industry Group Defence Council agreed with the view that Defence and industry need 'to build a stronger level of trust'.⁵⁰

14.34 The committee has discussed DMO's efforts to improve its business acumen. Even so, it should be noted that industry remains frustrated with DMO's failure to appreciate the business environment. Mr Priestnall stated that some DMO personnel have no commercial awareness of matters to do with cash flow and how businesses work. He gave an example of the chopping and changing in proposed dates for the release of tender documents. In his experience, better business practice on the part of DMO would mean that he does not find himself in a situation where he has to pay 10 project engineers and a project manager to sit around 'twiddling their thumbs'. He stated further:

45 *Submission 16*, p. 2. The Centre stated that this [perception] 'could not be further from the truth, 99.9% of Australia's defence industry is professional and patriotic with a passionate desire to deliver with value for money capability on time and to budget'.

46 *Submission 16*, p. 2.

47 *Submission 16*, p. 2. Mr Christopher Burns, Defence Teaming Centre, indicated that industry's relationship with DMO was adversarial, while with other agencies it was a collegiate, engaged approach. *Committee Hansard*, 11 August 2011, p. 4.

48 The Returned & Services League of Australia, *Submission 5*, p. 2.

49 *Committee Hansard*, 11 August 2011, p. 10. Mr Willox agreed that there must be an element of trust in the relationships. *Committee Hansard*, 11 August 2011, p. 5.

50 *Submission 10*, p. 2.

For a large company with deeper pockets, even though they are hurting, they can ride that out. They have multiple business streams. An SME, which are our powerhouse of innovation and entrepreneurship, cannot.⁵¹

14.35 It is clear that, when negotiating with the defence industry, DMO needs to have the business insight and appreciation together with strong negotiators to achieve the best value for money. As discussed earlier, DMO acknowledges it needs to develop a range of business and contracting skills within the organisation and to upskill its staff in how they deal with industry.⁵² Mr King highlighted the differences between DMO and industry:

Industry has a responsibility to its shareholders, to its organisation, to maximise its returns; it is obliged to by law. We have generally a community of people that are not from a business background...Similarly, by the way, as both public servants and as military folk, we do not really understand the drivers of industry as well as we might—cash flow; indeed, the need to make a profit.⁵³

14.36 In an environment, where the relationship between DMO and industry may already be strained, contract arrangements are central to underpinning a constructive partnership.

Contracting and risk sharing between Defence and industry

14.37 Good working relations provide a sound foundation on which to negotiate a contract. But a major defence acquisition project is a business arrangement where the customer and the contractor are each seeking to extract the best deal. The challenge is to establish a legal arrangement that satisfies and benefits all parties fairly. In this area, GAO cited some fundamental lessons to guide future decisions:

...a program must be put on a sound technical, cost, and schedule footing before it is approved—contract vehicles can accommodate risks but cannot fix a troubled program. At the same time, a flawed competition or contract award process can delay or disrupt an otherwise sound acquisition. A sound acquisition and contract strategy is essential to executing the acquisition within time and funding budgets.⁵⁴

14.38 In defence procurement, contracting is a key method of allocating risk between Defence and industry. Currently, the majority of Defence's contracts with industry are in the form of fixed-price contracts. Partly as a result of these contracting arrangements, Defence has been able to keep most projects—even many with

51 *Committee Hansard*, 11 August 2011, pp. 5–6.

52 Warren King, Defence Materiel Organisation, *Committee Hansard*, 7 October 2011, p. 9.

53 Warren King, Defence Materiel Organisation, *Committee Hansard*, 7 October 2011, p. 9.

54 Paul Francis, Michael Golden and William Woods, Statement before the Subcommittee on Defense, Committee on Appropriations, House of Representatives, 'Defense Acquisition: Managing Risk to Achieve Better Outcomes', 20 January 2010, p. 17.

significant problems—within budget: schedule delays are generally cited by DMO as the area where improvements are required.

14.39 Contracting arrangements that properly allocate risk between Defence and industry and provide adequate incentives for industry to perform well are one element of Defence's procurement arrangements that must be given consideration. For example, the GAO indicated that once the early acquisition planning is complete, Department of Defence 'must select contracting instruments that match the needs of the acquisition and protect the government's interests'.⁵⁵ It stated:

Of primary concern during this phase should be the proper allocation of risk between the government and contractor and ultimately what is in the best interests of the government.⁵⁶

14.40 The GAO referred to the range of contract types—from fixed-price to cost reimbursement—but noted that each 'comes with a different level of cost or performance risk for the government'.⁵⁷ According to the GAO:

Fixed-price contracts are generally considered to be the lowest risk to government because the onus is on the contractor to provide the deliverable at the time, place, and price specified in the contract.⁵⁸

14.41 A RAND study into submarine programs noted that:

The government must understand the relationships between desired performance and cost and set goals that should keep the program within cost constraints. The government should also use the contracting structure to incentivize private-sector contractors to design and build the submarine in the most cost-effective manner.⁵⁹

14.42 The study went on to suggest that fixed-price contracts were not the most appropriate for projects with risk and uncertainty:

Although fixed-price contracts can reduce risks of cost growth to the government, they are most appropriate when there is little program risk and

55 Paul Francis, Michael Golden and William Woods, Statement before the Subcommittee on Defense, Committee on Appropriations, House of Representatives, 'Defense Acquisition: Managing Risk to Achieve Better Outcomes', 20 January 2010, p. 5.

56 Paul Francis, Michael Golden and William Woods, Statement before the Subcommittee on Defense, Committee on Appropriations, House of Representatives, 'Defense Acquisition: Managing Risk to Achieve Better Outcomes', 20 January 2010, p. 5.

57 Paul Francis, Michael Golden and William Woods, Statement before the Subcommittee on Defense, Committee on Appropriations, House of Representatives, 'Defense Acquisition: Managing Risk to Achieve Better Outcomes', 20 January 2010, p. 5.

58 Paul Francis, Michael Golden and William Woods, Statement before the Subcommittee on Defense, Committee on Appropriations, House of Representatives, 'Defense Acquisition: Managing Risk to Achieve Better Outcomes', 20 January 2010, p. 6.

59 RAND National Defense Research Institute, *Learning from Experience*, vol. I, Lessons from the Submarine Programs of the United States, United Kingdom, and Australia, 2011, p. 6.

uncertainty and when few changes are anticipated. With the risks and uncertainty of a new program, especially one that differs in some way from previous programs, a cost type of contract is probably most appropriate. Whatever type of contract is used, both the government and the private sector should develop realistic cost and schedule estimates. Any differences in the cost estimates of the government and the private sector should be understood and discussed between the two parties with the ultimate goal of agreeing on the estimates and schedules.⁶⁰

14.43 The Commonwealth's policy framework for National Public Private Partnership states that to achieve value for money, risks are allocated to the party best able to manage them. In 2002, the then Deputy Auditor-General of the ANAO stated:

The public sector should be prepared to fairly compensate the private sector for taking on risk (sometimes, some of these costs are not immediately apparent in the public sector). At the same time, we need to be alive to the possibility that the private sector may offer to take on risks that it is not able to control with potential consequential implications for the public sector, both at an operational level and in terms of the project's value-for-money assessment.⁶¹

14.44 As noted earlier, for the most part, DMO has kept the majority of projects within budget partly through use of fixed-price contracts. This risk-adverse management approach may have a downside.

Industry perspective

14.45 Industry representatives have raised concerns about the current use of fixed-price contracts, suggesting that they are not optimally allocating risk between Defence and industry. The Australian Industry Group Defence Council noted the need to ensure a proper sharing of risk between the Commonwealth and industry, especially for complex acquisition and sustainment projects. It was of the view that Defence had the fundamental structures about right but that further work was needed to improve tendering and contracting arrangements. The Council recommended that, early in the capability development process, Defence identify 'the actual level of risk associated with every new major equipment acquisition and sustainment project'. It suggested further that Defence tailor acquisition strategies to match the risk, including a proper sharing of the risk, between the Commonwealth and industry'.⁶²

14.46 The Defence Council noted the Commonwealth's shift to fixed-price contracts as the standard contract arrangement continued to cause difficulties for companies seeking to price complex equipment acquisitions, especially those involving high-risk

60 RAND National Defense Research Institute, *Learning from Experience*, vol. I, Lessons from the Submarine Programs of the United States, United Kingdom, and Australia, 2011, p. 54.

61 For example see Ian McPhee, Deputy Auditor-General for Australia, 'Risk Management and Governance', Speech, National Institute for Governance, Canberra, 16 October 2002, p. 9.

62 Australian Industry Group Defence Council, *Submission 10*, p. 5.

combat system integrations. According to the Council, 'attention should be given to more flexible contracting arrangements, including Cost-Plus provisions during development phases of complex projects'.⁶³ By using more flexible contracting arrangements during the earlier development phases of projects, the Defence Council noted that both Defence and industry would be able to better identify the level and sharing of risk, and develop improved cost and schedule estimates.

14.47 Similarly, an industry representative referred to risk and risk management and noted that industry was bearing the cost risk:

The risk has been shifted to industry. We now invest in the facilities at risk. When the programs run late, we have to hold that cash outflow problem.⁶⁴

14.48 Another industry representative informed the committee that as a result of the fixed-price contracts, industry was deprived of necessary flexibility in an evolving environment, and delivers only to the original contract specifications:

...in an environment where technologies are changing quickly, delivering five-year-old or six-year-old technology or capability to someone because we have not had the flexibility in that process, is not doing the right thing for the war fighter, who should be getting the best that we can deliver at the time.⁶⁵

14.49 Industry representatives cited examples where a project was delivered on budget, on schedule and to the contracted specification. It was received positively by DMO but then criticised by the capability manager for not meeting the operational requirement—because it had been years since industry had been contracted to deliver the project.⁶⁶ This observation further underscores the importance of having the capability manager directly involved in the acquisition process.

14.50 Babcock also raised the lack of flexibility in current contracting arrangements:

Hence DMO receives what it asks for in each contract, and no more, as the provider concentrates on delivering the specification only.⁶⁷

14.51 The alliance contracting model with ASC, Raytheon and the Australian Government used for the AWD was cited positively by both industry and DMO representatives as providing a more flexible arrangement where problems can be managed without affecting the schedule.⁶⁸ In this context, it is worth noting the

63 Australian Industry Group Defence Council, *Submission 10*, p. 3.

64 *Committee Hansard*, in camera.

65 *Committee Hansard*, in camera.

66 *Committee Hansard*, in camera.

67 Babcock Pty Ltd, *Submission 15*, p. 5.

68 *Committee Hansard*, in camera and AWD Systems Centre personnel in Adelaide, SA.

findings of the recent RAND study, discussed previously, which drew attention to the contracting arrangements for the Collins Class. It reported that:

With the *Collins* program, although there were a number of technical risks with unpredictable outcomes, the Australian government used a fixed-price contract that greatly limited the flexibility that both parties needed when problems emerged. As with the *Astute*, the fixed-price contract for *Collins* led to an environment in which ASC had no motivation to provide more than what it interpreted were its obligations under a poorly defined contract. At the same time, the Commonwealth, fearful that it might be held liable for contract changes it could not afford, paid no more than the original contract price. The interactive and open environment necessary for a development program was negated by the *Collins* contract.⁶⁹

14.52 The RAND study argued that fixed-price contracts were appropriate 'when there is little risk and uncertainty (e.g., when technologies are mature and when specifications are well defined) and when few changes to the design or build are anticipated'.⁷⁰ The study suggested that the ideal arrangement would involve holding the contractor responsible for risks under its control (such as labour and overhead rates, productivity, materiel costs, etc.) but the government being responsible for the other risks outside the contractor's control (such as inflation, changing requirements, changes in law, etc.).⁷¹ It stated:

The lesson here is that technical risks must be identified early, and much thought must be given to deciding, with industry, the appropriate form of the contract and the incentive and risk sharing clauses built into the contract. Getting this wrong can almost guarantee problems with the conduct of the program and the relationships between the government and the contractor.⁷²

14.53 One industry representative informed the committee that his company had not had a discussion to mitigate the risks that eventuate as programs go for a very long time. He explained that discussion is around the commercial aspects, and not about spending money to assure capability, which suggested a focus on a commercial result rather than a capability delivery result.⁷³ Similarly, with regard to contracting and avoiding risk, the Submarine Institute of Australia argued in its submission that 'the methods apparently employed by the DMO to minimise risk (e.g. very strict attention

69 RAND National Defense Research Institute, *Learning from Experience*, vol I, Lessons from the Submarine Programs of the United States, United Kingdom, and Australia, 2011, p. 32.

70 RAND National Defense Research Institute, *Learning from Experience*, vol I, Lessons from the Submarine Programs of the United States, United Kingdom, and Australia, 2011, p. 32.

71 RAND National Defense Research Institute, *Learning from Experience*, vol I, Lessons from the Submarine Programs of the United States, United Kingdom, and Australia, 2011, p. 32.

72 RAND National Defense Research Institute, *Learning from Experience*, vol I, Lessons from the Submarine Programs of the United States, United Kingdom, and Australia, 2011, p. 33.

73 *Committee Hansard*, in camera.

and adherence to the letter of each contract, at the cost of actual progress) do not bode well for a highly successful program in SEA 1000'.⁷⁴

14.54 Evidence indicated that, as a means of mitigating contract risk, Defence should consider carefully how to achieve best value for money by providing an incentive to the contractor to meet or exceed program objectives, including cost, schedule and performance.⁷⁵

Committee view

14.55 Increased industry involvement earlier in the capability development process is clearly an important factor in the successful delivery of defence capability. Having industry input prior to projects being added to the DCP would help to prevent unrealistic expectations on the part of CDG, while industry involvement in early phases would help CDG and DMO to estimate costs and risks more accurately. Similarly, industry input in the design phase from sustainment experts would allow for more realistic estimations on sustainment costs during the earlier phases of projects.

14.56 The state of the relationship between Defence and industry—in particular between DMO and industry—indicates that there is room for improvement. The consequences of unproductive relationships between DMO and industry have been clearly demonstrated. This relationship is exacerbated by the non-involvement of the eventual client i.e. the capability manager. Additionally, the need for better business acumen and negotiating skills has been acknowledged by both DMO and external observers, and improvements in this area would allow DMO to negotiate more effectively with industry and achieve greater value for money in contracts.

14.57 Finally, there is scope for improvement in DMO's contracting arrangements with industry to achieve more appropriate allocation of risk between the government and industry—this may require a shift toward more flexible contracting arrangements and away from the current practice of fixed-price contracts. To be in a sound position to decide and negotiate the form of contract best suited for a particular acquisition, DMO needs skilled specialists in contracting but also needs to have a deep knowledge of the product it is purchasing—in other words it needs the right people in the right place.

74 Submarine Institute of Australia Inc, *Submission 9*, p. 3.

75 RAND National Defense Research Institute, *Learning from Experience*, vol I, Lessons from the Submarine Programs of the United States, United Kingdom, and Australia, 2011, p. 33.

