
DEFENCE INFRASTRUCTURE PROCUREMENT

Maximising Opportunity
and Improving
Competition

Northern Territory

SUBMISSION SUMMARY

Master Builders NT (MBNT) is pleased to be able to make a submission to the Senate Foreign Affairs, Defence and Trade Committee and we welcome the visit by the Committee to the Territory.

In this submission, MBNT has focused on the issues and opportunities very much from a Northern Territory perspective, as clearly that is our space. But we would like to place on record our strongly held view that the matters we raise with you in this submission apply equally right across regional Australia.

That is not just an opinion of MBNT. We have spoken with our sister organisations interstate, as well as political leaders representing regional Australia, and they all say the same thing. 'That opportunities are being missed because of a procurement system that is too narrow by design!'

Returning to the Northern Territory, the Defence Infrastructure program is one of the largest known investment pipelines in this jurisdiction over the next decade. The level of participation by local industry will not only determine the future of construction businesses, but, importantly, the very shape of this economy as well. That is the fundamental reason why there is such intense interest in decisions made around the Infrastructure Program.

It is also important that we acknowledge the pressure on Defence to deliver a substantial program, sometimes in remote settings, and the expectations it has around its own resourcing. We wish to restate that we have never simply sought to through 'stones'. We have always tried to position ourselves as a constructive partner with Defence and we believe our track record stands for itself.

We would encourage the Committee to see the opportunities that would come from a number of changes to the present shape of Defence Infrastructure procurement in the NT, including:

1. Establishing a Program Delivery Office in the NT;
2. Significantly lifting the oversight on decisions to bundle disparate construction projects into mega projects;
3. Incentivising Managing Contractors to use Head Contracts with key project elements; and,
4. Removing punitive sub-contract clauses that act as a barrier to entry and/or push up local sub-contracting prices.

We believe that those four changes, along with partnering with ICN NT, would deliver real savings to Defence in the delivery of its program, whilst capturing the intent and ambition of the North Australia Agenda and the desire of the Federal Parliament to increase the level of SME participation in Defence contracting.

**SUBMISSION TO THE SENATE FOREIGN AFFAIRS,
DEFENCE AND TRADE COMMITTEE**

**PROCUREMENT AND THE DEFENCE INFRASTRUCTURE PROGRAM
IN REGIONAL AUSTRALIA**

1. INTRODUCTION

1.1 Master Builders NT

Master Builders NT (MBNT) is part of the national Master Builders movement, which has 33,000 members distributed across Australia. MBNT membership includes commercial and residential builders, civil contractors, the full cross-section of trade contractors, as well as supply and professional services businesses. The operational scope of those businesses runs from the very small businesses with a turnover of less than 200,000, right through to international firms with multi-billion dollar turnovers in Australia.

The Master Builders movement has a proud history built over the past 127 years of constructive contributions to public debate in Australia. It has always been built on the key values of being frank in advice and balanced in intent.

MBNT welcomes the opportunity to make a submission to the Committee, especially to highlight some sensible modifications to procurement which can significantly expand the opportunities for Australian firms to participate in the Defence Infrastructure program.

1.2 Defence Infrastructure Program in the NT

The 2016 White Paper released by the Prime Minister and Defence Minister identified upwards of \$20bn of new infrastructure projects in the Top End of the Northern Territory over the period 2016 – 2036.

The details of those projects are not publicly available. However, we are led to believe that the list includes the possibility of new bases, as well as upgrades to existing bases, facilities for the USFPI Marine Rotations and other infrastructure.

Discussions with Defence Officials has indicated that of the \$20bn, approximately \$8bn of new investment in facilities will occur over the decade from 2016 – 2026. That time horizon is obviously far more certain, and as a consequence, this Submission focuses on that time horizon and investment quantum.

2. BACKGROUND

2.1 Industry Partnership With Defence

MBNT first commenced a dialogue with Defence officials early in 2015. At that time, the conversation focused on the level of construction activity then in the marketplace and our expectations on future demand for construction services.

The concern of officials was the availability of sufficient capacity and capability to accommodate the proposed Defence program, and the risk that as a large player in a smaller market, it would effectively be competing with itself, reflecting the obvious concerns around inflationary pressures and higher prices.

Noting those concerns, MBNT offered to commission independent econometric analysis that Defence could use as part of its early program design. That offer was accepted and MBNT subsequently commissioned Mr Chris Murphy, of Independent Economics, to undertake a two part study examining:

- The anticipated level of overall demand for construction services from 2015 onwards;
- The level of industry capacity and capability in the marketplace; and,
- The impact that Defence would have with its proposed program.

Defence provided anticipated program numbers to Independent Economics under a Confidentiality Agreement, guaranteeing a strong reliability to that research. Mr Murphy provided MBNT and Defence with a two volume report and MBNT released a summary document titled 'Capacity to Spare – Defence and the NT Construction Industry' in June, 2015.

In October, 2015 MBNT arranged for those reports to be updated, following the release by the Australian Bureau of Statistics of updated construction activity data. A supplement of the 2015 'Capacity to Spare' reports was then provided to Defence and industry.

Following the release of the 2016 White Paper which announced significant changes to the proposed spending profile by Defence in the NT, MBNT commissioned a second study by

Independent Economics, this time utilising updated program information provided by Defence. That updated study was released in July 2016.

Those studies were fully funded by MBNT via the generous support of our membership.

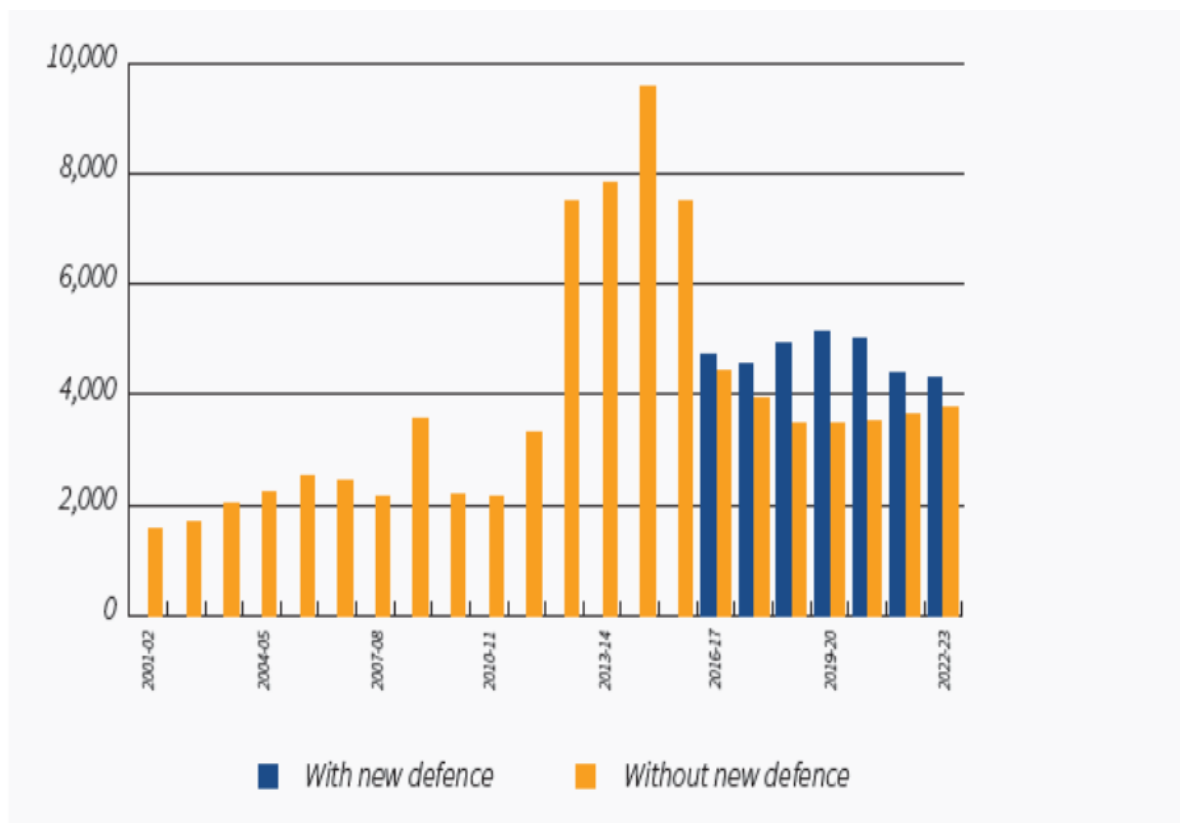
The econometric work has been invaluable in helping to limit the impact of both personal anecdote, and opinion, on such fundamental matters as construction demand and industry capability and capacity. Clearly, econometrics is not fact, but it does bring a much higher standard of rigour to the conversation. We have not heard of another example in Australia where industry has invested (other than in-kind) to assist Defence in its early infrastructure program planning.

2.2 Economic Impacts of the Program

Both the 2015 and 2016 'Capacity to Spare' reports confirmed that there was sufficient industry capacity and capability to accommodate the proposed investments by Defence. The two key contributors to this assessment were the then forecasted tapering of engineering investment in the minerals sector right across Northern Australia, and the significant increase in the size of the construction sector over the proceeding 15 years.

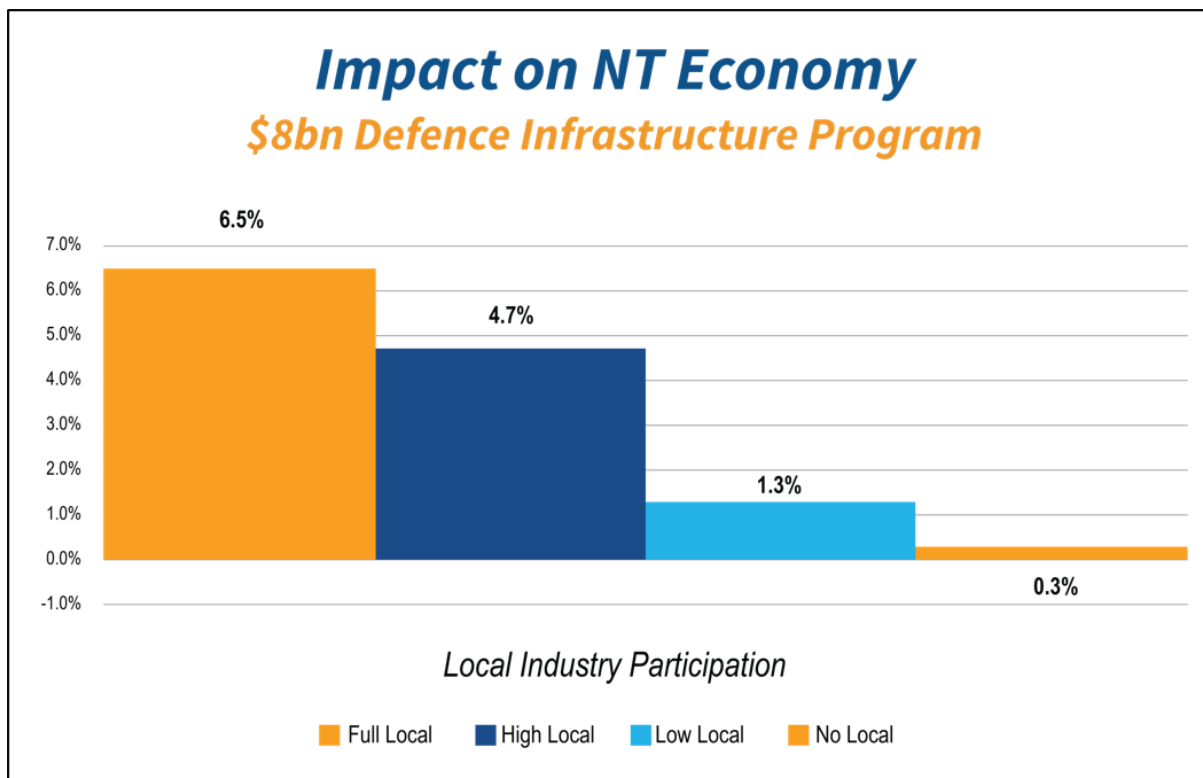
In his work, Mr Murphy was also asked to forecast demand with and without the Defence program, as well as the varying impact of that program depending on the level of local industry participation.

Graph 1 shows the impact of new Defence spending on Construction Demand.



The injection of Defence investment has a significant impact on construction activity going forward.

Graph 2 shows the impact on the NT economy of that spending.



Both graphs are relatively self-explanatory. We would like to draw the Committee’s attention to the story from Graph 2. In a quite sophisticated analysis, Mr Murphy worked with local contractors to develop a matrix that identified the technical limits to local capacity and capability. Some elements of the program were then discounted, where it was clear that for reasons such as specialisation and technology, it was likely that firms based interstate and/or overseas would take on those tasks. Those elements were carved out of the program, and then he modelled the impact of different levels of local business participation. As you can see, he identified that the Territory economy would be 4.7% larger, for a decade, if there were high levels of local engagement.

Finally, as one Australian Prime Minister is famously quoted, context is everything. On an annual basis, the proposed investment pipeline will average approximately \$800m per annum. That is almost equivalent to the capital program of the Northern Territory Government each year, and larger than any currently known private investment projects.

In that world, the Defence Infrastructure Program stands as one of the largest investment flows into the Northern Territory over the coming decade, which explains why there has been so much interest from MBNT and the remainder of the community.

3. PROCUREMENT OBSERVATION

3.1 Small Early Procurement Decisions

It is very easy to overlook the impact of small, early, procurement decisions on the shape and results of programs and projects. What can seem to be relatively minor decisions can determine the future level of opportunity for industry, whether the broader policy agenda is ever contemplated, and even how decisions are made on-site years later.

Rightly, there is always a lot of focus on the tendering and award phase of procurement, but that process, like most others, has already been shaped by decisions made much earlier on.

As a general rule, there is not the same degree of external focus on early decisions even though they tend to design the overall shape of projects. Government should have confidence that those decisions take on board matters such as:

- **The broad policy agenda.** For example, has the North Australia Agenda been factored in or has the drive by Government to expand the number of SME's contracting to it been designed in to the delivery model, contract and industry engagement processes.
- **The full market context.** Has market analysis been undertaken, especially around maintaining access to Australian Government projects, stimulating sufficient competition to maximise price pressures, industry capacity, industry capability and project timing.
- **Examining alternative delivery models against the prevailing policy agenda and market context.** In an environment of limited resources and pressing time pressures, there can be a temptation to adopt 'template procurement methodologies' as a streamlining strategy, when other methodologies might deliver better outcomes for Government.

MBNT wishes to stress that it is certainly not levelling any criticism at officials responsible for those early procurement decisions. This is a systems issue. We well recognise the complexity of the task of delivering a significant infrastructure program right across

Australia on operating military facilities. We believe though, that increased oversight or focus can help everyone to understand 'how decisions have been made' which builds confidence, and can create a virtuous cycle of continuous improvement over time.

The important message is that small, early, procurement decisions 'design' the shape of projects far more than explicitly acknowledged. That is why it is important that there is equal focus on that stage as there currently is on tendering and contracting.

4. MAXIMISING OPPORTUNITY AND IMPROVING COMPETITION

4.1 Establish a Program Delivery Office in the NT

As mentioned earlier, the Defence Infrastructure Program is estimated to be valued at somewhere near \$8bn, and delivered between 2016 & 2026. That is a monumental program, equivalent to the construction of a two train LNG facility or 4 full service major hospitals.

It is also the case that this work must occur on operating military bases and includes separate works to be funded and managed on Australian bases by the US Navy, under the USFPI umbrella.

It would make sense to establish a Program Delivery Office in Darwin, rather than to attempt to manage all of those activities from Canberra.

We recognise that Defence is under intense pressure to reduce overheads, but we believe that the lack of a local delivery office does several things:

- It sits in stark contrast to commitments by the Australian Government to expand capacity and capability in North Australia under the North Australian Agenda;
- It reduces the level of market knowledge and potentially leads to sub-optimal decision making as a result;
- It can potentially lead to decisions to aggregate disparate construction projects into mega-projects to accommodate and/or manage some of the risks that arise from not being on-the-ground on a consistent basis; and,
- Limits the opportunities for local businesses that provide services beyond physical construction, which would wish to contract with Defence and assist them to deliver their projects. Instead, interstate consultants with potentially limited local knowledge are engaged to provide those services from Canberra.

4.2 Focused Oversight of Project Bundling

Perhaps one of the greatest concerns for regional businesses is the bundling of various discrete construction projects into mega-projects. That one decision works immediately to limit the field of businesses which can tender to supply those services, and mostly to just a small group of national businesses.

Many Tier 1 contractors are members of this Association and we do not have any problems with their role in Defence contracting. Indeed, we support them in their Defence and other activities. The concern is that no other decision works to limit participation more than bundling, and the arguments in favour of that strategy can appear, at least on the surface, to be driven by internal administration needs rather than any synergies or savings from scale.

In recent times, the NACC contract in Tindal was valued at \$495m. We recognise that number is fluid, but the quantum provides some idea of the scale of the project. Larrakeyah/Coonawarra is the next significant project, valued at \$550m. Delamere, is estimated to be worth approximately \$150m and that contract was not put to the market, but offered as a variation to another mega contract.

In the pipeline is Air 7000 1(b) valued at \$400m and Air 6000 valued at \$800m. Air 7000 involves works in Edinburgh in Adelaide, and Tindal near Katherine. Air 6000 is at Tindal, and aggregates work around the airfield with residential services upgrades.

All of these projects have been or will be delivered under a single procurement methodology of Managing Contractor. It has been suggested that one firm holds up to 70% of all managing contractor contracts that Defence has in Australia.

Defence rightly argues that it requires a sophisticated commercial partner to assist it to scope, design, document and seek approvals for its projects and the managing contractor model delivers that for them. It works well in the co-ordination of activities on bases, but requires scale to justify the methodology. The truth is that while that is right, not all projects require such an approach. Many are low risk, straightforward projects, than can be delivered using the same methodologies as the remainder of the marketplace.

Bundling is a classic example of an 'early procurement decision' that shapes the results from the project from there on. The decision to bundle should be able to withstand public scrutiny. We would respectfully suggest that the Minister, or at the very least the Departmental Head, should make the final decision around the aggregation of projects.

4.3 Use Head Contracts Under The Managing Contractor Model

A successful managing contractor on a project is responsible for two phases of work. First, the scoping, design, documentation and approvals for a project. And second, to manage the physical works on behalf of Defence, once a project has been approved.

The current design of this model contains some perverse incentives. The managing contractor is required to bid a flat fee for both pieces of work. If it is successful in gaining those stage 2 works, which is what invariably happens, then there is an incentive because of that flat fee to reduce down the number of firms it selects to manage. That, coupled with a view within Defence on profit on profit, leads to a bias which sees contracts being let to large trade contractors with national footprints.

At the delivery phase there should in fact, be a bias towards maximising the use of local industry capability and capacity where price and competency are at least equal. However, the structural design around managing contractor has a built in bias against that.

There will always be projects under the integrated mega-project umbrella that would be better suited to be contracted as a separate package to a head contractor. This has the benefit of tighter project co-ordination and the likelihood that it increases the number of SME's who can join the supply chain to Defence. Defence advises that such an arrangement is theoretically possible, but all evidence in the marketplace is that the system works against those forms of delivery solutions.

MBNT strongly believes that managing contractors should be incentivised to utilise head contracts to deliver the stage 2 works for projects. It will deliver significant competition in tendering, leading to tight prices for the taxpayer, and assist Defence to achieve Governments targets for local SME participation.

4.4 Remove Punitive Sub-Contract Clauses

We have already seen instances where sub-contract packages have been put to the market referencing punitive sub-contract conditions in the contracts. The best example of this is \$30,000 per day for liquidated damages.

That is a simple device that works to push up local prices. Smaller contractors know that they have very little market power and definitely no control over scheduling and programming. It means that business owners invariably price in the risk of working on a Defence project, which delivers one of two results. Either Defence pays more than it should for those works, or the pricing of risk then prices SME's out of the market and projects are won by national firms with much larger balance sheets.

The counter-argument has been made that local firms need to be prepared for the higher standards of rigour required in working for Defence. At one level, MBNT would support that view. But we don't, and cannot, when it seems that some firms are able to negotiate things like liquidated damages away, while other firms cannot.

4.5 Partner with the Industry Capability Network

ICN NT is a not-for-profit organisation that works to link buyers and sellers. It maintains a database of firms and their capability, an online system of pre-qualification, and a team of consultants well versed in industry analysis.

With the NACC project in Tindal, Lendlease contracted with ICN NT to assist it with the pre-qualification of local industry capacity and capability with significant success.

Additionally, ICN NT reverse-engineered the NACC project, using information provided by Lendlease as well as Contractor Accreditation Limited (CAL), to build a supply chain map of the project. That was able to show at a much finer grain level which firms could meet the needs of the company and also where there were gaps in capability in the market.

Put very simply, the 'Capacity to Spare' work by MBNT provided a 'whole-of-market' analysis and the work of ICN NT supplemented that with information at the firm level.

We believe that the ICN NT is a resource which can significantly help Defence to achieve stronger levels of participation. In discussions however, it has indicated that such a partnership is not a matter for it, but a transactional decision of the managing contractor.

We would argue that that perspective is short-sighted and inconsistent with the wider policy parameters around industry engagement.