

Ai GROUP SUBMISSION

Submission to the Senate Finance and Public Administration Reference
Committee Inquiry into Commonwealth Procurement Procedures, Dec 2013

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About Australian Industry Group

The Australian Industry Group (Ai Group) is a peak industry association in Australia which along with its affiliates represents the interests of more than 60,000 businesses in an expanding range of sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other industries. The businesses which we represent employ more than 1 million people. Ai Group members operate small, medium and large businesses across a range of industries. Ai Group is closely affiliated with more than 50 other employer groups in Australia alone and directly manages a number of those organisations.

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Executive Summary

- The Australian economy is currently growing at a pace that is below its long-term average of around 3%. Treasury, the RBA and others expect this slow speed to continue into 2014 and 2015 due to ongoing domestic and international headwinds.
- This weak pattern of growth is placing increasing pressure on Government to find productivity improvements, but also to give appropriate weight to local activity and to ensure Australian businesses have opportunities to lift domestic output and incomes. In this fragile economic environment, Government must be wary of inadvertently exacerbating the tough trading conditions faced by businesses across many of our key industrial sectors. Government should avoid implementing short-term or narrowly considered savings measures or purchasing policies that may unfairly disadvantage local suppliers.
- With regard to procurement as in other areas of expenditure, Ai Group believes Government should adhere to established principles of best practice in Government expenditure and regulation, even as it seeks to bring the Budget back towards balance. Indeed, these can be of great assistance in identifying appropriate savings measures for Government. No areas or agencies of Government should be 'off-limits' to the application of best practice principles such as efficiency, effectiveness, transparency and equity in government expenditure.
- Government should take a long-term and holistic approach when applying these principles to individual costs and expenditure items. The emphasis should be on 'value for money' over the whole life of a product or service and should take into account factors such as risk, reliability and future maintenance costs.
- Australian businesses should have full and fair access to supply the goods and services required by the public sector and for major projects undertaken within Australia. There are, however, a number of barriers and distortions that frustrate and impede the full and fair participation of Australian suppliers. These barriers and distortions are exacerbating the intense competitive pressures currently being experienced by local, trade-exposed industries and particularly the manufacturing sector.

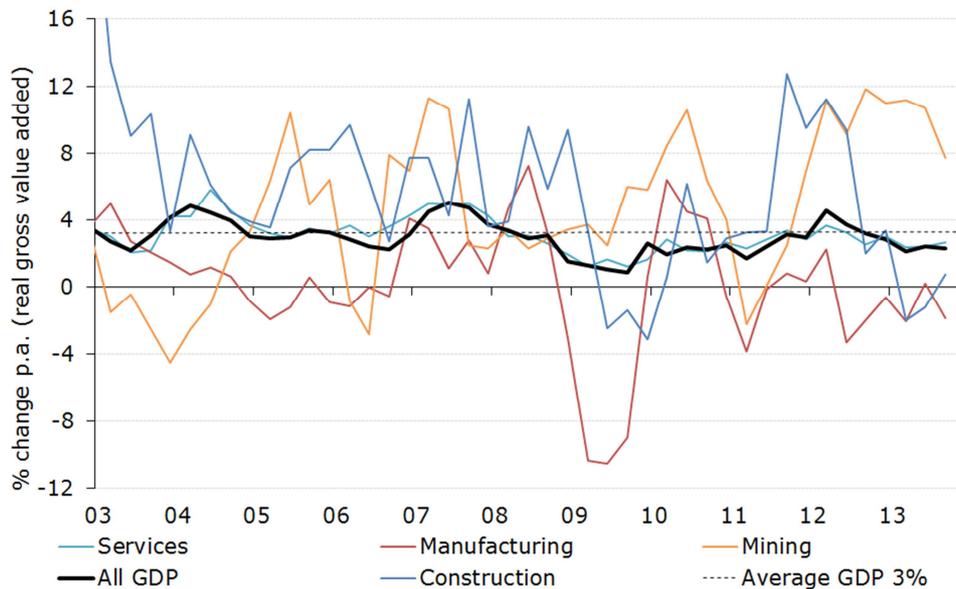
1. Economic Context

Australian economic growth slowed steadily through 2012 and 2013, with below-average rates of growth in real output (GDP) recorded in all three quarters so far this year. Real GDP grew by 0.6% q/q and 2.3% p.a. in Q3 2013 (inflation adjusted and seasonally adjusted), indicating the economy is treading water at best. Among our six largest industries (in value added terms), three sectors – mining, finance and health – showed strong growth in value-added output through 2013 while the other three – construction, manufacturing and professional services – were flat or declining (see chart 1). Mining output now accounts for more than 10% of national value-added output on its own, while these six largest industries produce almost half of our economic output (around 45%) and account for a similar proportion of total employment (43%).

Construction and manufacturing (our third and fourth largest sectors in terms of value-added output and employment, together accounting for around 15% of GDP and 18% of jobs) have experienced especially difficult trading conditions over an extended period of time, due to a variety of domestic and international factors. Manufacturing has experienced only one quarter of positive annual growth in output since early 2012 (0.2% p.a. Q2 2013). Meanwhile, construction saw two quarters of contraction in output in 2013 (in annual growth terms), despite the apparent boost that this sector was receiving from the mining investment boom during this period (see charts 1 and 2). This was because the rise in mining-related engineering construction was not enough to outweigh the falls in commercial and residential construction during the recent lows in their activity cycles. Trends in profits, incomes, employment and investment have followed a similar trajectory over this period in these two key sectors.

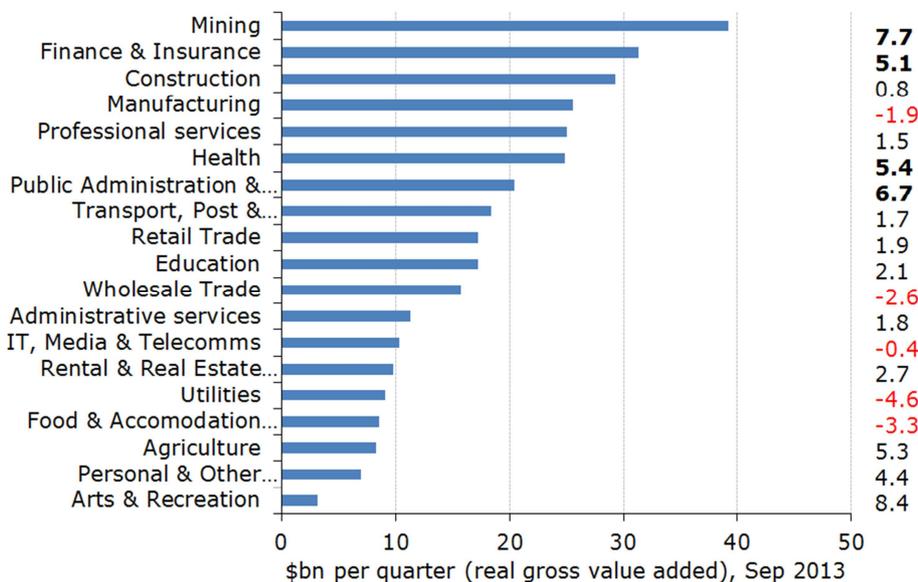
Although the Australian economy continues to perform significantly better than many of our developed-economy peers, these weak rates of national economic growth are of concern. The long-term average rate of growth in real GDP for Australia is around 3.0%, while the population growth rate is around 1.8% p.a. Real GDP growth of 3% or more is widely considered to be a necessary and minimum condition, in order to generate sufficient employment growth to stop unemployment from rising. With GDP growth of just 2.3% p.a. and no strong drivers of growth yet emerging to replace the recent (but now declining) support from mining investment, we can expect the unemployment rate to keep drifting up, with output and incomes per capita likely to drift sideways at best.

Chart 1: GDP and major industries, annual growth in real output (% p.a.)



Source: ABS, *National Accounts*. Sep 2013.

Chart 2: Real output by industry, \$bn per qtr and annual growth (% p.a.), Sep 2013



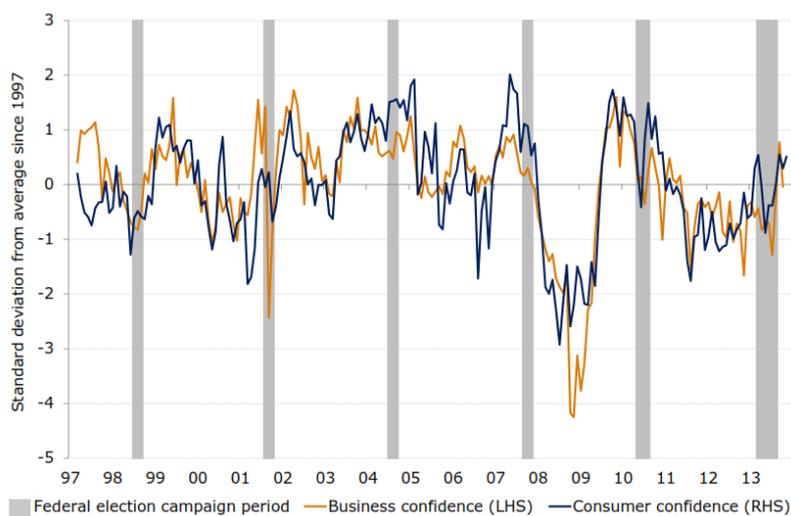
Source: ABS, *National Accounts*. September 2013.

The economic mood has been more positive in the second half of 2013, with several 'real-time' activity indicators showing a lift in local demand since the September federal

election. Real concerns remain however, about the ability of our non-mining sectors to step into the growth gap that is opening up in the wake of the mining investment boom, which has already reached its peak in this cycle. In a recent Statement, RBA Governor Stevens noted that since the election “*there has been an improvement in indicators of household and business sentiment recently, but it is still too soon to judge how persistent this will be.*” Of particular significance, Stevens also noted that “*the Australian dollar, while below its level earlier in the year, is still uncomfortably high. A lower level of the exchange rate is likely to be needed to achieve balanced growth in the economy.*”

The latest indications on confidence among businesses (the NAB monthly survey) and consumers (Westpac-MI and Roy Morgan) suggest the Australian economy is currently experiencing a fairly normal reaction to a federal election, with a sharp lift in confidence immediately after the election, followed by a moderation in economic expectations some time later. This moderation in mood might be setting in earlier now than in the 2000’s, reflecting the weaker state of the economy in general now, compared with the more prosperous, high-growth, pre-GFC period. Business confidence in particular, had already slumped back to its long-term average in October (see chart 3).

Chart 3: Business and consumer confidence in election cycles

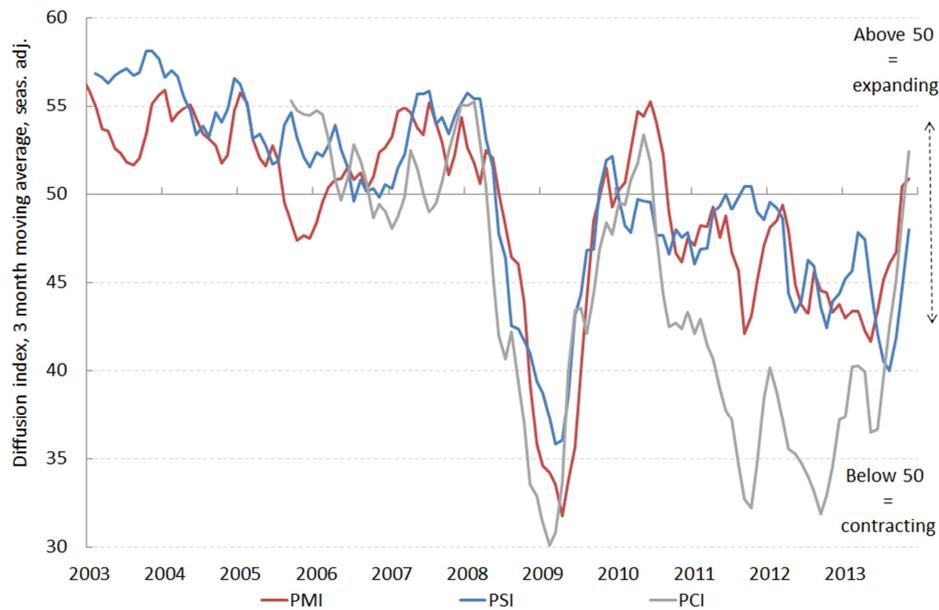


Source: NAB, Westpac-MI and ANZ.

These confidence measures confirm the trends emerging from the latest Ai Group Australian PMI®, PSI® and PCI®, which suggest a moderate but not especially strong improvement in local demand and activity in the last quarter of 2013 (see chart 4). For many of our economy’s largest industrial sectors, this last quarter of 2013 seems to be

offering a partial recovery at best from an extended period of tough trading conditions (due to factors such as the high dollar, weak local demand, shifting global growth patterns and high local costs), rather than new opportunities for outright growth.

Chart 4: Australian PMI®, PSI® and PCI®



Source: Australian Industry Group.

The outlook for the Australian economy is relatively slow and flat for the foreseeable future, because many of the headwinds noted above are likely to remain in play. This fragile trading environment will entail ongoing adjustment from business and industry and will require a strong degree of sensitivity, caution and stability in our economic policy settings. Treasury, the RBA and others expect GDP growth to remain below the long-term average (around 3%) in 2014 and into 2015 (see table 1). In November, the RBA revised down its GDP growth expectations for 2014-15, by about 0.5% points and in December, Treasury followed suit in its forecasts. Below-trend growth is now expected to continue over a longer period than was expected previously, due to factors including: a sharp fall in mining investment (which will subtract from GDP growth); only moderate growth in household spending due to slow employment growth and increased savings; and fiscal restraint by federal and state governments. Bright points in the outlook will be resources export volumes (up strongly) and housing construction (recovering).

The RBA does not publish detailed forecasts of employment, but the Australian Treasury expects employment growth to remain extremely weak over the outlook period,

improving from less than 1% p.a. currently to just 1.5% p.a. by 2016. This is likely to see the unemployment rate rise from its current level (around 5¼%) to 6¼% through 2014 and remain there until at least 2016. Workforce participation rates have fallen and are likely to remain lower, for demographic and cyclical reasons. This weak pattern of growth will place increasing pressure on Government and industry to find productivity improvements but also to support local activity to the greatest extent possible, in order to drive future growth in our output and incomes.

Table 1: Latest Australian growth forecasts (official sources)

GDP growth, % p.a. (year end)	2013	2014	2015	2013-14	2014-15	2015-16
RBA (November 2013)	2¼	2 - 3	2¾-4¼	2½	2¼-3¼	
Treasury (December 2013)				2½	2½	2½
IMF (October 2013)	2½	2.8				
CPI rate, % p.a. (year end)	2013	2014		2013-14	2014-15	2015-16
RBA (November 2013)	2¼	2 - 3	1½ - 2½	2¾	2-3	
Treasury (December 2013)				2½	2	2½
IMF (October 2013)	2.2	2.5				
Employment growth, % p.a. (annual average)				2013-14	2014-15	2015-16
Treasury (August 2013)				0.75	1.5	1.5
Unemployment rate, % (year end)				2013-14	2014-15	2015-16
Treasury (December 2013)				6.00	6.25	6.25
IMF (October 2013)	5.6	6.0				

Source: RBA, *Statement of Monetary Policy*, Nov. 2013; Australian Treasury, *MYEFO*, Dec. 2013; IMF, *World Economic Outlook*, Oct. 2013.

2. Barriers to Australian businesses in Government Procurement

Australian businesses should have full and fair access to supply the goods and services required by the public sector and for major projects undertaken within Australia. There are, however, a number of barriers and distortions that frustrate and impede the full and fair participation of Australian suppliers. These barriers and distortions are exacerbating the intense competitive pressures currently being experienced by local, trade-exposed industries and particularly by the manufacturing and IT sectors. The major barriers and distortions are:

- An undue emphasis on upfront costs rather than whole of life costs in public sector procurement. This emphasis results in the purchase of lower quality goods and services and neglects the costs involved in maintenance and through-life support which are key advantages that local suppliers are able to offer.
- An uneven weighting given to conformity with standards. Local producers are required to produce to stringent Australian and International Standards and non-conformity or false claims of conformity are much more rigorously enforced than is the case with many imported alternatives. This puts local businesses at a disadvantage.
- Selection criteria (implicit or explicit) that include a record of supply in other countries as demonstration of credentials. This favours offshore suppliers and is a particular barrier to emerging local businesses and domestic suppliers of innovative goods and services.
- Preference given to offshore suppliers. Preference is often given by overseas-based prime contractors to sub-contractors and suppliers in their country of origin under explicit or implicit local preference arrangements and practices.

In major mining projects, for instance, overseas-owned mining companies often give preference to suppliers from their country of origin. More recently there is increasing evidence that major, Australian-based mining companies, under arrangements explicitly or implicitly linked to raw materials supply contracts with China, are required to give preference to Chinese-produced capital equipment and other inputs used in Australia.

These barriers and distortions against local industry participation in government contracts and in major projects can be addressed by the adoption and adherence by government agencies of practices that adhere to purchasing principles set out below. For major infrastructure, construction and mining projects, governments should require prime contractors and holders of licences to adopt and demonstrate adherence to similar practices. These practices should work alongside programs aimed to facilitate local industry participation such as a strengthened Industry Capability Network.

3. General Principles for Government Expenditure

Ai Group supports the establishment and implementation of 'best practice' across all Government programs and expenditure activities, so as to maximize the benefits of Government expenditure to all businesses and communities. This is especially important during periods of scarce resources and competing budgetary demands, such as now. No areas or agencies of Government expenditure should be considered 'off limits' to these principles, including the large-cost areas of health, welfare, defence and education expenditure.

In essence, all Government programs and expenditure items should be:

- **Targeted**, with clearly articulated purpose, objectives, eligibility and timetables;
- **Appropriate** in size, scope, design and eligibility to achieve the stated objectives;
- **Effective** in addressing the stated objectives, targets and timetable;
- **Efficient** in achieving the stated objectives at least cost to the taxpayer AND to any participants or clients. In assessing a spending measure's efficiency, costs to both the public and private sectors should be taken into account, in order to assess the overall efficiency to the economy, businesses and society as a whole;
- **Transparent**, such that each spending measure is visible and can be traced back to its purpose and objectives in a clear, logical manner;
- **Equitable** in the design of eligibility criteria, targets, funding levels and outcomes across relevant industry sectors, businesses, geographies and communities;
- **Stable**, over the life of each program or spending measure. Amendments and updates may occasionally be needed, but wholesale changes to spending measures should be avoided, in the interests of establishing certainty and trust among businesses and the wider community. Stability is especially valuable in industry and business spending measures that affect planning and investment;
- **Fiscally sustainable**, such that all program costs can be met from an identified revenue stream, including general revenue, special purpose revenue, fee for service or other arrangements. For expenditure programs that are intended to have a limited tenure, their initial design should take into account the timeframe over which the government funding is likely to be needed and their potential for independent financial viability after government funding has ended. This can include for example, designing programs so as to enable transition to an

alternative funding model once government funding finishes. Such funding transitions should aim to minimise the market disruptions and distortions that can arise from sudden injections or reversals of government funding.

In implementing and assessing these criteria, it is important that Government takes a **holistic** and **long-term** approach when applying these principles to individual costs and expenditure items. The emphasis should be on 'value for money' over the whole life of a product or service and should take into account factors such as risk, reliability and future maintenance costs.

- Government spending measures should be assessed **holistically** so that any spillover benefits and/or other benefits that are not easy to quantify are taken into account. In doing so, any cost–benefit analyses should not be limited to only examining things that are easy to quantify. This is especially relevant to expenditure that has a local procurement aspect to it, with benefits that are long-term, less tangible or less easily quantified.
- The outcomes and effects of Government spending measures should be assessed taking a **long-term** view. This can be difficult to uphold during periods such as now, when short-term fiscal and budgetary constraints are paramount. But the ability to initiate spending measures that have a long-term benefit is exactly where Government spending often has an advantage over private sector spending, and is where it should be concentrated. The need for a long-term approach is often self-evident in expenditure areas such as education, skills, health and welfare but it is also crucial to infrastructure planning, business certainty and industry development.
- From a purely budgetary perspective, Government must be careful to avoid short-term fiscal savings that might **increase its long-term costs** or reduce its long-term revenue sources. Savings measures that simply postpone expenditure from one year to another (for example, by making a saving on an initial purchase price at the expense of higher future replacement or maintenance costs) are largely illusory. In many cases, discounted current spending simply means higher costs at a later date.

4. Principles for Government Procurement

Principle 1: Value for Money

Value for money looks beyond “least cost” and brings to bear a broader cost-benefit approach that considers whole-of-life costs, including in relation to maintenance, servicing, quality and ongoing supplier relationships.

Principle 2: Clarity, Transparency and Improvement of Processes

Procurement processes should be clear and transparent and be subject to ongoing improvement to reduce costs of tendering and access for domestic suppliers, particularly small and medium-sized enterprises. .

Principle 3: Full and Fair Access

Procurement processes should ensure local suppliers have full and fair access to supply opportunities under direct government contracts and with prime contractors and for major projects. This includes consistency in relation to conformity with standards and no preferential treatment of offshore suppliers.

Principle 4: Full Opportunities for Local Suppliers

Australian suppliers should have full opportunity to compete for the provision of goods and services under government contracts both directly and indirectly through supply to prime contractors. For major projects, a condition of awarding prime contracts and licences should be that local suppliers will have full and fair access to sub-contracting and supply arrangements.

Procurement plans should demonstrate how purchasers will facilitate opportunities for participation by local suppliers. Proactive strategies should be adopted to ensure a strengthened Industry Capability Network (ICN) informs local industry of opportunities and links purchasers with local suppliers.

Undertakings by purchasers should be monitored over the life of projects and purchasers should publicise the extent of participation by local suppliers.

Principle 5: Supporting Industry through Effective Planning and Communication

Large government purchasing activities and major project plans should be developed in a transparent way to ensure local industry is able to invest sufficiently to participate in major tenders. As much as possible, major procurement activities undertaken by Australian governments should be coordinated and staged to allow businesses scope to invest and achieve the economies of scale by aggregating demand across the federation.

In addition to these principles, Ai Group notes the following pre-election policy commitments of the Coalition and supports their adoption across Commonwealth

government agencies. In July 2013 the Coalition noted there are an estimated 80 procurement panels across Commonwealth Government agencies, managing more than 79,000 contracts to a combined value of at least \$32.6bn. The Coalition committed to:

- **Establish a centralised register** of Commonwealth contract and grant recipients administered by the Department of Finance;
- **Adopt a common form contract** encapsulating the terms and conditions all Commonwealth departments, agencies and service providers would agree to as part of their grants arrangements;
- **Establish a single, rationalised Commonwealth procurement panel** to administer a centralised register of service providers who wish to contract for the Commonwealth. This register, encompassing all firms registered under the procurement panels, would be centrally administered by the Department of Finance;
- **Include a short form for procurement tender** responses for those service providers who already meet the requirements of the appropriate panel;
- **Standardise contractual arrangements** for similar goods and services purchased by the Commonwealth, including requirements for insurance liability;
- **Standardise whole of Government probity guidelines** that allow appropriate commercial discussions to take place during the tendering process; and
- **Increase the threshold for sole source contracts** to an appropriate amount. This will reduce the cost of procurement for the Commonwealth and service providers for relatively low amounts of money (subject to requiring a public and legally binding declaration by procurement officers that they have no conflict of interest in awarding such contracts). (*Coalition Policy to Boost Productivity and Reduce Regulation, July 2013*).

5. Procurement of Defence materiel

Ai Group strongly believes that any savings in defence spending identified by the Commission of Audit should be redeployed within the Defence portfolio. This would be consistent with the Coalition's policy, prior to the election, not to make any further cuts to Defence spending and to increase expenditure on Defence to 2% of GDP, up from 1.59% now, over the next decade.

Defence Materiel Organisation (DMO)

The DMO is responsible for equipment acquisition and its sustainment. It currently employs 7,500 people - up from 2,500 a decade ago - and an annual budget amounting to approximately \$10 billion (\$4.2 billion on equipment, \$5.0 billion on sustainment of equipment & \$800.00 million on administration). Efficiencies could be obtained through removing administration duplication and changing current sustainment arrangements. For example:

- The majority of the Navy's patrol boats operate in the Indian Ocean, principally on border control and surveillance. Yet maintenance for the vessels occurs principally in Brisbane or Sydney requiring long transits for the vessels on a regular basis. Investment in maintenance facilities in Darwin would substantially reduce the cost of the existing maintenance arrangements.
- A similar situation occurs for the support of armoured vehicles based in the north of Australia. These are currently trucked 4,000 kilometres to facilities in south eastern Australia – such as Bandiana - for major maintenance, a highly inefficient and costly logistics activity.

Current tendering and contracting arrangements are too complex, too time consuming and too costly for Ai Group member companies. There is considerable scope to streamline the current arrangements leading to cost savings for the Commonwealth and the defence industry.