

The Auditor-General

Audit Report No.2
Performance Audit

Commercial Support Program

Department of Defence

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Canberra ACT
10 July 1998

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit of the Department of Defence in accordance with the authority contained in the *Auditor-General Act 1997*. I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Commercial Support Program*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage — <http://www.anao.gov.au>.

Yours sincerely



P. J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

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Summary and Recommendations

Audit Summary

Introduction

1. The Commercial Support Program (CSP) was introduced in 1991 following a review of the report, *The Defence Force and the Community* (the Wrigley Report), tabled by the Minister for Defence in 1990. This report proposed that greater use be made of civilian infrastructure and national resources by contracting out support functions where this was operationally feasible, practicable and cost-effective. The objective of CSP is to achieve best value for money in the acquisition of support services for the Department of Defence and to give the private sector an opportunity to participate in the provision of those support services. The CSP process involves requesting offers from the private sector to perform support services and comparing those offers with the proposal put forward by any in-house option, where such a proposal may be feasible. The option assessed as providing the best value for money is then selected and a contract is negotiated or, if the in-house option is selected, an agreement for the provision of the service is prepared.

The audit

2. CSP was chosen by the Australian National Audit Office (ANAO) for audit due to the significant value of activities involved and the relevance of CSP to other Government activities which may be subject to market-testing and outsourcing. To date, 94 activities have been market-tested under CSP with a total value over \$1.5 billion. The audit was conducted in order to assess whether CSP was meeting its objectives and to identify any areas where it may be possible to improve the timeliness, and therefore cost-effectiveness, with which CSP is implemented and the quality of the process itself to produce better outcomes.

Overall conclusions

3. The CSP program has contributed to greater cost-effectiveness of supplying Defence support services. Whether the competition has been won by the in-house option or a commercial tenderer, the process has created more awareness of the need for economy and has consequently been instrumental in improving the cost-effectiveness of the provision of these services. CSP methodology has been developed reasonably well but its implementation could have been more effective. CSP has demonstrated that the philosophy of improving the efficiency of service provision by

market-testing support services is sound. Better value for the Commonwealth could be obtained if more emphasis was placed on the implementation of a number of specific features of the market-testing and contract management processes.

4. This audit has confirmed that the second part of the objective of CSP is being achieved; that is, increased private sector participation. Such participation has been successful in competitions with the Department's own in-house bids. The proportion of market-testing competitions won by the private sector (70 per cent) has been significantly greater under CSP than under similar programs in the US (50 per cent) or the UK (30 per cent). In the cases reviewed in this audit, the Department has gone to great lengths to ensure that any possible inherent bias exhibited by Defence personnel towards in-house bids has been successfully countered. In two of the nine cases examined the in-house bid had won initially, but this had been overturned for reasons of perceived bias in the process. In both cases, in the subsequent re-evaluation process, a private sector firm won the contract.

5. In all cases examined, the activity concerned was being performed at a lower cost than it had previously. The Department recently reported projected recurring annual savings from CSP to date at \$155 million. These are an accumulation of the savings that were estimated at the time of finalising each CSP activity. The ANAO considers the exact savings being achieved cannot be adequately quantified because of difficulties in tracking costs both before and after CSP and changes in the allocation of tasks during the CSP process. Also, functions may have come into existence as a result of the CSP process - for example, a contract management function or a Divisional structure to manage the needs of military personnel 'embedded' in the contract (that is, military personnel made available to the contractor). It is clear, however, that CSP activity does result in at least moderate savings.

6. A recent report by the Joint Standing Committee on Foreign Affairs, Defence and Trade provides a note of warning in relation to CSP:

Frequently, the successful tenderer for the support contract relies on recruiting the trained Defence personnel who have been made redundant in the ADF because of the function's transfer to the commercial sector. Through employing these already-trained personnel, the successful civilian tenderer is able to provide a commercially attractive initial price for a support capability because there is no need to factor in staff training costs in the contract. This process becomes disadvantageous to Defence where the successful tenderer becomes the monopoly supplier of the support service, and Defence must subsequently renegotiate that contract from a position of

weakness, having eliminated its own in-house capability to perform the particular function.

4.20 While Defence currently advocates the efficiencies of the commercialisation process, there is evidence that the short-term gains resulting from the process may not be sustainable in the medium term. With the need for the civilian support agency to begin training replacement personnel, the increased costs will be reflected in the cost of the support function to Defence, and the apparent gains achieved in the short term may not be sustained.¹

7. Information available to the ANAO from overseas and from the UK in particular indicates that the concern expressed by the Joint Committee is valid.

8. Evidence suggests that CSP could have been implemented more quickly, resulting in the earlier harvesting of these savings. In some cases, the first major step with the CSP process, the development of a Statement of Requirement (SOR), has taken two years. The US standard for this task is around three months. The Defence Efficiency Review appeared to recognise that market testing could be more timely. Under the current Defence Reform Program (DRP)² support services are intended to be market-tested at a much faster rate than has been the case in the past.

9. Claims have regularly been made by both the private sector and in-house options that CSP is biased against them. The audit found no evidence of systemic bias against either option. Some contractors and in-house option teams have been dissatisfied with the results of the process. Although individual instances of unintended bias have occurred and some evaluation decisions have been overturned, the ANAO has found that the process is generally fair. As well, unit commanders have been broadly satisfied with the service they have received from both in-house options and contractors after CSP. Most felt that service delivery had improved as a result of CSP, but there has been no corroborating overall assessment of the effectiveness of CSP in the delivery of services. The cases reviewed by the ANAO showed some Defence customers for support services were quite pleased with the level of service while others have engaged in a series of performance-related disputes with the supplier almost from the start of the contract.

¹ Joint Standing Committee on Foreign Affairs, Defence and Trade, *Funding Australia's Defence*, April 1998 p. 35.

² The Minister introduced the Defence Reform Program (DRP) in April 1997 as a result of the Defence Efficiency Review to improve the efficiency and effectiveness of the achievement of the Defence mission.

10. Support services subject to CSP so far have been identified for CSP by means of a top-down process that has assisted in maintaining a holistic approach to the delivery of services. The ANAO considers it important that the Department maintain this approach in its present endeavours to widen and expedite market testing and contracting of support services under the Defence Reform Program. To outsource a particular support service at a Defence base may itself be justified and sensible in that particular context but the overall impact of individual decisions to outsource support services should be considered in the context of the Defence mission. The Department should ensure that the overall impact of support service outsourcing does not adversely affect core business and does not have the effect of eroding core capability by default.

11. The Performance Improvement Cycle, developed by the Department of Finance and Administration, requires Departments to question the need for activities to be undertaken by the Commonwealth and, if it were decided that there is such a need, to consider the best way of undertaking these activities. This means that Departments will need to explore the possibility of improving service delivery through different means such as business process re-engineering, benchmarking, quality assurance reviews and competitive tendering and contracting including purchaser/provider arrangements. The Performance Improvement Cycle provides a wider focus than CSP but includes the business process re-engineering and competitive tendering and contracting which are the fundamental features of CSP.

12. CSP has provided the motivation for Program areas in Defence to undertake market-testing. It has also provided a reasonable methodology for doing so. To a large extent the Defence Reform Program, introduced in April 1997, has supplanted CSP as the main driver for achieving improved efficiency in the provision of support services. The Performance Improvement Cycle approach is also expected to have a major influence. The Department could review the role and functions of CSP and the CSP Branch in the light of these later developments, specifically considering the roles of the newly formed Defence Corporate Support and Support Command in market-testing processes.

Department of Defence comment

13. The Department provided the following comment on the ANAO's overall conclusions:

Defence notes and agrees with the ANAO comments that CSP has been responsible for increasing the cost effectiveness of supplying Defence support services, that CSP methodology has been developed well including competing

In-House Options (IHO) with the private sector, and that the CSP objective of private sector participation has been achieved.

With regard to the ANAO observation that the Commercial Support Program could have been implemented more quickly and been more effective in harvesting savings:

- Defence accepts that the pace of finalisation of individual CSP projects has slowed in recent years. Such a development was inevitable as the simpler and more assessable CSP-targeted activities were tested, and as larger, more complex activities extending across several Defence Programs have been addressed.*
- The Defence Reform Program recognised this challenge and addressed it by consolidating like functions which are to be rationalised and market tested; and by requiring a fourfold increase in the rate of testing. The target of 16 000 positions to be tested over four years is substantial by any measure.*
- In terms of the realisation of savings, the Commercial Support Program has consistently exceeded the initial benchmark of 25 per cent, while the introduction of the Performance Improvement Cycle (being incorporated into the 5th edition of the CSP Manual) should assist in identifying and realising further savings.*

Key Findings

The market-testing process under CSP (Chapter 3)

14. The heart of the market-testing process is the development of the Statement of Requirement (SOR) for each activity. The ANAO was told by contract management personnel in Australia, the US and the UK that the development of an appropriate SOR is the most important step in the process. The cases reviewed in this audit demonstrated that the Department has had substantial difficulty in developing appropriate SORs. This has resulted in problems in the contracting process and contract management. In one case, an SOR attached to a Request for Tender that was issued in February 1997 was still being significantly amended in December, three weeks before bids were due. There could be better outcomes if the Department put more resources into developing comprehensive and workable SORs and using specialist expertise either from within the Department or the private sector.

15. The Department has not produced a strategy to accumulate expertise in the key areas of market-testing; that is, development of the SOR and any in-house option. Although CSP candidates have been identified by senior management as being suitable for market testing each CSP contest tends to be treated as a separate activity. An activity subject to CSP will attempt to attract personnel with appropriate experience to assist with a market-testing study but there appears to be no strategy to ensure that appropriately-experienced people are available. A strategy to develop and use such expertise would provide significant long-term returns to the Commonwealth in the acquisition of more cost-effective support services. The ANAO considers the failure of the Department to ensure that key functions are adequately staffed with appropriately experienced personnel as the most significant factor inhibiting CSP achieving its full potential. Experience so far indicates that the likely direct and indirect costs involved would be much less than the probable savings.

Maintaining levels of military personnel (Chapter 4)

16. In determining whether functions undertaken by military personnel could be performed by civilians, and therefore available for contracting, the Department needs to have a clearly specified framework in which to decide whether, for military reasons, it must retain certain positions as military billets. The Department requires a certain number of military personnel in various functional groups and geographical locations to be

able to carry out the Defence mission. This is referred to as Military Required in Uniform (MRU). The Department does not have a complete, detailed specification of these requirements. This has meant that there are often lengthy negotiations about what constitutes a core position and what military positions on a base or in a particular function are justified for defence capability reasons. The Department has worked around this problem in some respects by providing for military personnel to work for a contractor as part of the contract (embedding of military personnel) but this has a number of deficiencies. It would be preferable for the Department to identify all of its MRU by function and region and concentrate those positions into appropriate units, subject to military imperatives and depending upon the development of feasible unit structures. The most likely candidates for using embedded MRU would be those units too small to be economic and unsuitable to be amalgamated with other units.

17. MRU is an essential component of ADF preparedness. The 1996 ANAO report *Management of Australian Defence Force Preparedness* noted that:

[the ability to identify and quantify the resources required to achieve the mission of the ADF] is a complex task and Defence's ability to assess the resource requirements arising from specific levels of preparedness for each force element requires considerably more development.³

18. The Department should be able to identify the need for military personnel accurately across the entire functional continuum and to pinpoint any particular geographical requirement for those personnel. Unless the Department is able to define clearly the military positions it needs to meet expected military contingencies, it will be unable to ensure that market-testing does not diminish MRU below minimum desirable levels and impact adversely on defence capability.

19. A new definition has recently been developed as a result of the emphasis placed by the DRP on improving the 'tooth to tail' ratio (that is, the ratio of combat personnel to support personnel). It provides that an activity can be deemed to be core only when it is not practicable to allow it to be contracted out. In other words if the private sector can develop a solution which still enables all military needs to be met then the activity can be market tested. This definition will allow market-testing of a larger number of positions but it still requires the Department to determine which military positions and functions it needs to keep and which could be contracted out. Military personnel are significantly more costly than

³ The Auditor-General, Audit Report No17 1995-96 *The Management of Australian Defence Force Preparedness* p.10.

equivalent civilian personnel and should be maintained only if they are essential to the Departmental mission. The Ready Reckoner provided in the CSP Manual indicates, for example, that the average variable cost of a Colonel in the Army (or Captain in the Navy or Group Captain in the Air Force) is around \$142 000 per annum, far more than the average variable cost it indicates for the civilian equivalent (a Senior Officer Grade B in the Australian Public Service) of \$94 000 per annum.

Management of support contracts (Chapter 5)

20. The Department could also improve its management of support contracts. The Department had not always been able to compel the contractor to meet the terms of the SOR consistently. Having gone through a lengthy and expensive process to attempt to get best value for money from market-testing, the Department does not then ensure that the contract developed allows management to ensure that the value envisaged in the market-testing process is achieved. A contractor may win the right to negotiate by bidding low and then subsequently negotiate terms and conditions which ultimately allow the return under the contract to be increased.

21. US Defense support contracts have gradually become more focussed on maintaining the Government's ability to ensure that contractors meet both the contract requirements and the price that they have bid. Some successful mechanisms used by the US Department of Defense include:

- making contracts for a short initial term, generally one year, with a number of one-year extension options. This allows contracts to be terminated with relatively little difficulty if contractors fail to perform;
- identifying a proportion of the contract price as an award fee, to be granted by the contracting authority depending on the perceived level of performance;
- introducing service-level agreements into contracts which detail how much of a payment will be withheld if some task is not done satisfactorily; and
- developing Quality Assurance Surveillance Plans with the SOR to make it clear to potential contractors what the Department will do to ensure that they are meeting the requirement.

The private sector often suggests that such measures would be costly and unnecessary. But these costs generally would arise only if the contractor concerned does not provide what it has contracted to provide. In the only contract reviewed in this audit that includes performance incentives, it was

noted that the contractor goes to considerable lengths to ensure that the requirements are met.

22. The ANAO has recommended several methods of encouraging optimal performance from a contractor. These include the trial of suitable short-term contracts with a number of renewal options, incentive clauses, agreed levels of performance and remedies for specific deficient performance. The Department's response relied heavily on the notion that partnering and performance monitoring reduce the need for provisions in contracts that enable the Department to elicit required levels of performance from contractors. In response to Recommendation No. 11 (shorter contracts with annual options for renewal), the Department said, in part:

These [preferred alternative approaches for achieving performance] include providing greater effort in ensuring quality SORs, including clear and measurable performance indicators, skilled contract management and use of a Partnering approach to achieve more effective communication and relationship building.

And in response to Recommendation No. 12 (award fees and incentive contracts):

Defence considers other approaches to encouragement should also be considered including Partnering and performance monitoring, and reporting arrangements.

23. Of relevance in these respects are comments made in a recent report by the Senate Finance and Public Administration References Committee, *Contracting out of Government Services*:

Similarly the then Department of Finance in its submission to the committee stressed the need for 'a flexible approach to contracting arrangements rather than rigid requirements'. In the department's opinion the ideal relationship is one where:

"both parties ... recognise their mutual dependence and thus their mutual interest in developing a cooperative relationship rather than an adversarial one. ... The primary concern in relation to many contracted out services is that the outcomes of the service are achieved."

However these preferred model relationships, while appealing, sound unlikely to reflect the reality of many contractual relationships which are, after all, business relationships in which the parties do not necessarily have common objectives.⁴

⁴ Senate Finance and Public Administration References Committee, *Contracting out of Government Services, Second Report*, May 1998, p. 25.

24. The cases reviewed in this audit provided significant evidence to support the Committee's view. While accepting the benefits of a partnership approach, the Department, nonetheless, should have regard to the advice proffered to the Committee by a contract law specialist:

The whole purpose of a contract is to make a legally enforceable agreement.

To the extent that it lacks enforceability, that purpose is undermined.⁵

Thus the ANAO is proposing that the clear benefits of a partnership approach be underlined by more focussed contractual arrangements in respect of performance delivery. This is generally understood and accepted in the private sector.

The value of in-house options (Chapter 6)

25. Another area where CSP could have been more effective is that of in-house options. Under CSP, around 30 per cent of contests are won by in-house options. The resources devoted to development of in-house options are variable in both quality and quantity. On some occasions many personnel involved with the development of the in-house option were only available on a part time basis and most of the people involved had no experience in developing a contract proposal. This is in contrast to the private sector bidders which have specialist marketing areas to develop and promote their bids. In the US and the UK Defence Departments, in-house options have been much more successful in winning market-testing competitions than they have been in Australia. The fact that so few in-house options have won such competitions, compared with similar programs in the UK and the US, often against the same firms that are competing in those countries, suggests that in-house options developed in Australia under CSP are not as competitive as those developed in these other countries.

26. A strong in-house bid provides a sound benchmark against which to judge the commercial bids and should provide a viable alternative to those bids. The in-house bid is also of value in ensuring a cohesive approach. The process of developing the in-house bid can identify valuable interrelationships, for example, in skills and joint costs, with other areas of Defence activity. If the market-testing program is to provide best value for money, the Department should ensure that in-house options provide the best value for money that could be gained from an in-house bid including the opportunity to deliver the service differently.

⁵ Senate Finance and Public Administration References Committee, *Contracting out of Government Services, Second Report, May 1998*, p. 25.

27. In the US, successful in-house options go on to win competitions for work at other bases. Likewise in the US, an in-house option can be re-established even though it has lost a previous competition, provided it can demonstrate sufficient efficiency to warrant the cost of re-establishing internal service provision. Under CSP, in-house options do not compete for work in other areas of the Department. An unsuccessful in-house option cannot be re-established. If it is to get best value for money in the provision of support services the Department should be actively considering all viable options to ensure the cost-effective long-term delivery of services.

Department of Defence response to key findings

28. The Department provided the following response to the ANAO's key findings:

The market-testing process under CSP

Defence notes the ANAO comments about CSP tests tending to be treated as separate entities involving staff new to the CSP process. Defence considers that a critical success factor is the extensive involvement of the managers and staff affected in the CSP testing process and considers that the benefits of their involvement greatly outweigh the costs of providing CSP training and guidance to facilitate their involvement. Defence does maintain core cells of experienced staff, a CSP Manual and Practice Notes, and has a panel of expert industry consultants, all to assist in the CSP testing. Noting ANAO's comments, Defence will address the issue of increasing resources in Programs with key CSP roles, to maximise the efficiency and benefits of the process.

Maintaining levels of military personnel

While noting the ANAO commentary on the issue of Military Required in Uniform, Defence considers that the organisation of units to facilitate market testing must be subordinate to the requirement to structure the Defence Force to deliver Defence capability.

Management of support contracts

With the increasing numbers of support contracts arising from the CSP, particularly under the DRP, Defence is cognisant of the need to improve management of support contracts and is stepping up its efforts in training of contract management staff and networking between contract managers. The revised CSP Manual emphasises the need for continuity of contract management staff during the SOR development, selection and contract management phases. Adoption of PIC [Performance Improvement Cycle] principles involves a new focus on evaluation and review of implementation results.

The value of in-house options

Defence continues to support the involvement of IHOs in CSP competitions. Although they win less often than those in the US and UK (about 30 per cent compared with 50 per cent overseas), this is considered to be more a reflection of the strength of commercial competition for CSP contracts because of private sector faith in the fairness of the CSP process, than of any lack of competitiveness of IHOs. ANAO also does not explore where other factors such as local political issues, may affect the overseas ratios. Australian IHOs have a win rate equal to or better than any other bidder in CSP competitions and are consistently ranked in the top three of CSP bids. Understandably IHOs are not as competitive in the less specialised and less highly skilled functions.

Recommendations

Set out below are the ANAO's recommendations with report paragraph references and an indication of the Defence response. The ANAO considers that Defence should give priority to Recommendation Nos 4, 6, 11, 12 and 16, indicated below with an asterisk.

Recommendation No. 1
Para. 2.3 The ANAO *recommends* that the Department review the location of the CSP Branch in the Inspector-General Division with a view to avoiding a conflict of interest for the Inspector General arising in any audit or review of CSP or CSP-affected activities in Defence.

Defence response: Not agreed.

Recommendation No. 2
Para. 2.11 The ANAO *recommends* that guidance provided by the CSP Manual on communicating with staff be reviewed to ensure that in each case an effective communication strategy is developed as soon as possible after a decision to market-test an activity has been taken. This strategy should be reviewed after the event and the lessons learned incorporated into the future guidance provided to managers.

Defence response: Agreed.

Recommendation No. 3
Para. 2.30 The ANAO *recommends* that the CSP Manual incorporate an integrated set of model documents to inform those participating in the market-testing of activities of what is involved in developing the key documents in the market-testing process.

Defence response: Agreed.

***Recommendation No. 4**
Para. 2.41 The ANAO *recommends* that, to avoid the perception of bias, those responsible for the management of the testing process should have no more involvement with the in-house option than they would with other tenderers.

Defence response: Agreed.

Recommendation No. 5
Para. 3.11 The ANAO *recommends* that Defence identify activities for which commercial business solutions are not possible and, for all other activities, invite the private sector to develop arrangements which would enable those activities to be contracted out. For any activities where Defence accepts that the private sector is able to offer viable solutions the activity should be included in the market-testing program.

Defence response: Agreed.

***Recommendation No. 6**
Para. 3.32 The ANAO *recommends* that the Department develop a strategy for providing appropriately experienced staff in all phases of support contracting but particularly staff with expertise in SOR development who would be capable of developing a high quality SOR in the shortest possible time.

Defence response: Agreed with qualification.

Recommendation No. 7
Para. 3.37 The ANAO *recommends* that the Department specify the selection criteria for Management Review Team members to ensure that the appropriate level of knowledge of the activity and analytical and management ability is resident in the team.

Defence response: Agreed.

Recommendation No. 8
Para. 3.45 The ANAO *recommends* that the Department require market-testing teams to develop, concurrently with the development of the SOR, a strategy document which indicates how the achievement of outcomes set out in the SOR will be monitored.

Defence response: Agreed.

Recommendation No. 9
Para. 4.6 The ANAO *recommends* that, where a contract provides for embedded Military Required in Uniform, the Department identify and define the need for any necessary Divisional structure to serve the interests of embedded personnel and, where meeting this need will require the Department to incur a cost that would not be required if the in-house option were successful, take this cost into account in evaluating commercial tenders.

Defence response: Agreed.

Recommendation No. 10
Para. 4.11 The ANAO *recommends* that, if MRU are to be embedded in a contract, this should be done on a rebate basis where the contractor, or in-house option, includes, as part of its bid, a rebate per hour per position which is used in the financial evaluation of bids.

Defence response: Agreed.

***Recommendation No. 11**
Para. 5.7 The ANAO *recommends* that the Department, in a trial program of contracts designed to achieve greater control of outcomes:

- (a) seek to negotiate selected contracts for suitable support services for short initial periods (1-3) years with provision for annual extensions; and
- (b) review the trial program in due course to help define circumstances where such an approach might be usefully adopted for greater cost-effectiveness.

Defence response: Not agreed.

***Recommendation No. 12**
Para. 5.21 The ANAO *recommends* that the Department introduce award fees or other incentive measures, where suitable, into support contracts as a cost-effective means of encouraging optimal performance from contractors.

Defence response: Agreed with qualification.

Recommendation No. 13
Para. 5.28 The ANAO *recommends* that the Department require negotiation teams to negotiate an appropriate performance agreement for each support contract specifying the levels of service to be provided and the consequences of providing lesser levels of service.

Defence response: Agreed with qualification.

Recommendation No. 14
Para. 5.36 The ANAO *recommends* that, for better negotiation and management of support contracts, the Department establish a contract management cell and develop and document procedures for monitoring the contractor's achievement of required outcomes for each support contract. Where possible this contract management cell should be at least partially in place prior to negotiating the contract and at least one of its members should be included in the contract negotiation team.

Defence response: Agreed with qualification.

Recommendation No. 15
Para. 5.41 The ANAO *recommends* that Defence support contracts provide for the Department to have access to contractors' records, information and assets directly relevant to contract performance and that they also provide for the ANAO to have an equivalent level of access.

Defence response: Agreed.

***Recommendation No. 16**
Para. 6.8 The ANAO *recommends* that the Department establish an in-house option Unit to provide coordination, resources and advice to in-house bids and successful in-house options to ensure they operate in a commercial manner and give them opportunities to do so through Business Process Re-engineering where suitable.

Defence response: Agreed, with qualification.

Recommendation No. 17
Para. 6.12 The ANAO *recommends* that the Department introduce management accounting systems to establish the true costs of providing in-house options. These systems should "charge" the Department for any work done outside of the scope of the SOR as well as allowing for rebates for any staff taken off-line to perform tasks outside of the in-house unit.

Defence response: Agreed.

Audit Findings and Conclusions

1. Introduction

The origins of CSP

Background

1.1 The origins of CSP lie in the 1987 Policy Information Paper, *Defence of Australia* (DOA 87), which established the policy of defence self-reliance and set priorities for the development and cost-effective use of defence-relevant civil and industrial infrastructure.

1.2 DOA 87 proposed that, to advance the policy of self-reliance, Defence needed to change the way in which it conducted business and the manner in which it relied on the community to develop and sustain its military capacity. The need for change provided the initial impetus for the development of a formal program for commercial support in Defence.

1.3 Commercial support is not new to Defence. Over the years, Defence has relied upon contractors to perform support tasks. However, these arrangements were not based on a coordinated program to improve cost effectiveness but rather on the individual initiative of managers at various levels to save money, improve service levels or acquire expertise or resources that were not available within the Defence Department.

1.4 Defence's interest in and commitment to developing a formal Commercial Support Program were given further impetus by reviews in the early 1990's. The 1991 *Force Structure Review*, which combined the DOA 87 priorities for self-reliance with the priority Defence roles identified in *Australia's Strategic Planning 1990* (ASP 90), highlighted a need to minimise the resource demands of support functions. The key point in the establishment of CSP was a report entitled *The Defence Force and the Community: A Partnership in Australia's Defence*, tabled by the Minister for Defence in June 1990 and known as the Wrigley Report.

Wrigley Report

1.5 The Wrigley Report proposed that greater use be made of civilian infrastructure and national resources by contracting out support functions where this was operationally feasible, practicable and cost-effective. The report estimated that Defence could save \$396 million per annum through effective implementation of a program of market-testing of support services. This was later revised downwards to \$350 million per annum by a special

Interdepartmental Committee (IDC) set up to review the report and its implications.⁶

1.6 The IDC also concluded that the probable reduction in Defence personnel necessary to achieve savings of \$350 million could be up to 26 000 positions. The IDC was not envisaging that improved efficiency could eliminate the work done by these people, although some such savings were expected, but rather that the bulk of this work would now be done by personnel from the private sector rather than the Department of Defence.

International better practice

1.7 The Wrigley Report canvassed the benefits of community participation in defence activities in a number of other countries although the chief proponents of market-testing and commercial outsourcing were the USA and the UK.

1.8 Since the 1960's the US Government has had a methodology for market-testing of non-core government activities, defined by Budget Circular A-76. Although the A-76 process was often used, reports by the General Accounting Office indicate there was frequent resistance to A-76 studies at all levels. The procedural basis for A-76 studies has been developed and refined over the last 30 years and in some areas has useful lessons for competitive testing in Australia. In recent years there has been a renewed emphasis on improving the efficiency of support activities in the US military resulting in significant cuts in support budgets. These have compelled managers to improve cost effectiveness and required Service policy areas to refine and renew the guidance and assistance available to local commanders. Some of this guidance has been reviewed in the conduct of this audit to identify better practices which may be applicable to Australian conditions.

1.9 Likewise the UK Government has been market-testing support activities for some time, so much so that the Ministry of Defence believes it has all but completed its program, entitled *Competing for Quality*, and is now moving on to consider various means of encouraging private sector involvement in the development of Defence infrastructure. The practices and successes of the UK *Competing for Quality* program have also been reviewed as part of this audit to identify any aspects of the program which may be useful in the Australian context.

⁶ Report of the Interdepartmental Committee (IDC) on the Wrigley Review *The Defence Force and the Community* tabled by the Minister for Defence, May 1991.

A note of caution

1.10 Although there is significant support for market testing in both public and private sectors, a recent report by the Joint Standing Committee on Foreign Affairs, Defence and Trade provides a note of warning in relation to the long-term effects of outsourcing activities:

Frequently, the successful tenderer for the support contract relies on recruiting the trained Defence personnel who have been made redundant in the ADF because of the function's transfer to the commercial sector. Through employing these already-trained personnel, the successful civilian tenderer is able to provide a commercially attractive initial price for a support capability because there is no need to factor in staff training costs in the contract. This process becomes disadvantageous to Defence where the successful tenderer becomes the monopoly supplier of the support service, and Defence must subsequently renegotiate that contract from a position of weakness, having eliminated its own in-house capability to perform the particular function.

4.20 While Defence currently advocates the efficiencies of the commercialisation process, there is evidence that the short-term gains resulting from the process may not be sustainable in the medium term. With the need for the civilian support agency to begin training replacement personnel, the increased costs will be reflected in the cost of the support function to Defence, and the apparent gains achieved in the short term may not be sustained.⁷

Overview of CSP

Aim and Objectives of CSP

1.11 The Aim and Central Objective of CSP, as set out in the CSP Manual, are as follows:

Aim

To ensure that non-core support services and products are provided to core Defence activities in the most cost-effective manner.

Central Objective

To transfer support activities to the civil sector where operationally feasible, practicable and cost-effective.

1.12 CSP was introduced primarily as a means of making the provision of support services more efficient while safeguarding the ability of the Department to provide operational support in times of military contingency.

⁷ Joint Standing Committee on Foreign Affairs, Defence and Trade, *Funding Australia's Defence*, April 1998 p. 35.

1.13 Basically CSP requires management to study the activity to be reviewed and to develop a set of work practices which would make it as efficient as possible. The activity is then put out to tender to see whether the private sector can offer solutions which will result in a further reduction in costs. The Department also has an obligation to develop an in-house bid if the civilian staff of the activity so desire. Guidance in the steps associated with these activities is provided by the CSP Branch but the actual re-engineering and testing process is controlled by the individual Programs.

CSP targets

1.14 Targets for CSP testing include base support activities (gardening, cleaning, security, catering and accommodation-related activities, etc), equipment maintenance (except for operational maintenance), warehousing activities and training. Broadly any activity which can be done by a civilian in a time of war can be subject to CSP. There are some exceptions but this is a sufficient definition to gain a general understanding of the target area for CSP.

CSP is to be implemented in three tiers

1.15 When it was first designed CSP was to be introduced in three tiers. This provided a hierarchy of priorities for activities to be market-tested under the CSP program.

1.16 Tier 1 activities were confirmed by the 1991 report of the Interdepartmental Committee (IDC) on the Wrigley Report. These were ADF activities where it was assessed that the introduction of commercial support would not impair military readiness, where private sector capacity existed and where there was potential for effective commercial support. Substantially all Tier 1 activities have been tested.

1.17 Tier 2 is a continuing process which ensures that all non-core activities not constrained by quarantined non-core considerations are examined systematically and subjected to competition. Tier 2 activities were identified by senior program management. Tier 2 is divided into five two-year increments, introduced annually from July 1992. (Increment 3 includes those activities which came under test from July 1994 to June 1996. Increment 4 covers July 1995 to June 1997. Increment 5 covers July 1996 to June 1998.)

1.18 Tier 3 is designed to allow people at the operational or activity levels to propose candidates for CSP reviews. The viability of such reviews must be considered in the light of potential benefits. Economies of scale are important in deciding whether to proceed. To date no Tier 3 activities have been identified.

Need to maintain holistic approach

1.19 Support services subject to CSP so far have been identified for CSP by means of a top-down process that has assisted in maintaining a holistic approach to the delivery of services. The ANAO considers it important that the Department maintain this approach in its present endeavours to widen and expedite market testing and contracting of support services under the Defence Reform Program. To outsource a particular support service at a Defence base may itself be justified and sensible in that particular context but the overall impact of individual decisions to outsource support services needs to be considered in the context of the Defence mission. The Department should ensure that the overall impact of support service outsourcing does not adversely affect core business and does not have the effect of eroding core capability by default.

The CSP process

1.20 The CSP process is set out in the CSP manual. Figure 1 is a flowchart representation of the process and shows the key steps of defining the activity to be tested, determining the options, developing those options, evaluating them, selecting the preferred option and implementing the selected option. These are the fundamental steps in any purchasing decision, the difference with CSP being in the detail of the early steps. The CSP process must provide both the incentive and the opportunity for the current procedure to become more efficient, at least to provide a reliable benchmark against which to assess commercial bids and at best to become a viable alternative to those bids.

1.21 Historically, Defence has not accorded priority to documenting or monitoring the performance indicators or outcomes of its various support activities. This means the first major task faced by the Management Review Team responsible for conducting a CSP competition is to define the activity in terms of required outcomes. This is one of the most time-consuming parts of the entire process and often results in a work definition more in terms of processes than outcomes. The development of the Statement of Requirement is seen almost universally as the key step in the process. If not undertaken well, it is capable of causing an inadequate contract and a failure of the selected contractor or in-house option to meet the requirement.

Summary of CSP activity

Activities identified and tested

1.22 Tier 1 of CSP identified 32 activities to be tested, incorporating 2932 staff positions. All of these activities have been tested with 28 per cent being won by the in-house option and 72 per cent being won by the preferred commercial option.

Tier 2 of CSP identified 83 activities to be tested, incorporating 7762 positions. Over half of these activities have been tested, with a third being won by the in-house option and two-thirds by the preferred commercial option. Of the 34 identified Tier 2 activities that have yet to be tested, 15 were scheduled to be tested by the end of 1998 with the remainder scheduled up until 2000.⁸ The Defence Reform Program and the advent of the Corporate Support Program have superseded these plans and it is expected testing will proceed at a much faster rate.

1.23 Of the activities tested to date the total contract value of activities won by the preferred commercial option has been \$1079 million. In-house options have won activities worth \$474 million.

Reported savings

1.24 In a report on CSP outcomes the Department has reported projected recurring annual savings to date at \$155 million.⁹ The ANAO considers that the level of reported savings, although it is the most visible and easily understood measure, has limited value as an indicator of performance. Official public reports of savings in relation to individual CSP contests tend to range from 15 per cent to over 50 per cent but this is not a reliable indicator of the performance of the CSP process, as the level of savings is a function of the CSP process combined with the efficiency of the activity prior to CSP and the accuracy of the costing used before and after the activity has been subject to CSP. Aside from this it is very difficult to determine actual savings. Consultants engaged by Defence in 1993 to review CSP noted that Defence financial systems did not really have the ability to track savings. Their report said:

... strong concerns were expressed to the Review Team by Program and CSP Team staff regarding managers' ability to estimate accurately and then to monitor and realise such savings. The systems are just not there and nothing appears to be being done centrally by the responsible areas to address these matters.¹⁰

1.25 Savings as reported tend to be the difference between the estimated baseline cost and the quoted contract price. The estimated baseline cost is a construction assembled by applying data in the CSP Ready Reckoner to numbers of staff at the various levels. The development of such a cost

⁸ CSP Planned Activities are not currently being reported but this information comes from a report on planned activities at 31 August 1997.

⁹ Portfolio Budget Statements 1998-99 Defence Portfolio, Budget Related Paper 1.3A pp. 192.

¹⁰ Report to the Department of Defence : *A Review of the Commercial Support Program and its Performance* August 1993 p. 11.

estimate is difficult and, unless prepared by a costing expert who is fully conversant with the activity and its environment, may provide a misleading figure.

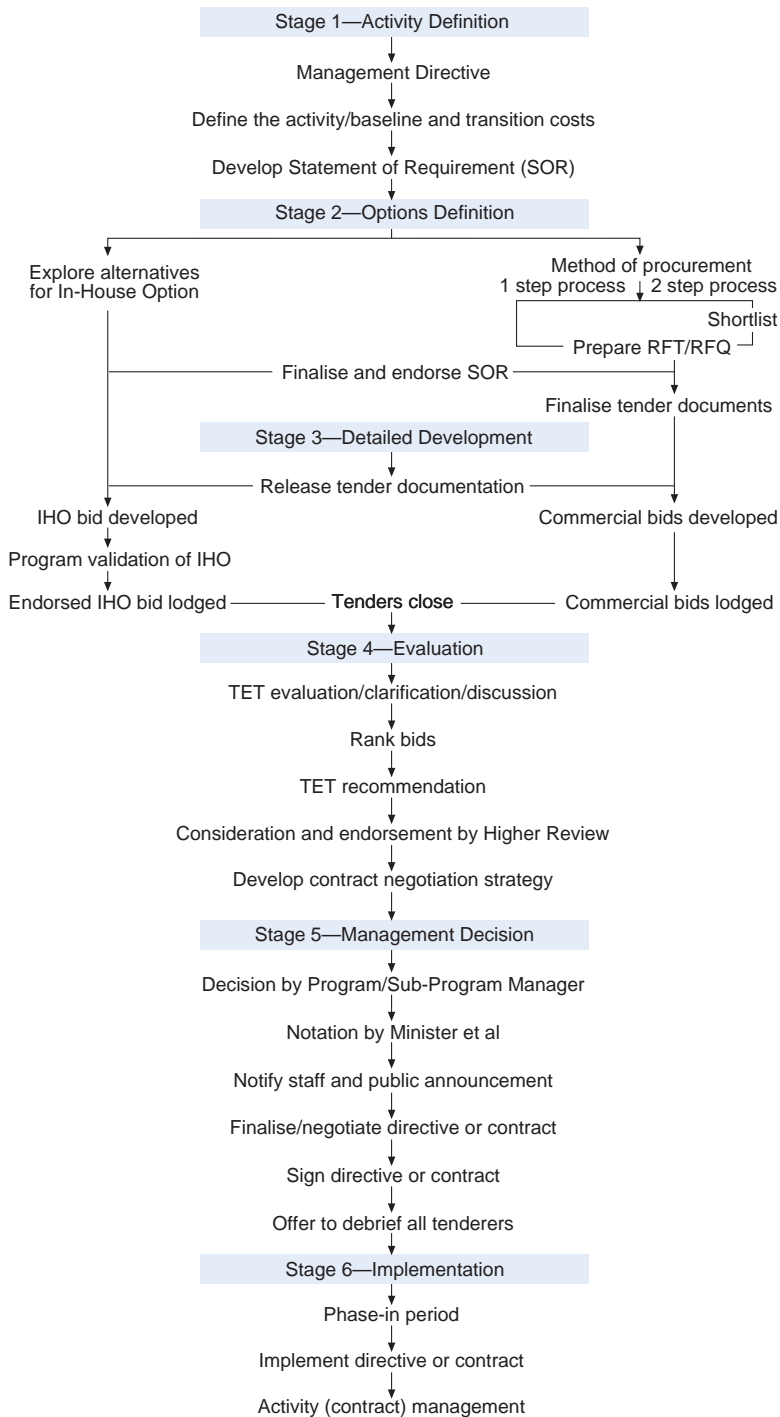
1.26 Savings are also a point estimate. The value of the contract let or the funding required for the in-house option may change with time. Indeed studies of contracting in the UK have shown that savings are much less than originally estimated. Estimated savings figures used to support the concept of contracting out, in Australia and overseas, initially average around 40 per cent. A study of garbage collection and hospital cleaning services in the UK in 1986 estimated actual budgetary savings as 20 per cent per annum. Further review of these contracts in 1991 indicated that the savings may have fallen well below 20 per cent once the contracts had time to settle in.¹¹ There is no mechanism in place in Defence to check that savings predicted at the time of letting a contract or establishing an in-house agreement were subsequently achieved. Accordingly it is unclear whether annual savings predicted in say 1993 have been consistently achieved since then.

1.27 Generally speaking the Department is not in a position to accurately define and cost an activity as it exists prior to CSP. The baseline cost on each activity is an estimate developed from staff numbers and past costs. The Department feels that baseline costs developed in this way are an accurate reflection of the actual cost of an activity. The ANAO considers that, in the absence of accurate costing information, this estimate is a rough guide to overall costs but does not have sufficient verifiable support to be used as a benchmark. In Defence's 1997-98 *Portfolio Budget Statements* no savings have been estimated on a number of activities because 'no baseline was available for evaluation'.¹² In the wake of the Defence Reform Program (DRP) the Department has withdrawn savings from Programs to prevent them leaking to other areas. This is a measure which has also been used in the US to ensure that savings achieved are real savings. It ensures that savings are made although they might not all have been made as a result of CSP.

¹¹ Cited in: Quiggin, John *Great Expectations: Microeconomic Reform and Australia*, Allen and Unwin 1996 p. 178

¹² Portfolio Budget Statements 1997-98 Defence Portfolio, Budget Related Paper 1.3A pp. 230-235

Figure 1
Flowchart of the CSP process



Source: CSP Manual, p.xii

1.28 The Department believes that the estimate of pre-CSP cost is sufficient for determining savings. The ANAO is not convinced that this provides an accurate picture or that the estimated savings claimed for CSP have all been achieved. Defence advised that under new arrangements savings will be recovered from Programs as they are made. This should provide better data on savings in the future. It should be noted that savings made are not returned to the Commonwealth Budget but are retained by the Department.

An alternative indicator of performance

1.29 CSP activity has resulted in savings in most if not all activities tested although, for the reasons stated above, the ANAO does not see the level of reported savings as a reliable and verifiable measure of CSP performance. It is clear, however, that CSP activity does result in at least moderate savings and that the sooner CSP is completed the sooner the expected savings can be realised.

1.30 It is now almost seven years since CSP was introduced (in 1991) but, out of 115 activities, only 81 have been tested. In addition progress has slowed in later years. At the current rate of around 7 per year the remaining 41 Tier 2 activities would not be complete until 2004. In the UK after a period of ad hoc market-testing the Competing for Quality program was introduced in April 1992 and six years later is regarded as nearly complete by the UK Ministry of Defence. Although the CSP process commenced with some vigour, the impetus has declined in recent years.

1.31 The drop in activity can be seen in Figure 2. This graph shows the implementation dates for completed activities and the planned implementation dates for incomplete activities.¹³ The graph also shows a cluster of activity in the eighteen months to June 1994 but after that the pattern shows fewer activities. The activities have also been plotted taking into account number of positions to see whether the size of the activity to be tested is the cause for the long period that has elapsed from the start of the program to the completion of testing of some activities. There appears to be no correlation between the number of positions to be tested and the elapsed time from the start of the program to the completion of the individual CSP tasks. The reason for the relatively slow implementation of the latter part of CSP is not easily determined from the information available, as those tasks which have been slow have little in common. Although it is possible to point to problems with individual activities, and

¹³ The advent of the Corporate Support Program and Support Command has placed CSP planning in abeyance for the time being. The planned activities were those planned before this happened.

of these the time taken to determine which positions and functions are available for testing is quite frequently a major retardant to the process, there is no single factor which stands out as a cause of the overall slowdown.

1.32 The Department does not agree that the rate of CSP testing in the past is a valid performance indicator as it is dependent on higher level imperatives. The Department has also argued that the rate of CSP testing has reflected various environmental factors and methodology changes:

These include activity aggregation, function complexity, resources applied, considerations on members required in uniform and use of civilians in an area of operations, examinations of options for tri-service rationalisation and single service management, multi-Program activity testing issues.¹⁴

Where to from here?

The Defence Efficiency Review

1.33 The report of the Defence Efficiency Review, tabled in April 1997, indicated that, as part of the reform process, a further 12 949 military and civilian positions, mostly in the logistics area, would be market-tested. The imperative provided by the DRP, which was announced by the Minister when releasing that report, means that this market-testing has the same impetus as the testing of Tier 1 activities - it is no longer a question of which of these positions would be tested but only a matter of how quickly the Department can test all of them. Significant savings are expected as a result of this market-testing process. Rationalisation and testing of logistics across the Department are already under way.

1.34 It is expected that the impetus given to CSP, in the DER, by the identification of so many positions for testing will speed the process of testing remaining Tier 2 activities.

Has CSP outlived its usefulness?

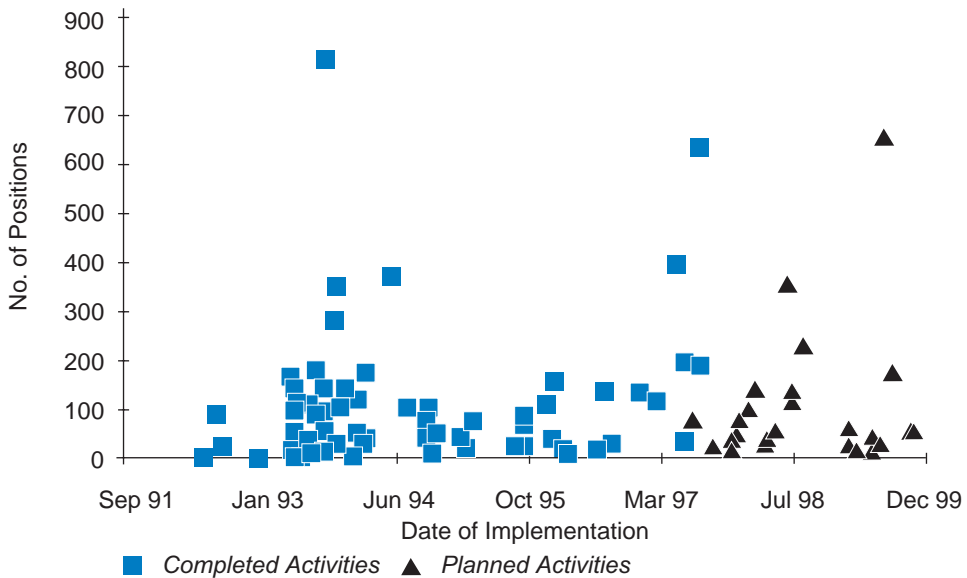
1.35 The introduction of the CSP process has provided both a methodology and a catalyst for improving the efficiency of providing support services in the Department. The methodology has been refined but has not changed significantly since CSP was first introduced. This is understandable as it is basically a procurement process. Aside from the complications of in-house options, the CSP methodology is a standard methodology for the procurement of services.

1.36 The catalytic effect imparted by CSP has been of outstanding value in breaking out of the state of inertia that existed before the Wrigley report but this effect has been overtaken to a large extent by the DRP. Defence

¹⁴ Departmental response to Discussion Paper on this audit, 17 March 1998.

Corporate Support (DCS) has been established with the role of rationalising and market-testing garrison support services and clerical and administrative support services across the Department. This will be driven by the Program which has executive responsibility. Likewise the testing of the bulk of the remaining non-core positions identified in the DER will be carried out under the auspices of Support Command. Although this market-testing will undoubtedly rely on the developed CSP methodology the future role of the CSP Branch should be reviewed.

Figure 2
Activities plotted against planned and actual start dates¹⁵



Source: Data provided on Defence's CSP Activities Database - <http://www.csp.gov.au>

1.37 CSP was developed before the present impetus to improve the efficiency of support services and the organisational structure that can facilitate such improvements. The effect of the DRP has been to require a fourfold increase in the rate of market-testing of support activities. This is therefore a good time to review the future of CSP as a program. The development of government policy on a Performance Improvement Cycle which introduces cyclical review of all functions and other performance improvement alternatives also requires revision of the CSP Program as it has been known in the past. The Department have advised that CSP methodology is in the process of being further evolved in light of these developments.

¹⁵ Graph constructed from data on completed activities extracted from the CSP Activities Database, located on the internet through the CSP Home Page at <http://www.csp.gov.au> and for planned activities from data extracted from that site when such information was still available in August 1997.

Other reviews of CSP

Consultants' report

1.38 The Department engaged consultants to review CSP in 1993. The principal objective of the review was to examine the degree to which CSP was meeting its aim and central objective. Significant issues noted in the report, entitled *A Review of the Commercial Support Program and its Performance* (August 1993), were:

- a need for the movement of savings from CSP to the “sharp end” to be transparent;
- the low level of expertise and the generally low rank of people involved in CSP evaluation teams;
- Defence financial systems were unable to cost CSP activities accurately and they had limited ability to track actual savings;
- the lack of appropriate skills and expertise to use the methodologies, financial guidelines and models in the people required to use them;
- the absence of appropriate change management strategies and the consequent feeling of frustration, anger and alienation experienced by people performing the function being tested; and
- the lack of a sufficiently strategic approach to the management of risk.

1.39 The consultants' report has been considered in the drafting of this audit report particularly with regard to the recommendations made and the action taken in response to those recommendations.

Report on Contracting for Services within the Department of Defence

1.40 In 1994 a study was commissioned by the Director-General, CSP and the Assistant Secretary, Contracting and Regional Operations Branch to review Defence contracting for services/support activities with the aim of improving contracting processes and documents, achieving consistency in the procurement outcomes sought by the private sector and to establish the elements of a program to educate and train competent creators and administrators of service/support contracts.

1.41 The study was conducted by a Principal Solicitor from the Attorney-General's Department and an adviser to the CSP Branch.¹⁶

1.42 The main conclusion of the study in relation to CSP was that the [1993 consultants' report] finding that the contracting and tendering process

¹⁶ Department of Defence - The Attorney-General's Legal Practice - *A Report on Contracting for Services within the Department of Defence* 30 June 1994.

in CSP could be considerably improved was correct. The study supported the notion that a skilled contracting officer was essential to the contracting process and that this officer should act as a conduit between those members of the team who possess management or subject matter knowledge and those who have specialist skills such as contracting, legal and accounting skills. The study also envisaged that this contracting officer would be involved from the development of the Statement of Requirement to assisting with the management of the contract for its duration.

Industry Commission Report on Defence Procurement

1.43 Industry Commission Report No 41 (1994) *Defence Procurement* identified CSP as an area where Defence could make the greatest efficiency gains. The Report acknowledged that CSP had achieved a great deal but indicated that it could be implemented faster and broadened to include certain activities which were then considered core activities. The report also made five recommendations in regard to CSP:

- Defence should consider not proceeding with in-house bids where they had little chance of success;
- transition costs should be estimated and included in tender documentation;
- successful in-house bids should be treated as autonomous units within the Department with their own accounts;
- successful in-house options should be re-tendered when the agreement expires; and
- Defence should take every opportunity to speed up implementation of CSP.

1.44 The final note on CSP was that the Commission had been impressed by the commitment of senior management to CSP and that this commitment needed to continue and be shared across the armed services if CSP was to achieve its basic aim.

Management Audit Branch reviews of CSP

1.45 During 1995 Defence's Management Audit Branch (MAB) completed a series of internal audits of Defence Programs' management of CSP. The audits selected a number of CSP activities for review. MAB reported that they were confident that the efficiency gains sought by these activities had been achieved. It was unclear from the MAB reports what evidence MAB had to reach this conclusion. MAB made a number of recommendations but did not indicate whether they had been accepted.

The audit

Reason and objective

1.46 CSP was chosen by the Australian National Audit Office (ANAO) for audit due to the significant value of activities involved and the relevance of CSP to other Government activities which may be subject to market testing and outsourcing. To date, 94 activities have been market-testing under CSP with a total value over \$1.5 billion. The audit was conducted in order to assess whether CSP was meeting its objectives and to identify any areas where it may be possible to improve the timeliness, and therefore cost-effectiveness, with which CSP is implemented and the quality of the process itself to produce better outcomes.

Audit criteria

1.47 This audit entailed assessing, from a sample of contracts for support services, whether CSP had resulted in the Department achieving best value for money in the acquisition of support services and whether it had enabled the private sector to participate in the provision of those services to the Department. Criteria used in conducting this assessment include:

- whether the policy and procedural guidance provided in relation to the CSP process established an effective process for market-testing;
- whether the Department had accurately and comprehensively defined the activity to be tested;
- whether all reasonable measures had been taken to ensure that possible bidders had knowledge of the market-testing of the activity;
- whether in-house bids were prepared professionally, competently and competitively;
- whether bids were evaluated fairly and in such a manner as to ensure that the bid which was best value won the contract;
- whether the contract negotiated by the Department protected the interests of the Commonwealth and enabled it to ensure that the contractor delivered the requirement; and
- whether the contract was managed in such a way as to ensure that the contractor performed to the required standard.

Audit methodology

1.48 The methodology of the audit was to review the central documentation including policy and procedural guidance relating to CSP and then to review a number of cases. Cases were selected after a review of files held by CSP Branch and discussions with relevant CSP Branch personnel. The emphasis in the review of these cases varied depending on

the elapsed time since the contract was let or the in-house option engaged. For older cases it was deemed relevant to concentrate on the ongoing management of the activity after CSP as the passing of time depreciates the usefulness of reviewing the letting process. With the more recent cases often too little time had passed to review the management of the contract but recency enhanced the relevancy of the contracting process.

1.49 The audit also drew on experience of market testing and outsourcing in UK and US defence forces, including a review of work done by national audit agencies - the General Accounting Office in the US and the National Audit Office in the UK - in relation to public sector outsourcing in those countries. Defence have advised that findings about overseas practice are not necessarily transferable because of the quite different environments. The ANAO has included reference in this report to overseas practices and benchmarks only where it considers those practices and benchmarks to be relevant to the Australian context.

Audit resources and cost

1.50 The audit was conducted in conformance with ANAO auditing standards and cost \$346 000. Fieldwork commenced in July 1997 and concluded in February 1998. After detailed examination of selected CSP contracts and CSP issues, the ANAO sought comments from Defence on audit issues papers and, in April 1998, put the proposed report of the audit to Defence for comment. The final report was completed having regard to comments provided in May.

Response to the audit

1.51 In response to an ANAO discussion paper during the audit, Defence commented as follows:

Considerable effort has gone into developing the CSP methodology over the years with the benefit of the extensive military and market-testing experience available to the Department and the monitoring of overseas practices. Accordingly, there is little likelihood of an audit of a couple of months being able to make substantial improvements.

1.52 The final report has shown, however, that there is scope for Defence to make improvements. Defence agreed, or agreed with qualification, to all but two of the ANAO's 17 recommendations. The ANAO considers that the disagreed recommendations, Nos. 1 and 11, have merit. Recommendation No. 1 has a bearing on the ability of the Inspector-General to make an independent review of the operation of CSP and CSP-affected areas of the Department. Recommendation No. 11 proposes the trial of suitable short-term contracts with a number of extension options to improve the Department's ability to ensure that it receives the services required under the contract.

Audit impact

1.53 The Department could make significant savings if it improved its ability to manage support contracts more effectively. The audit found that some Statements of Requirement and contracts had been drafted in a way that would motivate the contractor to provide what was contracted but that many had not. Similarly some areas had established an effective means of monitoring the performance of the contractor but this was not universal. Better contract preparation and management could result in considerable savings to the Commonwealth. Implementation of the recommendations in this report in relation to Defence's support contracts, which will eventually involve payments exceeding \$1 billion annually, could result in savings of \$10 million annually even from savings of only 1 per cent. Speeding up of the market testing process and improvement in the quality of in-house bids could also result in significant additional savings.

2. Organisation and Procedures

The role of the CSP Branch

2.1 CSP Branch provides the policy and a portfolio level service in relation to CSP. It is the only Branch in the Department with a clear portfolio-wide CSP focus and responsibility for taking a strategic view at the portfolio level. CSP Branch also provides a focus for co-ordination, collection and dissemination of lessons learned and updating CSP methodology. It is the central policy branch for CSP and Competitive Tendering and Contracting (CTC) type processes. The Branch provides an independent policy review of CSP outcomes prior to endorsement by the Minister for Defence Industry, Science and Personnel.

2.2 The Branch was relocated in 1997 and now sits within the Inspector-General Division. Although this is not a problem from the CSP point of view it adversely affects the independence of the Inspector-General in relation to his responsibilities for independent review and audit of Defence activities. As CSP Branch has such a fundamental role in ensuring the success of CSP and in providing guidance for CTC activities across the Department it is difficult to see how the Inspector General could provide an audit opinion on its implementation that was seen to be independent.

Recommendation No.1

2.3 The ANAO *recommends* that the Department review the location of the CSP Branch in the Inspector-General Division with a view to avoiding a conflict of interest for the Inspector-General arising in any audit or review of CSP or CSP-affected activities in Defence.

Defence response

2.4 Not agreed. Defence does not agree the placement of the CSP Branch within the Inspector-General Division adversely affects the independence of the Inspector-General. The role of the CSP Branch is limited to policy development and advice, review, audit and data collection. Such roles are fully consistent with other functions undertaken by the Inspector-General Division such as internal audit, evaluation, and fraud awareness and investigation. The CSP Branch was placed in the Inspector-General's Division because of these functional linkages and to facilitate the most effective independent scrutiny of the CSP activities being undertaken by major implementing Programs. Placement of this function in areas such as Support Command or Defence Corporate Support, as proposed by ANAO,

would fail to meet this requirement. As with other functions undertaken by the Inspector-General, Defence would use external sources of scrutiny to assess the effectiveness of the CSP Branch.

ANAO comment

2.5 Defence has said in response to Recommendations Nos. 6 and 14 that CSP Branch supports the Programs with CSP training, advice on methodology and other assistance short of actually market testing, and is available to assist and provide contracting and contract management advice for CSP activities. This indicates to the ANAO that CSP Branch in practice goes beyond a limited policy role that helps facilitate independent scrutiny of CSP activities in the Programs. A recent internal Defence circular on the CSP Branch said that the 'Inspector-General will continue to be responsible for the implementation of the CSP.' The ANAO considers that this situation creates a potential conflict of interest for the Inspector-General in any review or audit of CSP or CSP-affected activities in the Programs.

Building confidence in the CSP process

The public relations role of CSP Branch

2.6 Part of CSP Branch's role is to provide information and reassurance to Defence personnel who may become involved in the CSP process. As many of these people may lose their livelihood or their career as a result of CSP, the human element of CSP should not be understated. The Department has implemented this wide outsourcing program with little industrial action. The industrial relations aspects of CSP have been handled well.

2.7 CSP Branch is doing a good job in providing an overall view of activity on various CSP targets with regular newsletters and a comprehensive internet site. If there is a problem relating to the dissemination of information to affected personnel it is in informing them of what is happening in the testing of their particular activity throughout the course of the testing process. This is not the role of CSP Branch but of the individual activity management. CSP Branch does, however, have a role to play in ensuring that managers are focused on the human relations side of the CSP process.

2.8 The detailed guidance provided in the CSP Manual does not consider the mitigation of the effects on personnel until after the decision has been made. Discussions with individual staff are not advocated until that point although there is a requirement for staff to be generally informed of the process. If staff are not fully apprised of their individual position until then it is not surprising when some do not cooperate fully with the process. An investment of resources into developing a dialogue with the

individual staff members early in the process could reap significant benefits in terms of a smoother process and a better end result.

2.9 The in-house option team in one case distributed a document entitled *CSP Affected Staff - Information Pack* early in the CSP process, a month before the release of the Request for Tender, which provided staff with a clear picture of where they stood and provided for consultation with individual staff regarding their future. The document was passed to Army for a later CSP test. The use of this document was not included in the CSP Lessons Learned Data Base. The production and distribution of such a document should be a matter of course.

2.10 The ANAO Better Practice Guide, *Managing APS Staff Reductions*, June 1996, noted that:

Agencies report that, where managers speak directly to staff at key points in the process, staff morale is built up. When exchanges are frank and open, with management being straightforward and willing to tell staff when they do not have answers, staff will be confident that they are getting an honest hearing.

The CSP Manual could require a greater emphasis on dealing with the problems and concerns of individual staff than it currently does.

Recommendation No.2

2.11 The ANAO *recommends* the guidance provided by the CSP Manual on communicating with staff be reviewed to ensure that in each case an effective communication strategy is developed as soon as possible after a decision to market-test an activity has been taken. This strategy should be reviewed after the event and the lessons learned incorporated into future guidance provided to managers.

Defence response

2.12 Agreed. The CSP Manual has recently been revised to incorporate amongst other things the outcome of negotiation of a new Defence Employees Industrial Agreement. This agreement lays down mutually agreed consultation and briefing requirements that are to be followed. The revised CSP Manual and Practice Note provides more detailed guidance on communication and consultations with affected staff and a requirement for development of a staff management plan. Defence consults extensively with staff representatives and is responsive to suggestions for improvements. Defence does and will incorporate lessons learned into CSP methodology.

Mixed signals from CSP policy

2.13 The CSP central objective is not aligned with the CSP aim. The objective emphasises the transfer of support activities to the private sector if it is cost-effective to do so, whereas the aim is to achieve the **most** cost-effective solution. This has probably caused confusion and some skepticism among those affected by CSP.

2.14 The consultants' report in 1993 cited several staff members who were confused about the true aim of CSP. Some staff comments indicated that the main purpose of CSP was to transfer work to the private sector:

- *It was supposed to be a boon and to mean increased business for Australian industry;*
- *Commercial interests should be reaping a bonanza under CSP; and*
- *CSP is the ultimate extension of devolution, not simply from the centre but from the Department to an external provider.*¹⁷

2.15 In constructing a policy framework for an initiative such as CSP it is important that, in the hierarchy of aims, objectives, goals and procedures, each lower level is entirely consistent with the higher levels to avoid sending mixed signals.

2.16 One of the goals of CSP, set out in the Manual, removes the notion of cost-effectiveness altogether, or at least assumes that commercial bids will be more cost effective than Defence best practice:

*to transfer non-core support activities to the civil sector where operationally feasible and practicable, after competition with Defence best practice.*¹⁸

2.17 The aim and objective of CSP can be compared with the objectives of the Competing for Quality program in the United Kingdom, the equivalent of CSP, which carry no assumptions about the outcome of the testing process:

to improve value for money in the delivery of public services through competition; [and]

*to bring about a step change in the level of competition for the delivery of public services.*¹⁹

¹⁷ Report to the Department of Defence : *A Review of the Commercial Support Program and its Performance* August 1993, p. 11.

¹⁸ CSP Manual 4th Edition, Para. 2.6, p. 7.

¹⁹ *Competing for Quality: Policy Review - An Efficiency Unit Scrutiny*, UK Cabinet Office, 1996 p. 2.

2.18 These objectives are focused on the outcomes expected to be achieved. This is in contrast to the CSP central objective, which focuses on the process ie 'To transfer support activities to the private sector'.

2.19 The ANAO considered that, if the goal of transferring non-core activities to the private sector has equal or greater standing than cost effectiveness, the aim of CSP should be redrafted to reflect this. Otherwise it is necessary to review the guidance provided in relation to CSP to ensure that it reflects the true objectives of the program.

Defence comment

2.20 Defence noted that the true test is how the process operates. The priority as stated in the CSP manual is to transfer support to the civil sector, subject to that being operationally feasible, practicable and providing better value for money. Technical merit evaluation criteria used in assessment of bid value include criteria such as corporate capability and industry development (including SME involvement) that favour the civil sector in the best value for money / most cost effective determination. While in-house options (IHOs) may score lower in these criteria they often have compensating advantages in other criteria and accordingly have won about a third of the competitions.

2.21 Defence also argued that use of the UK wording 'to improve value for money ...' without also referring to the self-reliance and national infrastructure related objectives would be potentially misleading, as CSP evaluation criteria do take such objectives into account.

2.22 Accordingly Defence considers that there is no issue of incompatibility between best value for money / cost effectiveness and a goal of transfer of non-core activities to the civil sector, as evaluation criteria include elements that recognise value in national infrastructure development. Hence, in the interest of further clarity, Defence agreed to review the wording in the CSP Manual.

Documented guidance - the CSP Manual

2.23 The CSP Manual, now in its fourth edition, provides a comprehensive explanation of the CSP process. It also provides a ready reckoner to estimate baseline costs and enables in-house bidders to calculate salary and associated overhead costs. The stated purpose of the CSP Manual is to provide Program Managers and staff at all management and command levels with guidelines which:

- clarify policies, aims, objectives, and principles;
- provide a common decision-making process to select the best outcomes;

- develop management and financial methodologies;
- provide a common portfolio-wide framework to identify opportunities, study options, address issues and make decisions; and
- establish a top-down, evaluation, reporting and implementation scheme.

2.24 Four of these five objectives are accomplished well by the Manual. The objective to ‘develop management and financial methodologies’ is not achieved with the same degree of success. The comment was often made to the ANAO that the manual did not provide enough guidance on how to do some of the things required to be done. For example, in relation to the development of the tender Evaluation Plan the Manual notes:

*... a Tender Evaluation Plan (TEP) needs to be developed and approved, noting the plan cannot be changed. The TEP sets out the objectives of the request for tender and the process by which the objectives will be achieved. The TEP will repeat the evaluation criteria set out in the tender documentation and indicate the evaluation methodology including the weightings assigned to each criterion.*²⁰

2.25 The Manual notes in a later section that ‘the [Tender Evaluation Team] is to apply a suitable evaluation approach developed at the SOR stage to determine the overall value of each bid’. This guidance is probably sufficient for someone who is experienced in evaluation techniques but it could be difficult for people who do not have such experience to design or even define a ‘suitable evaluation approach’. A Practice Note on Value for Money provides one methodology for evaluating value for money but even this methodology would be more effective if it were used by someone with a good understanding of evaluation techniques. Another area which the Manual does not provide substantial advice on is contract negotiation. The Manual suggests that it ‘may be helpful to refer to relevant Commonwealth publications which specialise in contract negotiations’. The Manual does not provide detailed advice on how to go about contract negotiations. Some personnel involved in the testing of activities have considered that this was a limitation.

2.26 The Manual provides reasonable guidance on how procedures should be performed and particularly on when advice should be obtained. On the development of the Statement of Requirement, for example, the Manual advises that the *Consultancy Services Contract - Standing Offer* should be used, particularly for developing the SOR, and that a template SOR is available through the Consultancy Services Contract.

²⁰ CSP Manual, p. 75.

2.27 The CSP Manual is not designed to provide a complete education in the CSP process and if it did it would be too large to be readily useable, involving such complex fields as specification-writing, cost: benefit analysis, contract drafting and negotiation and contract management. It provides a reasonable amount of descriptive detail on the outcomes to be achieved from each step of the process and basic guidance on how to reach those outcomes. Much of this guidance refers to the use of consultants, however, and if access is not made to the right consultants at the right time then the best outcome may not be achieved.

2.28 One way in which the Manual could be improved to provide an indication to local management as to the complexity of the task and the nature of the various documents to be produced would be to develop a set of model documents. Models of items such as the SOR, the RFT, the Tender Evaluation Plan (TEP) or the Tender Evaluation Report would give local management a better idea of the documents they needed to produce. They often currently get copies of key documents from other areas which have been subject to CSP and these documents are then used as a basis for their own documents. This means that any flaws in these documents may be transmitted to these other activities. CSP Branch should take steps to ensure that any documents being used as a guide are technically sound. The best way of doing this would be to produce a set of model documents which not only demonstrate all the features required of them but form an integrated whole - ie the model TEP is based on the model SOR and the model Tender Evaluation Report is based on the model TEP.

2.29 One concern expressed to the ANAO by some staff was that the Manual tends to be based on techniques for acquisition of equipment rather than the supply of services. The ANAO review of the Manual did not support this perception but the introduction of the model documents should assist users to gain a better understanding of the relevance of the CSP process to the acquisition of support services.

Recommendation No.3

2.30 The ANAO *recommends* that the CSP Manual incorporate an integrated set of model documents to inform those participating in the market-testing of activities of what is involved in developing the key documents in the market-testing process.

Defence response

2.31 Agreed. The CSP Manual has provided guidance on aspects to be addressed in CSP documentation rather than provide model documents because of concerns about CSP testing projects adopting inappropriate clauses designed for other circumstances. (Even for apparently generic

services such as garrison support, requirements can differ in different regions so templates and standardised documentation cannot be used without modification to reflect the differences.) These considerations have not stopped such practices from occurring informally to some extent and Defence has now decided to provide models. Draft request for tender and contract models have been prepared and forwarded to industry for comment.

Risk management

2.32 Another area of the Manual which would benefit from further attention is that of risk management. For some years now Defence has been requiring its managers to make decisions based upon an appropriate analysis of the risk involved, through the development of a risk management plan where necessary. The 2nd Edition of the Manual had a section detailing the attention that should be paid to risk management throughout the CSP process. This was contracted in the 3rd Edition of the Manual and has disappeared completely from the 4th Edition. The CSP Branch has, however, recently issued an exposure draft entitled "*The application of Risk Management in a CSP environment*". This is indicative of a renewed emphasis on risk management within the CSP program and is expected to translate, in the short-term, into specific guidance for activity managers on when and how to undertake a risk analysis and develop a risk management plan for areas subject to CSP.

Training the participants

2.33 The other major role of the CSP Branch is in training. This has been tackled in systematic manner and there were very few negative comments offered about the training provided by the Branch. People seemed to accept that there was a limit to what could be provided in a few short training sessions and that training did not make up for a lack of experience.

The role of the Management Review Team Leader

2.34 As CSP Branch has no executive function the implementation of CSP is the responsibility of the Program managers. This responsibility is devolved to a combination of central office personnel and activity managers. Each Program has a CSP Program Coordinator who is responsible for managing CSP within that program. The exact role of this position varies from Program to Program. What is common across all programs is that each CSP Project has a leader, called a Management Review Team (MRT) Leader or Project Manager, with specific responsibilities. These are set out in the Manual and includes amongst a range of activities:

- setting up both the in-house and procurement teams; and
- ensuring the in-house option proposal receives in-principle higher management approval.

2.35 The MRT Leader is responsible for ensuring that the aim of CSP is achieved with respect to the particular project they are managing. The role of the MRT Leader, as specified in the Manual, is very broad and there is a potential conflict of interest in relation to the in-house option. The in-house option team and the procurement team do not have the same objectives and in fact are on opposite sides of the process, yet the MRT Leader is responsible for establishing both teams and for obtaining higher level management approval of the in-house option. A commercial bidder would complain of unfair treatment if they alone had to provide detailed information on their bid to the Project Manager before tenders closed and when the Project Manager still had to have significant discussions with other prospective bidders.

2.36 The private sector has often indicated that there is not a level playing field as far as in-house bids are concerned, particularly when the in-house bid has won, and the fact that the MRT Leader also has some responsibility for the successful in-house bid can fuel these concerns. In none of the cases examined in the audit have we found any evidence that the MRT Leader had biased the process towards the in-house bid but the potential for a conflict of interest to be perceived is apparent. On at least two occasions where the in-house option has been declared the winner of a contest, the decision has been overturned and the activity recontested because of complaints from the private sector based on probity issues. In order to remove this perceived conflict of interest the MRT Leader should be seen as an impartial arbiter, and should have no more to do with the in-house bid than he or she has with any other bid. If Defence is to be seen to be treating the in-house and commercial bidders equitably, responsibility for arranging the team and the approval of the in-house bid should rest outside of the CSP Process itself, with the relevant line commander.

2.37 Defence does not agree that there is a conflict of interest with the MRT leader having a responsibility to establish both the IHO and procurement teams as the Manual clearly indicates that the MRT leader must remain independent of both. Defence argues that the Manual does not say that the IHO has to provide detailed information on their bid to the MRT leader or Project Manager. The ANAO remains concerned, however, about the MRT leader's perceived independence in the light of the responsibilities of the position and industry comment.

2.38 The Industry Commission Report, *Competitive Tendering and Contracting by Public Sector Agencies*, noted that:

Where in-house bids are perceived to have an unfair advantage over external competitors, indirect costs may be imposed in terms of reduced competition

from external contractors. Perceptions of unfair competition may result from in-house teams having (or being perceived to have):

- *access to internal information...[and]*
- *a close relationship with agency staff responsible for evaluating competing offers ...*²¹

2.39 The *Competitive Tendering and Contracting Roadmap*, produced by the Department of Finance and Administration, is even more specific:

*The in-house bid must be, and be seen to be, developed independently and separately from the project team, even to the point of being in separate buildings. The in-house team should have no more access or exposure to the project team than any other tenderer. This point is the greatest stumbling block to probity in the process. If industry does not believe it will get equitable treatment it will not tender and unfair processes are likely to be challenged in the courts.*²²

2.40 The ANAO considers that having the same person operationally responsible for the tendering process and for establishing the in-house option and sponsoring that option through senior management approval processes does not provide the necessary level of independence.

Recommendation No.4

2.41 The ANAO *recommends* that, to avoid the perception of bias, those responsible for the management of the testing process should have no more involvement with the in-house option than they would with other tenderers.

Defence response

2.42 Agreed. CSP methodology has allowed two approaches. One has the Management Review Team Leader with overarching responsibility for the whole process but remaining independent of both the selection process and the IHO. The other has a Project Manager who is allowed to be part of the selection process but where the IHO is developed quite independently. Both approaches have gained the confidence of private sector bidders and employee representatives familiar with CSP. In order to simplify the process the 5th edition of the CSP Manual takes just the project management approach. This approach is consistent with the recommendation.

²¹ *Competitive Tendering and Contracting by Public Sector Agencies* Industry Commission Report No. 48, 1996.

²² *Competitive Tendering and Contracting Roadmap*, DOFA, Annex A.

3. The Market-testing Process Under CSP

Defining the activity

Core and Non-Core

3.1 The first step in testing an activity under CSP is to determine whether it is feasible for the Commonwealth to contract out the activity. If, for military or other reasons, an activity cannot be contracted out then there can be no commercial competition. The Manual advises as follows:

The mission of the Defence Organisation is to promote the security of Australia, and to protect its people and its interests. To ensure the success of this mission, a range of activities must be conducted by uniformed personnel or by Defence civilian employees. ... these are termed 'core activities'.²³

3.2 More recently the DER has redefined what is meant by core thus:

An activity should be determined as core when it is not practical to establish business rules that would allow it to be contracted out.²⁴

This definition comes with certain caveats in that there are some activities which must continue to be performed by military personnel. Theoretically it is possible to contract out anything, even combat forces, but Defence considers that there are no business rules which would, for example, allow combat and direct combat support to be contracted out.

3.3 Core activities cannot be contracted out and are therefore not subject to CSP. However, the boundary between core and non-core activities can be difficult to delineate in practice. On some occasions difficulties in determining the core/non-core boundary have delayed the CSP process.

3.4 Once identified, core activities are not eligible for evaluation under CSP. In addition, some non-core activities may not be available for evaluation ('quarantined non-core').

²³ CSP Manual, 4th Edition Annex B, p. 135.

²⁴ Presentation by the Inspector-General, Mr M McNamara, to Procurement '97 conference. Comment is taken from Mr McNamara's slides for the presentation.

3.5 The consultants' report in 1993 noted that they had:

*... some sympathy with the concerns of, industry representatives who are proposing that there should be some independent external voice assisting Defence with progressing core and non-core determinations.*²⁵

3.6 The new definition of core, cited above, makes it easier to involve the private sector in the determination of core and non-core. To test whether an activity can be market-tested or not Defence can invite the private sector to develop business rules which would allow the activity to be contracted out. If the private sector is able to develop a viable solution then the activity should be subject to market-testing.

3.7 Since the inception of the CSP program the emphasis has been on determining what is non-core, and therefore available to CSP. Once the Tier 1 activities were completed the progress of CSP has depended upon the identification of other non-core activities able to be tested. The ANAO considers that market-testing of support activities would progress much more quickly if the Department were to identify those activities which clearly cannot be contracted out (for example, because Defence, in accordance with Geneva protocols, cannot employ civilians in a war zone) and invite industry to present business rules that would allow market-testing of the rest.

3.8 Until recently core/non-core decisions were made by Defence's Force Development area on recommendations made by the Programs. Defence now have shifted responsibility and accountability for decisions on whether or not to market-test particular activities to Program Managers. This should shorten the time required to make a decision on whether to market-test in any particular instance. The Department is also developing new policy based on three new categories: combat, combat related and corporate governance. The ANAO considers that this new policy should incorporate the notion developed in the DER that the private sector should be invited to develop business solutions for all activities which it could feasibly bid for.

3.9 Activities can be divided into three types:

- those which cannot be contracted because they have inherent features which preclude either the use of civilians (for example, combat or operational maintenance which may take personnel into a combat zone) or require Public Servants (for example, requiring the exercise of delegations);

²⁵ Report to the Department of Defence : *A Review of the Commercial Support Program and its Performance*, 1993, p. 25.

- those which have no special features which could inhibit development of a commercial solution (for example, base catering or grounds maintenance); and
- those which have features which would ordinarily preclude the use of civilians or non-Defence civilians where these problems may be able to be worked around (for example, second level maintenance where it would be important for the military mission for trained deployable personnel to be available but where it may be possible to use Reservists or embed Military personnel).

3.10 The ANAO considers that the Department should try to identify as quickly as possible all activities of the first type and invite the private sector to propose solutions which would allow all other activities to be market-tested. This would test the level of market interest and also enable the Department to obtain a complete picture of those areas where it could improve efficiency through applying market-testing. This does not preclude the delivery of all activities being reviewed under the Performance Improvement Cycle but there is no point in examining the possibility of contracting out a combat unit, for example.

Recommendation No.5

3.11 The ANAO *recommends* that Defence identify activities for which commercial business solutions are not possible and, for all other activities, invite the private sector to develop arrangements which would enable those activities to be contracted out. For any activities where Defence accepts that the private sector is able to offer viable solutions the activity should be included in the market-testing program.

Defence response

3.12 Agreed. Defence has essentially done just this in the Defence Efficiency Review and is currently implementing the market testing under the Defence Reform Program. Defence is following the principles of the Performance Improvement Cycle agreed by the Government that also allows for some use of alternative and complementary market based tools for performance improvement.

The Statement of Requirement

3.13 The basic document in any CSP process is the Statement of Requirement (SOR). There are four issues which the Department should address. These are:

- the package of activities to include in the SOR;
- the length of time taken to develop an SOR;

- the quality of the information in the SOR; and
- the ability to use the SOR to ensure the contractor meets the requirement.

Packaging the requirement

3.14 The way that the requirements are packaged in the SOR affects the overall success of the project. The cost to Defence of competitive testing is quite high and does not increase much as the package of activities to be tested increases. Also, the more activities that can be included in a testing package, the more opportunities tenderers have to achieve economies of scale and apply innovative techniques to the solution, both of which reduce the cost to the Commonwealth.

3.15 The US General Accounting Office reports that studies have indicated that competitions for larger activities produce greater savings. US Air Force data showed that, in competitions for 1 to 25 personnel positions reported savings averaged 13 per cent and that in competitions for over 300 positions the average savings were 41 per cent. US Navy figures are similar.²⁶

3.16 In the UK larger activities have generally been recognised as producing a relatively higher level of savings than smaller activities. An Efficiency Unit Scrutiny of the 'Competing for Quality' program surmised that this was because:

- (a) *they offer greater scope for re-engineering process, and for staff to develop multiple skills and perform multiple tasks;*
- (b) *they offer more scope for reducing management overheads; and*
- (c) *suppliers are able to put better quality managers into large projects, which facilitates the change process.*²⁷

3.17 Many of the activities tested under CSP have been quite small, incorporating as few as four staff positions. Figure 3 shows the relative size of activities tested in terms of number of positions. Although the activities planned to be tested shows a trend towards testing more positions in one competition, 15 per cent of activities planned to be tested still have fewer than 25 positions.

3.18 The 'Activities Planned' show plans at August 1997. These plans have now changed with the introduction of the Defence Corporate Support Market Testing Program. It is planned to test support activities (specifically garrison support and clerical and administration activities) in the largest

²⁶ Report GAO/NSIAD-97-86 - Base Operations: Challenges Confronting DOD as It Renews Emphasis on Outsourcing.

²⁷ Competing for Quality: Policy Review - An Efficiency Unit Scrutiny, UK Cabinet Office, 1996 p. 8.

possible packages, but the activities outside of DCS would also benefit from this approach. (Although the information on planned testing in Figure 3 has been superseded it has been included in the chart to confirm that, prior to the DRP, there was a trend towards testing slightly larger work packages.)

3.19 Attempts to bundle activities together, particularly across Service boundaries, have met with some resistance. For example, when it was suggested that cleaning contracts in the Darwin area be aggregated under one contract the views of one Air Force unit were reported as follows:

Base management believe that they are obtaining the best value available through their current contract; they believe that a tri-service arrangement would cost them more than the current arrangements... Hence, they see no benefit from becoming part of a single cleaning contract for all Service establishments in the DAR area ...

3.20 A tri-service market-testing activity in this case may have produced a result that was more cost-effective for the Commonwealth even if it did mean that Air Force costs would have increased. It is also likely that the belief that the tri-service arrangement would cost the Air Force more was only a supposition. The outcome of market-testing a tri-service arrangement cannot be known unless the testing is undertaken.

3.21 An objective of the DCS Market-testing Program is “to achieve the largest economically sustainable market-testing package”.²⁸ This concept is supported by the data from overseas and is to be commended. DCS has the responsibility for delivering Garrison Support Services and Clerical and Administrative Support Services and has indicated it will rationalise and market-test all these areas soon. It is planned to announce the decision on the last of the garrison support competitions by September 1999. Because it has an executive responsibility for these support functions DCS is able to impact more directly upon the speed with which market testing progresses. For example, for garrison support DCS is intent on having “no more than a single prime contractor for each region”. Prior to DCS the achievement of such an objective would have been hard to achieve because of the difficulties of obtaining consensus between the Services in any particular region.

3.22 Under the new approach functions are transferred out of their former Program under agreements that specify the service to be provided leaving much greater flexibility for rationalisation, aggregation and market-testing of the resources employed. This centralisation of support services

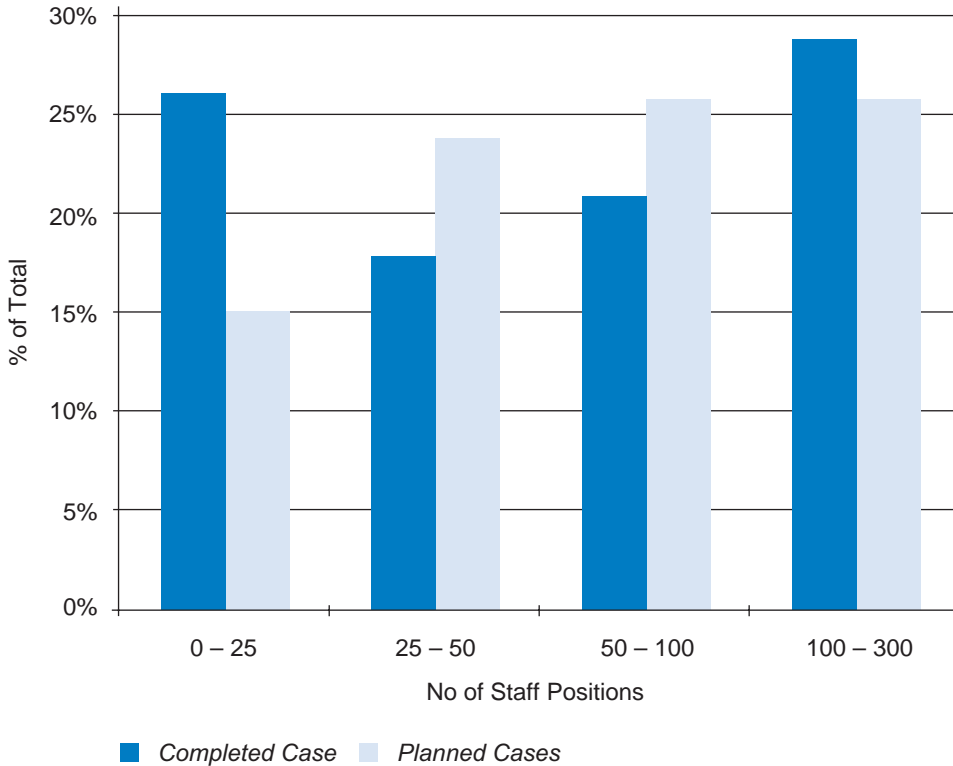
²⁸ Presentation made by the head of the Defence Corporate Support Program to Procurement '97 conference.

under a single purchaser / provider leads to increased efficiencies in terms of economies of scale. Defence advised that the new arrangements present some challenges and are still evolving to accommodate those challenges. Defence also advised the ANAO that:

Aggregation needs to be undertaken intelligently, taking into consideration alliances that may be necessary and industry ability to respond to RFT/ RFQs which can now be significantly larger in scope.

3.23 This approach will also directly impact upon the potential for the development of a viable in-house option, as no one unit in the area will have the ability to assemble an in-house bid to cover the entire region. The ramifications of this are discussed in the chapter on in-house options.

Figure 3
Size of CSP Packages - Positions Tested



Source: Created from data extracted from the CSP Activities Data Base. Planned cases were those planned at 31 August 1997.

3.24 The Defence Reform Program (DRP) called for market-testing of logistics functions, which is the responsibility of Support Command. The DER Report indicated that 11 158 logistics positions were to be market-tested. Testing of 5081 of these positions is the responsibility of Support Command. The program published by Support Command indicates that plans are in place to test 4675 positions by December 2000. This represents 92 per cent of the identified positions. The schedule prepared by Support Command shows that in some cases, a project management directive, the document which commences the market-testing process, will not be issued until July 1999.

Length of time taken to develop an SOR

3.25 In some instances it has taken eighteen months to develop an SOR. The average time is around 12 months but there is a wide variation of times, not necessarily explained by the differing complexities of the services being specified. Part of the reason for this appears to be the great variation in experience and ability of the personnel given the responsibility of preparing the SOR. These may come from the activity itself or may be drafted in from elsewhere. They may or may not include consultants or be experienced procurement staff. If they are working on the base or in the unit being tested they may have other work to do and may only be involved in developing the SOR on a part-time basis.

3.26 Defence contract management personnel in Australia, the UK and the US agree that development of the SOR is the most important step in the process. Bidders need to know exactly what they are bidding for and the SOR team must get it right. There was no evidence that taking a long time to develop an SOR made it a better document upon which to base the contract. One recent SOR passed between two levels of review six times but this was more a process of resolving disputes about the SOR rather than one of continuous improvement.

3.27 The market-testing of support services has been demonstrated to result in improved efficiency and substantial savings. In the UK, US and Australia reported savings from market-testing range from 10 per cent to 50 per cent with an average of around 30 per cent. As noted elsewhere in this report, there may be problems quantifying these savings but there can be no doubt that a material level of savings occurs. The more quickly all support functions can be tested, the earlier these savings can be achieved. Concern has been expressed by Ministers and senior Defence personnel about the slow pace of the CSP process. Much of the delay is due to the time taken to develop SORs. Some of this delay is the result of negotiations between different areas of the organisation about what should and should

not be included in an SOR and disagreements tend to be based on differing management perceptions of what the activity should cover.

3.28 The only factor that seems to be common to the development of all SORs is that the process for selecting personnel for CSP teams does not ensure that the people doing the job have the necessary experience and expertise. The consultants in 1993 noted this as an issue with regard to the teams assembled for CSP tasks. They stated:

Most persons consulted by the Review Team observed that many of the staff designated to undertake and/or be part of the CSP evaluation teams in Programs, while extremely dedicated and hard-working, were relatively unskilled for the purpose and often quite junior.

They went on to say:

In particular, help with “scoping the activity” in the first place and then, as appropriate, helping with in-house option development and tender evaluations, were areas identified for possible external assistance.²⁹

3.29 Developing an SOR that will form the basis of a contract is a complex, high-risk task. It is one with a significant learning curve for personnel who have not done it before. Understanding the process involved in developing an SOR is more difficult and takes longer than understanding the activity to be tested. Negotiation skills are also extremely important. If the SOR development team allows negotiations between the various interested parties regarding the scope of the SOR to drag on these delays will flow through the project. If the emphasis is placed on a knowledge of the activity in assembling an SOR team, the team will have to spend time becoming familiar with the process of developing outcomes-based requirements. Also their vested interest in the activity area may cause them to deal with disagreements about scope in a less than objective fashion. This will extend the time taken to develop the SOR.

3.30 In the US the A-76 process, the process used to market-test support activities, now specifies a 12 month time line from the starting to plan the process to announcing the successful bid. This includes a period of three months for the development of the Performance Work Statement (PWS), the equivalent of the SOR, and is done concurrently with the development of the in-house option. Recent work done by the Defence Corporate Support Program in developing a timetable for market-testing of garrison services shows a period of four months from commencement of the process to release of the RFQ, which is similar to the US time requirement. One technique

²⁹ Report to the Department of Defence : *A Review of the Commercial Support Program and its Performance* August 1993, p. 37.

which is used to speed the development of PWS in the US Navy is that contracting of consultants is centralised by the Office of Outsourcing Support to assist Bases to undertake the development of the PWS.

3.31 If a short time frame is to be achieved the team must know at the outset how to prepare a complex SOR, in order to avoid lost time in several iterations of review and amendment. To have the SOR developed in the shortest possible time the best possible resources need to be put on it. This would involve development of a cadre of contracting experts with experience in developing SORs and managing contracts who could provide a member for every Management Review Team, or engaging suitably experienced full-time consultants. This team member, whether internal or external, should be regarded as the expert, with responsibility for driving the development process.

Recommendation No.6

3.32 The ANAO *recommends* that the Department develop a strategy for providing appropriately experienced staff in all phases of support contracting but particularly staff with expertise in SOR development who would be capable of developing a high quality SOR in the shortest possible time.

Defence response

3.33 Agreed with qualification. Defence has established a commercial panel of expert consultants able to support or undertake any part of a market testing process. There are also cores of CSP expertise established within Defence Programs while CSP Branch provides support to Programs in the form of training, advice on methodology, and other assistance short of actually doing testing on behalf of Programs. Defence cautions against rushing the SOR development process unduly since it is a critical element that needs to be done with great care to ensure it accurately reflects the future requirement and is presented in clear outcome oriented terms.

Quality of the SOR

3.34 The make-up of the review team also affects the quality of the SOR. In some cases SORs have inadvertently omitted necessary functions which the contractor has subsequently argued should be paid for on top of the contract price. On other occasions SORs have been ambiguous in allowing contractors to argue that they did not regard a particular function as being part of the contract. For example, one base support contract included maintenance of fire trails around the base. The contractor has argued that some fire trails are in such a poor state that they need to be re-developed before they can be maintained and that this is not part of the contract. This

issue is still to be resolved. An appropriate expert on the process of assembling an all-inclusive SOR would significantly reduce the risk of such uncertainties. The content of the SOR is important, and the personnel from the activity who are involved in the development should be carefully selected for their knowledge of the function and their analytical ability. They should generally be senior people assigned to the task full-time. The team should be able to analyse the function, formulate the requirements and turn them into a set of defined, measurable outcomes.

3.35 In the US the A-76 Handbook notes that the team could include:

... individuals with expertise in management analysis, position classification, work measurement, value engineering, industrial engineering, cost analysis, procurement and the technical aspects of the activity under study.

It goes on to state that:

The team should document mission requirements and seek new and innovative ways to provide the required products or services.

Consultant experts are frequently used in these studies.

3.36 Base commanders may argue that they cannot afford to have their best people tied up on SOR development for three or four months. Nevertheless it is generally agreed that SOR development is the key to the market-testing process and, in the long term, more important than most short-term management problems that may result from key people being off-line for a few months.

Recommendation No.7

3.37 The ANAO *recommends* that the Department specify the selection criteria for Management Review Team members to ensure that the appropriate level of knowledge of the activity and analytical and management ability is resident in the team.

Defence response

3.38 Agreed. Selection of project team members is a matter for individual Programs in accordance with the guidance provided in the Manual. Such guidance is similar to that quoted as being provided in the US A76 Program manual.

Outcome based requirements

3.39 An SOR should be framed in terms of outcomes rather than procedures. One contractor complained of being required to cut the grass more frequently than needed to keep it at an acceptable level. Instead of

requiring the grass to be cut a number of times per month the contract should specify that the grass should be kept between a maximum and minimum height. If an SOR is expressed in terms of measurable outcomes it is far easier for both the Commonwealth and the contractor to be sure that they understand what has to be done to meet the requirement.

3.40 Although the CSP Manual requires that the SOR be developed in terms of outcomes, the SORs reviewed by audit have often specified conditions based on completing a process rather than delivering service. For example, one requirement for cleaning a Base theatre stated that all seats must be dusted and this dusting must be done with a cloth, not a feather or wool duster. It would have been preferable to state that the seats were to be clean. The contract seems to permit the contractor to complete the work without meeting the true requirement and may also restrict the possibility of innovative work practices by the contractor to improve the efficiency of the function.

3.41 One way to ensure the MRT frame the SOR in terms of outcomes is to require concurrent development of a plan on how to ensure that the contractor meets the requirement. The US A-76 process requires outsourcing teams to deliver, with the SOR, a Quality Assurance Surveillance Plan (QASP) which describes the methods of inspection to be used, the reports required and the resources to be employed in monitoring the performance of the contract. This plan is not necessarily provided to tenderers but its concurrent development means that the MRT must focus on the expected outcomes of the support activity. The US Navy Outsourcing Support Office has produced a Manual to guide Review Teams through the A-76 process. A section from the model QASP in that Manual demonstrates the considerations that should be covered by such a plan:

Service Provider Records

The Quality Assurance Evaluator (QAE) will review the service provider's records to ensure that all reporting requirements of the Performance Work Statement are being met. The QAE will also spot check these records for accuracy and completeness. The QAE will verify that the customer satisfaction survey is conducted in accordance with statistically valid methods.

Availability of vehicles

The QAE will conduct spot checks to confirm that actual vehicle availability is consistent with the service provider's reported availability levels. The QAE will confirm that vehicle availability is being maintained at or above

82.5%. If the reported level is different for the actual level and/or the level is below 82.5%, the service provider will be directed to take remedial action.³⁰

3.42 The Department has advised that it has drawn away from past practice of using in-house quality assurance personnel in Defence procurement. It stated:

*Performance indicators available to bidders and the chosen contractor are used in monitoring performance rather than the quality assurance approach referred to in the US Government A76 Program.*³¹

3.43 Whether a quality assurance program or a set of performance indicators is used, what is important is that the team developing the SOR is focused on developing a set of requirements that is achievable and that this achievement is capable of being monitored.

Example from cases - The pitfalls of an inaccurate SOR

Although the contract had a competent and persistent Contract Management Cell (CMC), the Department experienced inconsistent delivery of required contractual outcomes. The contractor conceded that its performance during the contract had been below standard, but considered that a number of problems, identified during the phase-in period, had contributed significantly to this poor performance.

It appears to the ANAO that the contractor underestimated the extent and cost of the services provided under the contract. As a result, the contractor critically re-examined the SOR to minimise its losses. Maintaining that present payments did not cover the cost of performing some tasks, the contractor attempted to renegotiate areas in which the SOR was ambiguous and where the quantity of work identified by the data pack was inaccurate. The contractor further claimed that any attempt to discuss a different interpretation of an area within the SOR was met with outright rejection by Navy.

The Department agrees that the appropriate time for the resolution of these issues was during the tender process or at contract negotiations, not 18 months into the contract. Recently, both parties have undertaken to document areas of disagreement and seek legal advice in relation to them. In cases where this advice conflicts, the outstanding issues will go to an independent arbiter for resolution.

³⁰ US Navy Outsourcing Support Office *Succeeding at Competition: Guide to Conducting Commercial Activities Studies* pp. 2-24.

³¹ Departmental response to Discussion Paper on this audit, 17 March 1998.

3.44 The development of a contract monitoring strategy at the time of drafting the SOR would maintain a focus on the development of outcomes based contracts and would also provide a sound basis for developing a contract management unit for managing the contract after it is let.

Recommendation No.8

3.45 The ANAO *recommends* that the Department require market-testing teams to develop, concurrently with the development of the SOR, a strategy document which indicates how the achievement of outcomes set out in the SOR will be monitored.

Defence response

3.46 Agreed. CSP Methodology requires the parallel development of required outcomes and performance indicators as part of the SOR. The performance indicators provide the measure of how outcomes will be monitored. Depending on the nature of the performance indicator and the skill of the individual contract manager to be involved there may be value in provision of additional guidance. Defence provides contract management training on such matters and the methodology in the 5th edition more clearly reflects the need for the contract manager to be involved in the development and selection process so that there is a clear understanding of performance requirements.

4. Maintaining Levels of Military Personnel

4.1 One of the significant issues with the implementation of CSP is that the Commonwealth must maintain a certain number of Service personnel to enable it to remain self-sufficient in a military contingency without breaching Geneva Protocols that prevent civilians being employed in a combat area. Thus the Air Force needs to maintain deployable aircraft maintenance skills, the Army needs to maintain deployable vehicle mechanics and so on. In the normal context of peace time operations deeper-level-maintenance skills are not required to be deployed. The equipment can be transported back to a service depot and this deeper-level-maintenance could be considered non-core. In a military contingency it could be possible that some deeper-level-maintenance skills could be required to be deployed and this requires the Services to have the relevant deployable resources to meet whatever needs might arise.

Maintaining the required number of military personnel

4.2 The concept of Military Required in Uniform (MRU) has been developed to ensure that the ability of the Military to respond to a military contingency is not eroded by the CSP process. MRU incorporates overall figures but also requires that military capability be maintained in particular functional classifications and geographical areas. This presents an obvious problem for CSP - how to maintain MRU but at the same time contract out non-core functions. One of the ways developed to do this is by requiring contractors to provide positions for a number of Military personnel as part of their contractual obligations. This is known as embedding MRU in a contract.

4.3 The draft paper *Embedding Australian Defence Force Personnel within Commercial Support Activities*, prepared by CSP Branch, promotes the notion that the purpose of embedding MRU and Department of State (DOS)³² personnel in a support contract 'is to provide a fit and trained work force upon which the Defence Organisation can call to meet Australia's Defence objectives.'

³² Department of State functions are those which must be performed by military or Defence civilian personnel. These include positions which have specific delegated authority such as approval of payments or personnel actions.

Problems with embedded MRU

4.4 Embedding personnel in a contract has a number of potential problems. One of the cases reviewed had a significant number of embedded personnel and in this case there were difficulties with how Service personnel handle the situation of working for a contractor and the clash between military priorities and contractor priorities.

Service personnel didn't sign up to work for a contractor

4.5 One officer commented to the ANAO that "Service personnel didn't sign up to work for a contractor." This difficulty became apparent early in the case reviewed when action had to be taken to institute a Divisional structure because the highest level Serviceman working for the contractor was only a Sergeant-equivalent and personnel did not feel they had the support or interest of any rank higher than that. At the time of the audit this Divisional structure appeared to be working reasonably well and officers reported there had been a sharp drop in the level of discontent of embedded personnel with the introduction of this structure. This is a structure that does not need to exist with an in-house option. It is a cost to the Commonwealth of having a contractor and should be included in the evaluation of tenders.

Recommendation No.9

4.6 The ANAO *recommends* that, where a contract provides for embedded Military Required in Uniform, the Department identify and define the need for any necessary Divisional structure to serve the interests of embedded personnel and, where meeting this need will require the Department to incur a cost that would not be required if the in-house option were successful, take this cost into account in evaluating commercial tenders.

Defence response

4.7 Agreed.

Two different approaches to MRU

4.8 The use of embedded MRU on a contract also incorporates a funding issue. In one of the cases reviewed the MRU were basically provided to the contractor at no cost. As each tenderer had bid on the basis of having MRU personnel available for 177 days per year, the benefit from these positions may have been included in the price bid for the contract. But once the contract was signed there was no change in the contract price whether the Department filled all of these positions or any of them. The contractor regarded these personnel as an important part of its workforce and

remonstrated with the Department on a number of occasions when these positions were not filled or were filled by inappropriate personnel.

4.9 Another MRU case examined had a different arrangement. The SOR identified 35 MRU positions. The contractor was required to provide, as did the in-house option, a list of rebates (on a per hour basis for each MRU position) which it would grant the Department from its contract price, for Military personnel posted into these positions. This means that the Department achieves a return for the military personnel it provides to the contractor and there is a cost to the contractor for using these Military personnel. It also allowed the in-house option to compete on the same basis as contractors. In this case the in-house option did not incorporate any Military as part of its bid, but offered rebates in the same fashion as the other contractors.

4.10 The ANAO considers that, if MRU are to be included in contracts, there should be a cost to the contractor of using these personnel. If the purpose in maintaining these MRU positions is to provide Military personnel for military purposes, these personnel must be able to leave the contractor from time to time under an agreed protocol to undertake military training and other duties.

Recommendation No.10

4.11 The ANAO *recommends* that, if MRU are to be embedded in a contract, this should be done on a rebate basis where the contractor, or in-house option, includes, as part of its bid, a rebate per hour per position which is used in the financial evaluation of bids.

Defence response

4.12 Agreed.

Examples from cases - Embedded Military Personnel

The contractor was required to allow for 50 military personnel to be rotated through the equipment maintenance workshop. The stated purpose of these Skills Acquisition and Retention positions (SARs) was to ensure that the Service maintained, in its operational level maintenance personnel, a level of expertise in deeper-level-maintenance.

The existence of all of these positions was not essential to the continued operation of the equipment. When relevant military personnel were absent, the contractor was able to meet Service requirements by shifting personnel from another area or other less immediate work. The filling of these billets suggests that Defence did not consider the rotation of personnel to be essential. The contractor noted that 16 personnel were placed in core billets for less than 5 months and 8 personnel had been posted to these billets when their applications for discharge had already been submitted and approved.

Defence did not meet this staffing commitment to the satisfaction of the contractor. A review of the minutes of quarterly management meetings between the two parties showed that the contractor was continually concerned with the staffing of military billets and not kept fully informed on billet postings and vacant billets. A list of billet postings in late 1995 for the previous year showed that the Service had met its commitment of 177 workdays per billet per year on an average basis but there was wide fluctuation in the staffing of individual billets. Some billets provided as few as 30 available workdays while others provided over 200.

Anecdotal evidence suggests that embedded military personnel were dissatisfied with their positions. Due to the low rank of even the most senior embedded Service personnel they did not feel they were part of a military command structure, and hence were concerned for their military careers. The unit introduced a Division structure, to look after the needs of the embedded personnel, to supplement non-APS civilian managers who had no experience of the military.

5. Management of Support Contracts

Management of the contract

5.1 When a support activity has been contracted out it is important that the Commonwealth has the means, incorporated into the contract, to manage the contract and to motivate the contractor to perform. The ability to do this starts with the SOR and associated performance specifications but can be enhanced by the way the contract is drafted and the structure put in place to ensure that the contractor provides the required outcomes. Our review of cases highlighted many instances of poor contract performance where the Commonwealth did not take any effective action to improve the performance of the contractor.

5.2 One of the base support contracts reviewed in this audit had significant quality problems almost from the time the contract was signed. Despite numerous meetings over the course of this three year contract, the overall standard of service was poor, but probably not poor enough to terminate the contract. Every issue that was raised with the contractor was met with a promise to remedy the individual problem. Generally the contractor took some action but new problems kept arising consistently. It was evident in the documentation that the contractor had a fundamental deficiency which precluded it from providing the required level of service. This was confirmed by the commanding officer's assessment of the contractor's performance at the end of the contract.

Contract structures

5.3 An innovation used by the US Department of Defense to encourage contractors to provide support services to the required standard is to limit the contract to one year initially but with several one-year renewal options. This means that the Department need not terminate the contract for poor performance; it can merely decline to take up one of the renewal options. This arrangement, by permitting Defense to end the contract at any yearly renewal point, allows Defense to set the contract term for a longer period, because there is no danger of being tied to a poorly performing contractor.

5.4 Base support services at the US Army's National Training Centre at Fort Irwin, California have been contracted out since 1981. Each time the contract has been let it has been for a base year with four one-year renewal options. Since 1981 the options have been taken up each time,

which indicates that the various contractors have been performing to a satisfactory level. A contract with a short initial period and annual renewable options represents a simple and effective way of ensuring that a contractor strives to keep the customer satisfied. The evidence at Fort Irwin indicates that it works. The annual renewal options have all been taken up and the customer has been satisfied with the contractor performance.

5.5 In Australia the Defence view is that Defence and Industry consider there is better value for money in longer contracts and Defence considers that the performance benefits are achievable through the use of clear performance requirements and skilled contract management. Three of the longer CSP contracts have been 11, 10 and 7 years and the average length of contracts has been 3.7 years. If a contractor has under-bid a contract or has significant cost pressures elsewhere it could deliberately reduce the resources it puts into any particular contract. This can lead to performance that is generally unsatisfactory but not demonstrably poor enough for Defence to take legal action to end the contract.

5.6 In at least two of the cases reviewed this appeared to be the case. In one case over 150 notices of non-conformance were issued in three years. None of the notices reviewed by the ANAO, when considered in isolation, were sufficient to warrant termination. Comments on file indicate that, if the Commonwealth could have exited from the contract just by declining to take up a renewal option, it would have done so. The ANAO considers that Defence should trial the kind of contract structure that US Defense has found successful.³³

Recommendation No.11

5.7 The ANAO recommends that the Department, in a trial program of contracts designed to achieve greater control of outcomes:

- (a) seek to negotiate selected contracts for suitable support services for short initial periods (1-3) years with provision for annual extensions; and
- (b) review the trial program in due course to help define circumstances where such an approach might be usefully adopted for greater cost-effectiveness.

³³ Short contracts can also save the principal from being tied to a contractor that, for technological or business reasons, is no longer capable of fulfilling the requirement in the most cost-effective manner. Generally, however, this does not apply to CSP support service contractors.

Defence response

5.8 Not agreed. Short-term contracts can provide inducements for contractors to ensure that they perform well for fear of not having the contract renewed. However where there are large establishment costs for a contractor and in the interests of reducing the cost of tendering for the contractor and a contracting agency, alternative approaches are preferred for achieving performance. These include providing greater effort in ensuring quality SORs, including clear and measurable performance indicators, skilled contract management and use of a Partnering approach to achieve more effective communication and relationship building.

5.9 In respect of larger, more diverse and complex aggregations of activities that involve greater tendering and establishment costs which must be amortised by a contractor, short time constraints and the added risk of earlier termination would unnecessarily inflate the value of bids received.

5.10 CSP activities frequently involve the aggregation of complex technical functions requiring significant capital and intellectual property commitments from contractors. In some cases, such as specialist deep level aircraft maintenance, industry may not have the existing capability to undertake the activity and short contract periods would preclude the willingness to invest in the development of the skills base and technology to undertake such activities.

5.11 Defence acknowledges that the “one year and renewable annually” approach to services contracts is used in the US as well as the longer term contracts approach preferred by Defence for CSP and that the former approach may have been more appropriate in the case of the small, single function, early CSP contract referred to by the ANAO. Defence CSP testing is now performed on much larger, multi-function activities and is unlikely to have CSP contracts that would be suitable for the trial program suggested by ANAO. Also, unlike the US, Australia does not have a program where government agencies are required to set-aside work for small and disadvantaged businesses that may involve greater risk and provide greater justification for single year contracts.

5.12 In accordance with the Defence and Industry Strategic Policy recently announced by the Minister for Defence Industry, Science and Personnel, CSP takes a partnering approach in contracts with local companies.

ANAO comment

5.13 It should be noted that the use of the recommended contract structure at the US Army National Training Centre at Fort Irwin is for base support including maintenance, cleaning, catering etc. Fort Irwin is a base

that can have a population up to 5000 and it is 30 kilometres from the nearest town. Its entire support infrastructure centres on the base support contract. From 1980 until the most recent iteration of the contract this has all been in one contract. This is a large, multi-function contract and on each occasion the contract has been for one year with four one-year options.

5.14 In making this recommendation the ANAO envisages that the Department would act in good faith in deciding whether to take up an option or not and would decline to renew a contract only if the standard of service was unsatisfactory. The Department's approach to CSP involves reliance on partnering and the development of good business relationships. In such an environment the ANAO would expect that the private sector would also believe that the Department would act in good faith. If, in accordance with partnering, bidders consider this to be the case and believe in their own ability to meet the requirement, there would be no reason for them to apply a cost premium.

5.15 The Department considers that bidders would impose a cost penalty if extendible short-term contracts were used but would not impose such a penalty on contracts with default termination provisions that it considers would achieve much the same effect. The ANAO considers that experienced Defence contractors may adopt such an approach because they believe it is unlikely that the Department would terminate a support contract. As noted above, there were over 150 notices of non-conformance over a three year period on one base support contract. Although some of these notices concerned serious hygiene issues in catering (including some cases of serious food poisoning over the term of the contract), there was no move to terminate the contract. Information on file indicates that the contractor was surprised and disappointed when unsuccessful in winning the contract a second time. At the end of the contract the unit commander was scathing in his assessment of the contractor's performance. The ANAO cited this contract, not as an example of the type of activity that this form of contract is suitable for, but to highlight what can happen when the Department signs a long-term contract and performance under the contract is poor.

5.16 The ANAO remains of the view that the recommendation for a trial in appropriate cases has merit. The proposed contract structure offers not only a means of avoiding prolongation of an under-performing contract but also a motivation for contract managers to actively assess whether the contractor is providing an adequate service. Evidence suggests that contract managers are reluctant to take action to terminate a contract, even if the contractor is consistently under-performing. In the short-term/renewable options contract structure found in the US the contract manager must make a deliberate decision on whether to renew the contract and justify that

decision. US Defense contract managers are thus accountable for their decisions to renew or not and less likely to take the option of renewing if there is documented evidence of continued under-performance by the contractor. There is no evidence in the files reviewed by the ANAO that any contract manager here has been held accountable for not taking action to terminate a contract in those cases. A documented decision made to continue a contract is much more accountable than the absence of a decision to terminate one.

Award fees

5.17 Another contract device used commonly in the US for ensuring a contractor meets the needs of the Department is the award fee. Fort Irwin has contracts based on cost plus an award fee. The US Navy Submarine Base at Bangor, Washington has a fixed price plus award fee contract. An award fee is made to the contractor at the end of each year (or some other period) based on its performance over the period. With a cost plus award fee arrangement the award fee is basically the contractor's profit margin. The customer carries the risk of any cost increases or inefficient work practices but is able to recover some of this by reducing the award fee. With fixed price plus award fee the contractor has already made some profit but has borne the cost risks - in order to earn the award fee the contractor must perform well.

5.18 The contractor's General Manager at Bangor indicated to the ANAO that his major performance indicator from his company's perspective was how much of the award fee he was able to earn for the company. Anything under 90 per cent of the possible fee would have been regarded as poor performance by him with serious consequences. This meant that he was very focused on keeping the customer satisfied.

5.19 The fee awarded at each base was determined by an individual, based upon a submission by the contractor and recommendations by contract administration staff after a thorough evaluation process. The evaluation criteria at Fort Irwin, for example, use objective criteria such as level of compliance with quality plans, speed of responsiveness to unscheduled tasks, cost management and care of Government property as well as subjective criteria such as manner of problem resolution, overall satisfaction of contract requirements and the quality of the interface with customers. Under the contract at both bases the decision made by the designated officer is final and not appealable.

5.20 The award fee should be set at such a level that if the contractor achieves a level of performance expected under the contract then it should make a normal profit. If the contractor performs at an exceptional level,

with consequential benefits to the customer, the award fee can provide additional reward in recognition of this. An award fee system for support contracts is another means of encouraging contractors to meet the requirements of the contract in an efficient and professional manner. The combination of award fee determination and a contract based on a series of one year options gives the customer a wide range of measures with which to motivate the contractor at marginal cost.

5.21 Incentive contracts should be used only where the potential net benefit justifies the effort involved. With a support contract that provides for the contractor to provide the same service for a period of time, it is possible that the contractor's performance over the term of the contract may decline. Performance incentives would allow the customer to discourage this decline in performance and the net benefit that may be achieved from these incentives is high. It is generally possible for the services delivered by a support contractor to fall to a low level and still meet the requirement. The objective of incentive contracts is to encourage the supplier to improve upon contracted performance. With an award fee it is possible for the customer to use the incentive to reward the contractor (or otherwise) for the standard they achieve without resort to costly administrative or legal action.

5.22 The Department advised that it did not favour cost-plus contracts with award fees. It also said:

If a service is adequate in meeting performance indicators, why pay more to get greater performance when it is not required? If it is less than adequate, corrective action should be taken by the contractor without a bonus payment.

The ANAO agrees that cost-plus contracts have an inherently higher level of risk than fixed price contracts.

5.23 The ANAO considers that, with a fixed price plus award fee contract, where the contract price, and hence the award fee which is a percentage of the contract price, is established as part of the competitive process, the Commonwealth is not paying any extra, it is merely paying what the market sets as the price for the service performed to the required standard.

Examples from cases - Performance Incentives

A unique feature of a contract for aircraft maintenance at an Australian Defence Base was the provision for performance incentives. Initially, the contractor was required to have sufficient aircraft available to meet 98 per cent of the needs of the unit in any given month. If greater availability was achieved, the contractor was rewarded through a scale of bonuses. In the first year of the contract, the contractor achieved the maximum bonus for five months only and not at all in the first four months. The contractor sought to have the incentive formula changed in a way which would have enabled it to achieve 100 per cent more easily, but this was rejected. After the first year, the contractor consistently achieved 100 per cent aircraft availability.

The required level of service was renegotiated three years into the contract. It was increased to 100 per cent of unit needs and the whole bonus was included as part of the contract price. Under the new arrangement, if the contractor achieved 99 per cent availability, the contract manager was able to withhold 5 per cent of the contract price. Previously, the contractor would receive an additional 5 per cent of the contract price for achieving this availability. Due to the arithmetic of calculating a percentage of a larger amount, the change also had the effect of slightly increasing the amount of money the contractor would lose for failing to meet the requirement. Since this change, the contractor has still consistently achieved 100 per cent of the unit requirement.

Clearly, the existence of the incentive clause and automatic application of the mechanism has ensured that the contractor entered into the contract with sufficient resources to meet contractual obligations, and was sufficiently motivated to consistently perform to the required level.

Recommendation No.12

5.24 The ANAO *recommends* that the Department introduce award fees or other incentive measures, where suitable, into support contracts as a cost-effective means of encouraging optimal performance from contractors.

Defence response

5.25 Agreed with qualification. The newly released *Commonwealth Procurement Guidelines: Core Policies and Principles, March 1998* makes no mention of incentives as such but says that the Commonwealth takes a flexible approach to assuring quality, based on the risk and value of each

procurement. Defence believes that a case by case approach is needed and does not favour financial incentives as a standard approach. Where appropriate, an agreed penalty for shortfall in performance arrangement might be used but this will depend on the nature of the service and how the performance is to be measured. Defence considers other approaches to encouragement should also be considered including Partnering and performance monitoring, and reporting arrangements.

Defined levels of performance

5.26 One of the problems found with the contracts reviewed was that the Department had few options in dealing with contractor performance that was poor but not poor enough to terminate the contract. Even if a contract gave the Department power to terminate a cleaning contract, it would be reluctant to do so if the cleaning was not to the required standard on only one occasion. But it is often difficult to have a service done again when the time for providing that service has passed. For example, on one support contract a senior officer advised that the service at an official function did not meet the required standard in a number of ways. Stopping payment for this particular activity would have been difficult, firstly because it is difficult to value the inadequacy and secondly because the contract did not include any means of reducing payment for a service poorly performed. It is not possible to perform that function again.

5.27 One means of maintaining equity for the customer in such situations is the inclusion in the contract of defined levels of performance. These would identify certain service levels or performance standards that the contractor must meet or exceed. They should also specify the consequences of failure to achieve these service levels, such as credits granted to the customer on future invoices. They may also specify certain terminal levels of failure which can give the customer the right to end the contract. With this arrangement both the contractor and customer are aware of the standard of service to be provided and of what will happen if it is not achieved. A level of performance for maintenance of motor vehicles, for example, may specify that if an overall availability of 80 per cent is not achieved the contractor's fee will be reduced for every percentage point under 80 per cent. This reduces the room for dispute and litigation. The main point of issue becomes the actual level of availability unless the performance deficiency is significant enough to take more serious action.

5.28 At the time of commencing negotiations with a successful bidder the customer has a specified requirement and a proposal from the bidder to meet that requirement. If, in negotiating the final contract, the negotiation team can turn that statement of requirement into a comprehensive Performance Agreement which details the sanctions or rewards resulting

from particular levels of performance of each requirement, the management of the contract will become much more effective and less time-consuming.

5.29 The Department has stated that CSP practice prefers that requirements of specific performance levels should be included in the contract documentation directly. The only evidence of this in the cases reviewed was in an aircraft maintenance contract where payments were reduced on a sliding scale if the contractor achieved less than 100 per cent of the required aircraft availability. The contract appears to have worked well in practice. Whether this agreement is integral to the contract or a separate document is not as important as the fact that it should exist.

5.30 The Department also stated that its experience had shown that a 'partnering' approach combined with a good SOR and contract is the best practice to follow. This would be ideal but the ANAO's review of cases showed this to be relatively rare. The contracting process should provide a convenient means of ensuring that the Commonwealth only pays for the level of service it receives.

Recommendation No.13

5.31 The ANAO *recommends* that the Department require negotiation teams to negotiate an appropriate performance agreement for each support contract specifying the levels of service to be provided and the consequences of providing lesser levels of service.

Defence response

5.32 Agreed with qualification. Depending on the particular service being market tested, the quality of the SOR and bidder responses there may or may not be a need to negotiate performance levels and consequences of reduced performance. The recommendation is agreed with the qualification that such negotiations are only necessary if the requirements have not already been suitably addressed in the SOR and bidder responses or contract.

ANAO comment

5.33 The audit disclosed a number of occasions where a contractor failed to provide what was detailed in the SOR to the required standard. Even where the SOR was comprehensive there is generally no remedy under the contract for minor breaches. If a specified service has not been provided to the required standard, discussion with the contractor may prevent this happening again. But if the Department wanted to take action because it had been adversely affected by the deficient service on that occasion, it had little recourse but to resort to legal remedies. It would be far better if the Department had been able to refer to an agreed level of performance

and require a remedy based on the agreed schedule. The ANAO feels it would also significantly reduce the level of such minor non-compliance.

Contract Management Cells

5.34 In some of the contracts reviewed during this audit the Department has been pro-active in ensuring that the contractor does what it has contracted to do. The Contract Management Cell in one Base Support contract is a good example of this. It has been very active in reviewing contractor performance in all areas, so much so that the contractor has made many representations to the Department for contract variations to get additional compensation to service the contract. The Department has indicated to the contractor that the contract was probably underbid but the result of the competitive tendering process could not be revised without re-tendering the activity. Meanwhile the Contract Management Cell is ensuring that the contractor cannot make up for its mistake by under-servicing the requirement.

5.35 In others contracts reviewed the contract has been managed almost on an exception basis with the Department only becoming aware of a failure to meet a particular requirement if there is a problem.

5.36 The procedures for actually managing a support contract vary from Service to Service and from Base to Base. In the cases reviewed there was not a consistent process for ensuring that the contractor is achieving the outcomes desired by the contract. In areas where no contract management cell exists the reporting systems tend to be mostly passive. Contract management processes have become much more active in the US. At Fort Irwin, for example, an instruction sets out procedures to be used to assess the adequacy of contractor processes to deliver services consistently. It provides details of the entire monitoring process from understanding contract requirements to process measurement, product audits and data collection. It goes on to explain how to assess the contractor's management systems and then to use the data from these systems to evaluate the performance of the contract.

Examples from cases - the benefits of a vigilant Contract Management Cell

A Navy base support contract was managed by a Contract Management Cell (CMC) comprising 4 officers, all with contract experience, whose role included the daily monitoring of the performance of the contract, educating base staff on the required outcomes and vetting all changes to the contract.

During the first 8 weeks of the contract, the CMC was not fully staffed and there was minimal performance monitoring. The Department believes that this allowed the contractor to establish its own performance standards which did not always accord with those required under the contract. The CMC estimated that in the first year of the contract only 75 per cent of the contractual outcomes were met.

The CMC could not rely solely on the contractor's quality assurance processes to ensure that standards were met and all tasks completed. A major task of the CMC was to educate non-contract staff on the deliverables under the contract. These staff represented the first line of monitoring as they were often the customer for many of the services provided. In addition, the CMC used repeated warnings that further transgressions from the contract would result in the imposition of financial measures. One year after contract establishment, a Navy report estimated that the contractor was achieving 95 per cent of required outcomes across the contract.

5.37 The CSP Manual provides the following advice on project monitoring:

It is important that monitoring procedures are set out in the contract or in-house directive and backed up by the necessary resources, skills and procedures within the Program;

The Contract Administrator must coordinate the activities of technical and other representatives, who monitor the performance of the contract or In-House Option Directive. Technical requirements are verified by representatives provided by or through the Defence Quality Assurance Organisation. Quality Assurance representatives will audit the contractor's quality systems and control of processes. The audit includes verification that goods and services provided conform with contract requirements and validation of contractor documentation.³⁴

³⁴ CSP Manual, p. 139.

5.38 Given that in many cases the staff involved in the review team have not had experience in letting major contracts this advice may be assuming a level of knowledge that is not present. Apart from ensuring that contract administrators have appropriate guidance and expertise the Department needs to take action to ensure that the process from contract letting and negotiation is seamless by ensuring personnel from the contract negotiation phase are also involved in implementation and management. This would mean that the contract management team understands the context in which the contract is agreed and is in the best possible position to maximise the benefits arising from the competitive process.

Recommendation No.14

5.39 The ANAO *recommends* that, for better negotiation and management of support contracts, the Department establish a contract management cell and develop and document procedures for monitoring the contractor's achievement of required outcomes for each support contract. Where possible this contract management cell should be at least partially in place prior to negotiating the contract and at least one of its members should be included in the contract negotiation team.

Defence response

5.40 Agreed with qualification. CSP practice is for each contract to be managed by an on-site, dedicated management team appointed within the Program. To assist and provide contracting and contract management advice for CSP activities, Defence has expert units accessible to Programs, such as the Joint Purchasing Support Agency and CSP Branch. The draft 5th edition of the CSP Manual incorporates best practices that have been developed in CSP activities, including the need for individual contract management cells, application of performance indicators for monitoring contractor's achievement and continuity of personnel within a Program from the CSP process to the contract management cell. This methodology addresses the intent of this recommendation.

Access to contractors' records

5.41 The ANAO has in previous reports in 1992, 1995 and 1998 recommended that the Department provide in contracts for the ANAO to have direct access to contractors' records where those records are directly related to the expenditure of Commonwealth funds.³⁵ Defence did not

³⁵ Audit Report No.22 1992-93 *New Submarine Project*, Audit Report No.31 1994-95 *Defence Contracting* and Audit Report No.34 1997-98 *New Submarine Project*.

agree. The JCPA in its Report 337 in 1995 said that Defence should reconsider its opposition to allowing ANAO access to contractors' records.³⁶

5.42 Under the *Auditor-General Act 1997* the ANAO has access to Commonwealth agencies' records and, the ANAO has been advised, to contractors' records that may be needed for an audit. However, in the interests of transparency and efficiency, it would be more effective if significant support contracts provided for the ANAO to have access to contractors' records to ensure that adequate systems and processes are in place to protect the Commonwealth's interests. This is particularly important with the growing reliance of the Department on contractors' quality assurance systems and partnering with the private sector.

5.43 Recently, in the context of increasing use being made by Commonwealth Departments of third party service providers to deliver Government Services, the ANAO wrote to agencies asking that, in making contracts, they provide for:

- the agency to have access to contractors' records, information and assets directly relevant to contract performance to give the agency an adequate level of control and performance monitoring of contractual arrangements; and
- the ANAO to have an equivalent level of access (but not an unfettered access to contractors' premises) to enable the ANAO to fulfil its statutory responsibility to the Parliament.

Recommendation No.15

5.44 The ANAO *recommends* that Defence support contracts provide for the Department to have access to contractors' records, information and assets directly relevant to contract performance and that they also provide for the ANAO to have an equivalent level of access.

Defence response

5.45 Agreed. As required by *Commonwealth Procurement Guidelines: Core Policies and Principles* March 1998, Defence support contracts will include provision for adequate access to records by the ANAO where appropriate. Defence will continue to provide the ANAO with access to records which it holds to measure contractor performance.

³⁶ Joint Committee of Public Accounts, Report No. 337 *A Focus On Accountability: Review of Auditor-General's Reports, 1992-93* p. 208.

6. The Value of In-House Options

The importance of the In-house option

6.1 Market-testing of support services under CSP is a normal acquisition process with the added dimension of an in-house bid. There is some disquiet in the private sector about the fairness of competing against an in-house bid. The 1993 consultants' report noted that:

*The public position of industry regarding the CSP reflects a concern to maintain good relationships with Defence is in marked contrast to the position expressed privately;*³⁷

and, in relation to aircraft maintenance activities:

*Comparatively few commercial tenders have been successful and commercial tenderers have real difficulty in accepting that Preferred in-house options (PIHOs) will prove to be viable in the medium term.*³⁸

6.2 This mirrors the feelings expressed in the UK. The Efficiency Unit Scrutiny noted:

*There is a strong perception amongst many actual and potential bidders that they are at an inherent disadvantage when competing against an in-house option ... Only a minority saw the in-house team as just another competitor, and less than one in twenty felt they had an advantage over the in-house team. In contrast in-house teams felt at a disadvantage (mainly because of weakness in knowledge of the process, commercial awareness and project management experience).*³⁹

6.3 This audit found instances where the playing field was not level as far as in-house options were concerned but these instances were acting against the in-house option just as often as they were acting for it. In one instance, a Tender Evaluation Team (TET) rated the PIHO as the best option but this was later overturned by the Project Director on the basis that it carried too great a risk, something which should have been included in the tender evaluation plan and therefore in the TETs assessment. In another, the form of the contract was established as a standing offer with no

³⁷ Report to the Department of Defence: *A Review of the Commercial Support Program and its Performance* August 1993 p. 17.

³⁸ *Ibid.* p. 18.

³⁹ *Competing for Quality: Policy Review - An Efficiency Unit Scrutiny*, UK Cabinet Office, p. 60.

guarantee of work so that a commercial bidder would be required to continue to pay a specialist maintenance workforce, even if the Commonwealth decided that no maintenance work was necessary.

6.4 Defence has advised that 'IHOs have demonstrated their ability to perform effectively and checks have indicated that in aggregate they can marginally out-perform contractors.' In the US around 50 per cent of A-76 contests are won by in-house options⁴⁰ but in Australia only around 30 per cent go to the in-house bidder. The existence of a viable in-house option is of great importance if the Commonwealth is to achieve best value for money from market-testing. A good in-house option provides benchmarks against which other offers can be measured. Particularly in the Australian context where a small market often means few viable bidders, the presence of the in-house option makes it possible to assess whether the commercial options being offered represent value for money or not. The in-house option also provides a focus for staff because they are in a position to compete for the ongoing delivery of the services required. For both of these reasons it is important that the in-house option be prepared and presented professionally.

6.5 The quality of in-house bids seen by the ANAO was extremely variable. It seemed to depend on who was assembling the bid and what resources they had to do so. As noted above, the success of the market-testing process in achieving best value for money is, in part, dependent upon the preparation of a high-quality in-house bid. The in-house bid is also of value in ensuring a cohesive approach. The process of developing the in-house bid can identify valuable interrelationships, for example, in skills and joint costs, with other areas of Defence activity.

6.6 The CSP Manual provides little guidance on the make-up of the in-house team. Relevant provisions of the manual are as follows:

The In-House Team leader will be selected by the Program with the assistance of the Management Review Team Leader; ...

Set up a development team

- *Preferably have a dedicated and committed team (including a union delegate); think as if you are the directors of a company (i.e. independent).*
- *As far as practical, select people with the requisite range of skills for the task ahead and obtain funds and other resources needed.*⁴¹

⁴⁰ GAO Report No. T-NSIAD - 96 - 148. *Defense Depot Maintenance: Privatization and the Debate Over the Public-Private Mix* April 1996 p. 13.

⁴¹ CSP Manual p. 62.

6.7 Further on in the Manual it indicates that consultants should be used and that the in-house team should “request funding from the Program.” This means that an in-house bid must compete for funds with areas which Program managers may see as having a more immediate value in terms of meeting the objectives of the program.

6.8 In order to be as competitive as possible, and therefore maximise the benefits accruing from the market-testing process, the in-house bid should be established with the best people available, including consultants where necessary, and should have access to the resources that a similar bid in the private sector would have access too.

Recommendation No.16

6.9 The ANAO *recommends* that the Department establish an In-house Option Unit to provide coordination, resources and advice to in-house bids and successful in-house options to ensure they operate in a commercial manner and give them opportunities to do so through Business Process Re-engineering where suitable.

Defence response

6.10 Agreed, with qualification. Defence has adopted such an approach for CSP testing within Air Force in the past and found it to work well. Such units should be at individual Program level as required to support the respective Program Managers in meeting their responsibilities to an IHO.

Managing in-house options as autonomous units

6.11 The Industry Commission report *Defence Procurement* recommended that successful in-house bids should be managed as autonomous commercial units and treated by Defence as such. In the US this is the way in-house providers are managed. Some in-house providers actually charge the US Defense Department for their services and run their operations from the proceeds of those charges. In Australia it is often difficult to determine how much an in-house option is costing because, aside from the fact that the Defence accounting system does not have the capability to disaggregate financial information to this level, the in-house option is not a truly separate entity. It is subject to staff movements and military absences and often does work not specified in the SOR and has work done for it by other areas of the Department.

Examples from cases - Preparing an in-house option (IHO)

The development of the IHO for a base support contract occurred over a 12 month period. Most of the personnel committed to this task were required concurrently to carry out their regular duties, resulting in long hours (16-18 hours a day) and high stress levels.

Staff morale impacted on the development of the IHO, because of the possibility of job losses and associated sequential events looming across the base. With the base situated in a regional area, negative media reports created undue speculation amongst personnel and the community. Senior management initiated a consultation process for staff in which members could discuss their concerns. Well-structured IHO training seminars were provided and, in conversations with the ANAO, staff openly acknowledged the benefits associated with learning new skills that could possibly lay a foundation for a future career.

The performance of the IHO in the tender evaluation was an unanticipated disappointment. The IHO had been conducting services to an adequate standard. The Tender Evaluation Team (TET) felt that the IHO lacked detail and substance, ranking the IHO 4th on price, 6th on technical worth and 5th on value for money. The fact that an In-house option that was already seen as performing adequately by Base management submitted a tender that was only ranked 6th on technical worth raises questions about the quality of bid preparation.

6.12 The Department should account for the in-house unit as a separate entity within the Department so that it is possible to establish how much it is costing, and what effect decisions made outside the unit impact upon the cost and effectiveness of the unit. This would allow the Department to gain a better understanding of the true costs and benefits of an in-house option and to better evaluate the bids received from in-house options.

Recommendation No.17

6.13 The ANAO *recommends* that the Department introduce management accounting systems to establish the true costs of providing in-house options. These systems should “charge” the Department for any work done outside of the scope of the SOR as well as allowing for rebates for any staff taken off-line to perform tasks outside of the in-house unit.

Defence response

6.14 Agreed. The CSP Manual requires that an IHO be allocated its own cost centre code so that costs managed by that cost centre are separately identifiable. The DEFMIS financial management system used by Defence

incorporates a field for reporting the consumer cost centre, which allows for identification of costs incurred by other cost centres on behalf of an IHO. The Ready Reckoner of personnel costs provides average overheads applicable to personnel engaged in the activity. Such an approach to overheads is also used by the private sector. As DEFMIS does not account for personnel costs, an IHO must separately record personnel numbers and proportion of time on IHO work to derive personnel costs.

6.15 Defence will develop an activity based costing module as part of the DEFMIS replacement system. Used in conjunction with a personnel costing system to be introduced which allows allocation of personnel costs to cost centres, it will provide the management accounting information on the true cost basis including the charges and rebates for personnel as suggested by ANAO.

Example from cases - Benefits of a well-constructed in-house option (IHO)

Before CSP, this aircraft maintenance activity was an inefficient and ineffective 'production-line' process which was unresponsive to customers' needs and without scope for its work-force. With the implementation of the in-house option (IHO), the maintenance wing underwent significant cultural changes to its management structure and business methodology. To address the requirements of each aspect of aircraft maintenance, 10 cellular work teams were set up, 8 of which were integrated with each other. The new structure provided greater flexibility to cope with workload variations, greater scope for personal involvement, increased problem solving capacity and a greater focus on quality and delivery improvements.

The cellular work team structure provided the facility for costs to be identified and charged against individual teams, thus giving a true business perspective to the work teams and allowing them to benchmark their performance against commercial best practice. In this way, the IHO has evidence of significant savings to the Department. For example, the engine maintenance facility now requires significantly fewer employees than before CSP (360 down to 190) with a reduction in the proportion of military personnel (72 positions demilitarised) and is regarded by base management as providing a better service.

Competitive neutrality

6.16 It has often been suggested by unsuccessful in-house options or commercial bidders that the market-testing process was biased and restricted their chances of winning. The audit found no evidence of systemic bias against either private sector or in-house options. Individual instances of unintended bias have occurred and some evaluation decisions have been overturned. Individual contractors or in-house option teams have been disgruntled by the result of the process. The ANAO has found that the process is basically fair. Any unsatisfactory decisions that have been made have been the result of individual decisions that have gone against required procedure. Private sector bidders are very focused on ensuring they are treated fairly and whenever they have complained about what they saw as irregularities in the process, the Department has gone to some lengths to investigate the complaint.

Evaluation

6.17 As noted elsewhere in this report the presence of an efficient, well presented in-house option is of great importance if the Commonwealth is to achieve best value for money. The 1993 consultants' report commented that there were major weaknesses in some in-house options including very poor presentation and the apparent assumptions made by in-house option teams that the evaluation would apply military knowledge rather than fully stating the basis of assumptions.⁴² A member of a Tender Evaluation Team made a similar comment to the ANAO in relation to a recent tendering process. It is important that in-house option teams prepare a bid which adequately presents the case for the in-house option.

6.18 In the US it has for a number of years been recognised that changing from the status quo to an alternative delivery mechanism incurs significant costs, which are not readily measurable, and the savings to be made from making such a change need to be considerable. The A-76 process estimates these costs at the lesser of 10 per cent of the annual activity cost or \$10 million. The types of cost that this margin is meant to accommodate are the costs of taking longer to redeploy staff than expected and the costs of disruption to the area and the other areas of the organisation that it deals with. It is not practicable for these transition costs to be estimated or, in the latter case, even measured after the event.

⁴² Report to the Department of Defence: *A Review of the Commercial Support Program and its Performance* August 1993 pp. 104-5.

6.19 A comment frequently made to the ANAO in the US and in Australia was that some transition costs cannot be readily estimated in the competition process but are significant. In Australia if transition costs cannot be readily estimated they are not taken into account and there is no required margin of savings to provide for the possibility of these costs being incurred.

Improving the viability of in-house teams

6.20 In the US some bases and units have bid for the work being outsourced at other bases if they have had some competitive advantage and on occasions these “external” in-house bids have been successful. Also the Efficiency Scrutiny Review in the UK recommended that:

Consideration should be given to linking in-house teams into semi-autonomous ‘Regional Service Organisations’ where geographically and constitutionally feasible.⁴³

6.21 Just as appropriate packaging can result in the most efficient solution to a support requirement it is possible to improve the efficiency of an in-house bid by spreading management overheads across a number of activities. For example, if one Defence establishment in Sydney is testing base support activities, the in-house bid team could ally itself with an in-house base support operation which is already in place in Sydney to spread the management overheads of both activities and also make savings from economies of scale. It is probable that the Department would need to institute procedures to facilitate contact between the in-house options already in place and the new bidder. A commercial operator who already had a contract for an activity at a Base would not duplicate its overhead expenses to implement a similar activity at a nearby Base.

6.22 The ANAO suggested that it could be useful, in an effort to maximise the efficiency of in-house options, if the Department were to encourage in-house bidders to ally themselves with in-house options already in place in similar geographic and functional areas. The Department responded that it considers the development of the most cost-effective aggregation arrangements is a responsibility of the Department rather than of the IHOs involved. The ANAO is unaware of any cases where in-house options in a region had been aggregated to bid for a regional activity but accepts that the Corporate Support market-testing schedule is still in its early stages.

⁴³ *Competing for Quality: Policy Review - An Efficiency Unit Scrutiny*, UK Cabinet Office, p. 45.

Examples from cases - in-house option (IHO) staffing considerations

This in-house option (IHO) was not managed as a truly autonomous unit like a commercial contractor. The IHO had no authority over staffing levels and personnel appointments, resulting in a lack of trained personnel. In the initial stages of the IHO, the stock control activity experienced delays in the recruitment of staff, transient staff, concern that specific supply knowledge was lost, and inadequate training of staff.

Staffing levels were established with little or no flexibility, with senior management not distinguishing between the IHO and a 'regular' unit. The time allocated to Service personnel to undertake ceremonial activities, parades and training exercises was underestimated in the original bid. Required to undertake both duty and IHO requirements, Service personnel worked excess hours to complete their IHO tasks. In the first 9 months of its operation, the IHO recorded 272 man weeks (20 per cent of total) of absence of permanent staff.

The IHO lacked provision for contract variations of a kind that would be allowed to a commercial operator. The unit experienced a significant increase in activity and tasking since the endorsement of the IHO. No budgetary allocation was made to allow for the payment of penalty rates to APS staff, resulting in extreme situations for Service personnel. Service tanker drivers were required to perform long hours of duty averaging 81.5 hours per week. This included a shift that commenced on Friday at 1400h and concluded Monday 0730h.

Canberra ACT
10 July 1998



P.J. Barrett
Auditor-General

Appendices

Appendix 1

Abbreviations/Glossary

Commercial Support. The performance of Defence related tasks by the private sector, eg. the manufacture, servicing and repair of Defence equipment and facilities, and the provision of selected services.

Commercial Support Program (CSP). A program whereby in-house activities are subjected to competition with the commercial sector where operationally feasible and practicable.

Competition. The process of allowing potential suppliers of goods and services to tender for the award of a contract, based on their submitted performance and cost structures.

Contingency. An assessment of the kind of threat or conflict Australia could practically face, and its intensity and duration. This allows Defence planning to proceed even in the absence of a specific threat or scenario for a threat.

Contracting Out. The process of inviting the private sector to carry out in-house (Defence) activities under the direct control of Defence, and on occasions utilising Defence resources.

Core. Those activities/functions performed in order for Defence to be able to meet its expressed mission and constitutional obligations. (See also Core Activities and Functions.)

Core Activities and Functions. Activities and functions which are so integral to the operational effectiveness of the ADF, that performance by other than ADF or Defence personnel would diminish or put at risk their effectiveness. This criterion renders them ineligible for consideration for commercial support.

Defence Mission. To promote the security of Australia, and to protect its people and its interests.

Department of State Functions. Functions which carry responsibilities to the Government and the Parliament under the Constitution, the Public Service Act and other legislation. These include, for example, the development of Defence Policy, strategic defence planning, reporting to Parliament, programming and budgeting, requirements determination and overall resource management, and are not suitable for transfer to the commercial sector.

DOA 87. The Defence Policy Paper: Defence of Australia 1987.

Effectiveness. The extent to which an activity satisfies the purpose for which it was established.

Efficiency. A measure of resource commitment to the activity.

Financial Evaluation. Analysis of predicted costs and benefits from a Defence internal perspective.

In-house. In the CSP context, 'in-house' defines an activity as belonging to, or being performed by Defence civilians and/or uniformed personnel.

Industry. CSP Manual provides that, in the context of CSP, 'industry' is used as a generic term to include non-Defence organisations in the public sector (eg. the Department of Finance and Administration (DOFA)), as well those firms in the private sector that are engaged in such areas as providing services and manufacturing goods. The CSP seeks to have Defence compete with those industries that have a capacity to perform the function or activity.

Inputs. The resources used or consumed in producing outputs or outcomes.

ITR. Invitation to Register Interest. An ITR is a formal invitation seeking industry interest in a broadly based project proposal.

Management Review. A management review is a considered and analytical evaluation of an activity to determine if the job can be accomplished in a more economical manner. Such a review will first identify essential functions to be performed by an activity and its boundaries. The results of the study will be used to develop the in-house option bid for comparison with commercial bids providing the product or service.

Management Review Team (MRT). A team designated to carry out a management review.

Market-testing. In the context of CSP, implies competing the in-house option bid with industry bids.

Non-Core Activities. Those activities which are clearly not part of Defence's organisational core, and which are not integral to the support and sustainment of core, may be designated as 'non-core'. Proposals on whether an activity is core or non-core will be made by the relevant program manager.

Savings. In the CSP context, 'savings' are the net reductions in expenditure (of resources, manpower, or money) achieved by a Program level. Thus if an activity 'saves' 20 positions, and five of those positions are reallocated elsewhere within the Program, a net saving of 15 positions has been achieved by the Program.

Statement of Requirement (SOR). A description of an activity in terms of required outputs and constraints.

Tender Evaluation Team (TET). The Team of specialists who develop the Tender Evaluation Plan (TEP), conduct the evaluation, rank bids and make a recommendation/s.

Tier 1. In the context of the CSP, Tier 1 activities are those identified by the Wrigley IDC as candidates for immediate commercial support consideration.

Tier 2. In the context of CSP, Tier 2 activities are those activities that become candidates for commercial support following the continuing process of CSP evaluation through top down direction (ie Program Manager direction).

Tier 3. In the context of CSP, Tier 3 activities are those activities offered for commercial support resulting from initiatives instituted by operational level managers. It is necessarily dependent upon a viable incentives scheme.

Value for Money. Is the final outcome of a rigorous qualitative and quantitative assessment in the purchase of goods or services to achieve the most effective, efficient and economical product.

Appendix 2

Performance audits in the Department of Defence

Set out below are the titles of the ANAO's performance audit reports in the Department of Defence tabled in the Parliament in recent years.

Audit Report No.22 1992-93

New Submarine Project

Audit Report No.5 1993-94

Explosive Ordnance

Audit Report No.11 1993-94

ANZAC Ship Project -Monitoring and Contracting

Audit Report No.19 1993-94

Defence Computer Environment Supply Systems Redevelopment Project

Audit Report No.27 1993-94

US Foreign Military Sales Program (follow-up audit) Explosives Factory Maribyrnong

Audit Report No.2 1994-95

Management of Army Training Areas (follow-up audit) Acquisition of Additional F-111 Aircraft

Audit Report No.13 1994-95

ADF Housing Assistance

Audit Report No.25 1994-95

ADF Living-in Accommodation

Audit Report No.29 1994-95

Energy Management in Defence ANZAC Ship Project Contract Amendments

Overseas Visits by Defence Officers

Audit Report No.31 1994-95

Defence Contracting

Audit Report No.8 1995-96

Explosive Ordnance (follow-up audit)

Audit Report No.11 1995-96

Management Audit Defence Quality Assurance

Audit Report No.17 1995-96

Management of ADF Preparedness

Audit Report No.26 1995-96

Defence Export Facilitation and Control

Audit Report No.28 1995-96

Jindalee Operational Radar Network Project (JORN Project)

Audit Report No.15 1996-97

Food Provisioning in the ADF

Audit Report No.17 1996-97

Workforce Planning in the ADF

Audit Report No.27 1996-97

Army Presence in the North

Audit Report No.34 1996-97

ADF Health Services

Audit Report No.5 1997-98

Performance Management of Defence Inventory

Defence Quality Assurance Organisation

Audit Report No.34 1997-98

New Submarine Project

Audit Report No.43 1997-98

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Audit Report No.1 Performance Audit
Corporate Governance Framework
Australian Electoral Commission

