Follow-up Review: Defence Procurement Policies and Practices for Major Acquisitions

The Ministry of Defence and New Zealand Defence Force

June 2019

pwc

Helene Quilter
Secretary of Defence
Freyberg House
Wellington

12 June 2019

Dear Helene,

Follow-up Review of Defence Policies and Practices for Major Acquisitions

In accordance with our letter of engagement, dated 2 May 2019, we attach our report, being the follow-up review of Defence Policies and Practices for Major Acquisitions.

As discussed and agreed, the review has been conducted on the basis of a detailed assessment of a range of documentation supported by a series of interviews. Sir Brian Roche was the lead reviewer, supported by Ben Wakely, Director in PwC Consulting.

The observations contained in this report should be read in conjunction with the 2018 Review of Defence Policies and Practices for Major Acquisitions and the disclaimer set out in Appendix A.

Yours sincerely

Jeroen Bouman
Partner
Jeroen.x.bouman@pwc.com

Table of contents

Executive summary

We, Sir Brian Roche and PwC, have been asked to provide a follow-up review of Defence's procurement policies and practices for major capability projects, with a particular focus on the progress of the Defence Capability Change Action Programme (DCCAP). This review is a follow-up to our 2018 report and should be read in conjunction with that report. Our findings are summarised below.

Summary of our findings

The findings from our 2018 Review still remain relevant

From all the interviews we have conducted and documentation we have read, we remain comfortable with the level of risk mitigation currently taking place across the Capability Management System. In our view, DCCAP is an investment that has the ability to successfully manage risk in major military acquisitions in New Zealand.

While the progress of the Capability Management System under DCCAP is impressive, the inherent risk of procurement failure in a military context remains real. Is the system perfect? No, nothing is perfect. It will not be possible to completely stop risks from materialising, as uncertain events outside of the control of the system can and will occur. Is the system more than likely to deliver outcomes with an appropriate level of risk management? In our view, absolutely.

We have also seen further progress since our previous review

DCCAP has continued to instil a strong risk management culture across both the Ministry of Defence ('Ministry') and the New Zealand Defence Force ('NZDF') in the management of major capability acquisitions. This risk management culture continues to remain a focus despite core NZDF leadership changes over the last 12 months. The programme has increased the capability of project staff and the quality of procurement advice, while building trust and confidence for decision makers in the military procurement 'system'.

Since our last review, DCCAP has also acted as the basis for achieving the confidence of external third parties such as the Treasury, with high results attained in the Investor Confidence Rating (ICR) across the Capability portfolio. Improvements were highlighted at the sub-portfolio level in procurement capability, senior level commitment and leadership, benefits management, P3M3 and organisational change management.

However, the true test of the Capability Management System will not be a 6 month, 12 month or 3 year progress report, but rather the embedding and continued optimisation of a way of working or a culture that puts quality of outcomes and risk management first.

Areas of focus

In our view, risks will accrue to the Government if the Capability Management System, including its component parts (such as the IPTs and governance structures) are 'unpicked'. In that context, we are mindful of the need to see the system as a process with embedded checks and balances – it is an integrated system, which informs itself. Removing elements of this system will have consequences and potentially put at risk the very objective of the considerable investment made to date.

The Capability Management System is still relatively fresh and is charged with the management of a large number of significant projects (in terms of scale and risk) that can have an overall length of about a decade from initial planning to complete introduction into service. Some of the core projects are now moving beyond business cases and moving into acquisition phases and transition into service. These phases are where the DCCAP system will be tested, where all the investment, planning and preparatory work will be proven or otherwise.

The strength of the Capability Management System and its ability to both cope with risks that crystallise quickly, and report and respond rapidly in a flexible way will continue to be tested – we see that as a positive in any dynamic learning system.

We have made a number of observations throughout this report to support:

- Transitioning to new leadership
- Refreshing the 'International Exemplar'
- Embedding governance arrangements
- Developing succession planning
- Improving the relationship with the Treasury
- Maturing portfolio and dependency management
- Sustaining the involvement of military personnel
- Managing foreign exchange risk.

As DCCAP is now moving past the stage of transformational change and as the Ministry and NZDF move through periods of leadership change, the major themes of this follow-up review revolve around embedding and optimisation.

New leadership will still need to tread carefully, taking care not to declare success too early. In our view, the primary focus for the future should be continuing to embed and optimise the system and cultural changes, based on the strong foundations that are now in place.

Introduction

This section summarises the purpose of this follow-up review of Defence's procurement policies and practices for major capability projects and provides an overview of our findings.

Purpose of this review

The challenges and risks of acquiring military capability are well documented both internationally and domestically. These challenges and risks are both real and relevant for any military procurement system no matter how sound its design.

For many years, the procurement of military capability in New Zealand was prone to serious amounts of risks, running without a structured management system, governance structure, or the depth of people and talent required to lead and operate a coherent system built on a culture of risk management and mitigation.

In 2015, as a result of a number of external and internal reviews, the Ministry of Defence established a capability management improvement programme, the Defence Capability Change Action Programme (DCCAP). The purpose of DCCAP is to address shortcomings in Defence's capability management practices and to deliver some core principles around a procurement strategy based on proven assets/platforms that are inter-operable with key defence partners, that have been militarily certified, and are supported by a technology growth path

The system is designed to ensure a balance between Policy, Capability and Funding. Its purpose was, amongst other things, to ensure that decision-making is supported, and reflective of the investment required in military hardware/assets that facilitate and deliver on the agreed policy objectives of the Government.

In 2018, Sir Brian Roche and PwC undertook a Review of Defence Procurement Policies and Practices for Major Capability Projects. The Review found that the Capability Management system established through DCCAP:

- is well led by aligned and motivated leaders
- has a number of inbuilt checks and balances to mitigate risk
- operates within a well-defined structure and governance regime
- has clear delegations and accountabilities in place; and
- is making strong inroads into embedding a new way of working within an environment that historically had challenges with transparency, alignment and resourcing.

Sir Brian Roche and PwC have now been asked to provide a follow-up review for 2019. The scope of this 2019 follow-up review is to assess and provide further assurance on the progress that has been achieved and to make recommendations on future actions and next steps, as well as any new or emerging developments. This follow-up review is intended to be read in conjunction with the 2018 Review.

Activities

In order to inform this follow-up review, we have undertaken the following activities:

1. Interviews with a selection of individuals involved in various capacities in the Capability Management Framework, including: Executive and senior management, Capability sponsors/owners in Single Services, Professional Service Providers, members of various governance boards, and Treasury

2. Review of key DCCAP documents and core elements of the Capability Management Framework

3. Review of a selection of governance reports, progress reports and project reports.

Structure of this Review

This follow-up review is split into the following two related parts:

1. The first part covers our system-level observations

2. The second part presents a number of more specific observations formed during the course of interviews and document review.

System-level observations

Below are a number of themes and aspects that we considered at a system-level during this follow-up review to get a sense of the health of the risk management culture across the Capability Management System. These themes are carried through further in the following analysis.

Theme	Aspect
Tone at the top	Leadership: clarity of direction • Senior management set clear and consistent expectations • Leaders role model risk management thinking
	Responding to bad news: welcoming disclosure • Senior management actively seek out information about risk
Governance	Risk governance: taking accountability • For the most part, management are clear about their accountability for managing risks
	Risk transparency: risk information flowing • Timely communication of risk information across the organisation • Risk events are seen as an opportunity to learn
Competency	Risk resources are empowered • Project staff are empowered to support risk management and have the support of leaders • Staff are able to challenge how risks are managed
	Risk competence: embedded risk skills • A structure to support those managing risk is in place • Training programmes are in place
Decision making	Informed risk decisions • Decision makers seek out risk information in supporting decisions • The quality of information provided to support decision making is of a high standard
	Rewarding appropriate risk management • Leaders are supportive of those seeking to understand and manage risks

Tone at the top – the leadership and vision

Leadership

As mentioned in our previous Review, the current Secretary of Defence and the current Chief of Defence Force showed considerable leadership to initiate and implement the degree of positive change to the defence procurement system that we have seen.

However, DCCAP is now at a point where it must transition to a new set of leaders. The Secretary of Defence is leaving the Ministry of Defence and the Chief of Defence Force has less time available to dedicate to the governance and oversight of the Capability Management System.

We think that it is vital that transition to the next generation of leaders is well managed and the importance of the current architecture well understood. The stakes remain high as there are a lot of significant projects in process and the ramifications for any mistakes will reverberate through the public domain, as well as through Ministers and industry.

The leadership will need to continue to develop and foster a robust understanding of large project execution and the risks involved. Continued strong leadership and resolve will be required to optimise and embed the existing infrastructure. Challenges will inevitably arise, but the foundations to support decision-making and risk management are already in place.

The current leadership has built strong cultural awareness and changed a lot of the organisation culture in capability acquisition. The next phase should be about embedding and refining this culture.

It is a difficult task to embed risk management into the ongoing ways of working so that it reliably makes a difference. However, the risk culture will always start with the tone at the top, and it is imperative that the next generation of leadership continues to drive risk management, consistency and quality of outcomes, and the on-going use of the Capability Management System.

Vision – refreshing the International Exemplar

The International Exemplar 2020 also helped set the tone for DCCAP. It is an important piece of architecture that describes a vision for an end-to-end, integrated capability management system. Core tenants of the vision include proper governance and executive oversight, underpinned by clear policies and processes, strong professional expertise and skills, a culture of risk management, and a collaborative relationship with public and private sector partners.

Not all respondents understood what an objective standard of an international exemplar meant, or when one could say that the Defence system had attained 'international exemplar status'.

With 2020 fast arriving, we were asked to consider what the process for refreshing the International Exemplar 2020 vision might look like. In our view, while some of the language may need to be refreshed, we think the foundations of the document remain sound. The document remains worthwhile as a strategy as it reminds all stakeholders of 'why' DCCAP exists and what the system is striving for. There is an ongoing need to continue to highlight the "why" – experience does show that people often forget the rationale, need and trigger for why interventions such as DCCAP were implemented in the first place.

We believe the current vision makes a lot of sense. We would advise against drastically changing or renewing the vision with so many important projects in flight. In our view, the vision could be 'refreshed' as opposed to renewed, and the terminology is important. Any refresh of the International Exemplar 2020 should build on the existing architecture and foundations in place. The progress in 2020 against the original strategy could be recorded to consider how well the programme did, appropriate benchmarks for the future could also be considered, with language refreshed and simplified to reflect an ambition to:

- be best in class
- embed a culture of risk management
- continue to optimise risk management in a flexible or dynamic way.

Although DCCAP has improved risk management within the culture of the organisations and, in our view, has succeeded in driving the culture to make risk management more relevant and effective, we continue to emphasise the need to embed these changes. Defence have an opportunity now to define what it means to be the international exemplar, continuing to drive success and embed change.

Respondents in our interviews mentioned that other governments now regularly look to New Zealand to understand the lessons and achievements of DCCAP. The opportunity and challenge is to continue to set the standard, be the organisation that people come to, other governments come to, to view best in class.

Governance boards and driving continuous improvement

Governance boards and risk transparency

We continue to see real strength in the governance arrangements, especially when combined with a blended IPT model across the Ministry and NZDF that leverages the strengths of professional project managers and military subject matter experts.

The transparency and accountability shown in appointing externals to governance boards is working well. Feedback on the performance of external board members has been overwhelmingly positive and the external interviewees continued to provide favourable insights on the level of risk management and reporting occurring at both the project and governance levels.

We reviewed a number of governance reports and various documents relating to project stage gates, it was clear from the documentation that there is genuine honesty and openness about risk. We were able to view documentation where immediate risk management action on projects was required. In these examples, risks were identified and communicated in a timely way, a number of layers of management were involved in supporting risk mitigation and different boards were holding management to account to uplift the risk profile of the project. This degree of transparency across the system, and with our review team, spoke to the level of the risk culture.

Governance vs management

One observation that was touched on in our previous report, and mentioned throughout these follow-up interviews, revolves around the blurring of governance and management roles and responsibilities. In the Capability Management System, people are regularly asked to play multiple roles, wearing different governance and management hats. For example, sitting on governance boards whilst at the same time playing line management roles. At times, there is a suggestion that the blurring of the lines between governance and management has the potential to lead to challenges in separating governance issues from day-to-day management.

A governing body's role is to oversee management. It must be satisfied that the management team or project team is doing its job in accordance with policy and resources. Good governance helps:

- Improve performance
- Set direction
- Take a big picture view separate from the operations
- Ensure there is accountability and oversight of operations
- Manage risk.

Our view is that majority of the governance taking place in the Capability Management System is performing at an excellent level with clear delineation of roles and responsibilities. We also understand that the Ministry has done a lot of work in this area to support increased understanding and awareness of the differences in the different roles. However, in our view, it is worth continuing to clarify the difference between the roles and responsibilities of governance and management to avoid any confusion, especially amongst those being asked to wear multiple hats.

Boards and management also need to have the ability to engage in robust debate and a mutual willingness to challenge and to offer and receive constructive criticism. Providing clarification and on-going reminders for staff wearing dual hats will help prevent any bias creeping into governance boards.

Governance through whole-of-life

Some of the large projects under management are now moving beyond business cases and moving into acquisition phases and transition into service. During these phases, the interplay between project governance and management will become increasingly important from a risk management perspective.

The project governance and IPT structures set up by DCCAP support the on-going management of risk through introduction into service, but questions remain around whole-of-life-cost management and how lessons learned in the on-going operation and management of capability will continue to be evaluated and reflected throughout the system. From the limited engagement we had with the NZDF service chiefs, we understand that the way of approaching through-life governance and management is maturing in line with lessons learned from success of DCCAP. However, exploring this in more detail was outside the remit of this Follow-up Review.

The Capability Management System is still relatively new, and how capability acquisitions are transitioned into service, operated efficiently and disposed of remains critical to the on-going reputation and success of the system. These are not discrete steps; every step needs to inform the others. The process should continue to be acknowledged as a system where lessons are reflected and continuous improvement is the goal.

The role of governance beyond the transition into service phase and the way it links into the existing Capability Management System could be considered further. Further integration would support accountability and performance of operational teams and transparency of information. It would also help to drive opportunities to learn and further development the maturity of the Capability Management System.

Competency – People, flexible processes and continuous improvement

The people

The system is only as good as its people. This has been true to date of DCCAP and will remain true into the future. The capability uplift seen across both organisations in the short time DCCAP has been in place is obvious. DCCAP has developed professional project managers and experts that are prepared to manage and deal with risks and issues as they arise in a flexible way.

We have engaged with various individuals across all levels of the capability management system and a strong set of cultural values has been evident – people are keen to participate, they are positive, pro-active, open and there is a noticeable emphasis on team work, which is really important in the Capability Management System's blended model.

Part of the success of DCCAP, and the DCCAP leadership, is the people the respective leaders have surrounded themselves with. Many of these senior leaders (for example, the current Vice Chief of Defence Force, the Assistant Chief of Defence Capability, and the Deputy Secretaries at the Ministry) have become critical to the success of the Capability Management System.

However, now there are risks that some of these key people across both organisations will move on in their careers, transitioning out of roles in capability management. Key person risk and succession planning should be a continued focus for on-going leadership to ensure plans are in place to retain the right capability and capacity, and where needed - hire the right types of talent. Maintaining the high standards and expectations of people established through DCCAP is critical to on-going performance.

Further thought will also need to be given within the Defence Force as to how a military career model can be promoted to support Capability Branch, taking steps to foster, challenge, and grow Defence personnel to view Capability Branch as a crucial part of their longer-term career prospects. This is modelled to a large extent by the existing leaders, but should continue to be emphasised to junior officers and 'rising stars' coming through the ranks.

Flexibility

DCCAP has made significant progress in developing effective tools and techniques for managing risk within capability acquisition. Risk management has been systematised using a holistic, integrated approach based on a blended model.

The term 'system' can often be taken to denote a static structure, one synonymous with bureaucracy. However, there are important parts of the DCCAP system that need to be dynamic, and in fact are designed this way, to respond to ambiguity and uncertainty in the political, commercial or operating environment.

As we were undertaking these interviews, a number of respondents noted that Defence had not made as much progress on DCCAP in the last 12 months, as 6 months of time had been lost revising the Defence Capability Plan. However, in our view, it is one of the strengths of DCCAP that the system is flexible enough to respond to competing demands and respond to uncertainty with a degree of planning and project management seldom seen elsewhere in the public sector.

In our view, the level of bureaucracy in the Capability Management System is reasonable and the management approach appropriate in the balance taken between process/stability and flexibility/change.

This flexibility will need to be fostered further by future leadership in conjunction with Treasury officials, as the Capability Management System aims to:

- deliver on the plans outlined in the Defence Capital Plan in an environment where there are a number of competing fiscal and political priorities
- manage the risks of a large number of in-flight projects that are reaching critical stages in their project cycles (i.e acquisition phase and transition into service).

Continuous improvement

While the DCCAP system is relatively new, and we are yet to see some of the larger, once in a generation, procurement projects progress all the way through the capability lifecycle, the signals are very positive, especially when compared to past failures.

Lessons have been learned from previous procurement mistakes and these have been captured both within the system as institutional knowledge (given as guidance to professional project managers), but also within the governance and management structures refined to support project delivery and risk mitigation.

The challenge now, as we alluded to in our last report and have continued to emphasise here, is not to declare victory or success too early.

As an intervention, the DCCAP has had significant impact, but the focus is to now move away from the view that the programme is 'special' or unique and move to the view that this should be business as usual. Embedding core aspects of the DCCAP system within the normal ways of working across the Ministry and NZDF will be critical and will require on-going commitment, leadership and flexibility.

One of the challenges in embedding the risk management culture is to work out how to measure success or identify cultural indicators of success to support telling a strong success story to key stakeholders. Organisational culture is commonly considered using qualitative assessment, rather than hard metrics or other quantitative features. It could be worth applying measurement techniques and assessment to the risk culture as a way to monitor progress and support making improvements. Measuring 'leading' and 'lagging' indicators such as beliefs and behaviours, or general attitudes about compliance issues, or measuring and learning from events that have already occurred, can head off slack compliance habits.

As critical capability transitions into service, the role of on-going independent evaluation and deep dives should also be considered to ensure that lessons learned are captured and continue to feed into continuous improvement frameworks.

Decision-making

The benefits of the Capability Management System

The quality of information presented to decision makers is of a high standard and the process to compile that information has vastly improved from that which operated prior to the introduction of DCCAP.

Securing investment decisions requires confidence in the delivery system and DCCAP has been the vehicle to deliver that confidence. Large decisions on capability acquisitions will always be difficult and risk factors will always be relevant, but the combination of the blended IPT model and the Capability Management System's governance framework provide strong layers of risk management. Core principles of procurement have been instilled as part of the Capability Management System to support decision-making. Principles include avoiding solutions where novelty or experimental risk is present, instead seeking technology that is proven and interoperable with partners, as well as being certified in a military context. In our view, these different layers of risk management should continue to provide decision makers, customers and other core stakeholders with confidence and assurance in the information presented and the rigour involved in the associated processes.

The different layers built into the Capability Management System also operate off a relatively lean funding model compared to the scale of the investment in major capability projects and the level of risk that could manifest in the system.

In our view, the benefits of the Capability Management System are clear, they mitigate against the threat of a counterfactual scenario where risk management is eroded and risks accrue to the Crown (i.e large budget blow-outs or acquisitions that are not fit for purposes). How these benefits are articulated, quantified or measured could be considered further with support from the Treasury. This exercise would help to further strengthen the success story of the Capability Management System and clarify the implications for decision makers if they tamper with risk management structures.

Planning to support timely decision-making

One of the big constraints on the Capability Management System's ability to achieve the Defence Capital Plan involves putting business cases through in a timely manner. Officials continually attempt to forecast the various Cabinet Committees throughout the year to plan and schedule approval dates, but opportunities to push decisions through can be difficult.

With the development of the Defence Capital Plan 2019, some projects have slipped against the original schedule, there is a need to realistically plan for the ability to take business cases forward otherwise the system will continue to experience delays..

Relationship with The Treasury

Defence capital planning is seen as an exemplar in the public sector from the White Paper process through Capability Planning and Capital Planning. This process of converting strategy and policy into capital planning leads to much clearer conversations with politicians and decision makers on fiscal options and needs to meet broader strategic objectives.

In our view, the blended DCCAP model combined with a high degree of strategic and capital planning should form the basis for a strong relationship with Treasury officials. However, we believe the relationship needs to be strengthened to support delivery against the capability and capital plans and agreed policy outcomes.

At present relationships are highly personality dependent and need to be focused on outcomes and value for money. All parties are critical to the conversation and critical to the timely decision-making and risk management. We would recommend that leadership continue to build a more involved relationship, and this will require work from all three organisations, to continue to build familiarity with DCCAP's ambition, the plan to embed the Capability Management System, the on-going work programme and recognition of the risks to New Zealand if major procurement is compromised.

Other specific observations

Below are a number of specific observations formed during the course of interviews and document review.

Dependency management

As we touched on in our 2018 report, success in a major acquisition project, in terms of both successful acquisition / operational delivery and the on-going realisation of benefits, is often dependent on a significant number of other projects. Frequently, dependent projects sit outside the responsibility, and control, of individual project leads and governance. These projects also often sit outside of the capability portfolio. Successful project delivery means the management of dependencies with projects in areas such as Information Technology, Communications and Information Systems and Estate and Infrastructure.

Areas of improvement

IPTs are being more proactive in identifying dependencies and assumptions. IPTs are considering what is outside the control of the project and implementing processes for dealing with these dependencies. The Capability Management System is maturing in its approach to dependency management, with definition and communication standards being given to 'Defence-led' projects and more effort and time being given for planning and interaction.

External respondents reflected on their experiences of successful dependency management throughout the Capability Management System, success was often based on the following:

- Relationship building across portfolios and other projects
- Cross- educating across portfolios and other projects as both IPTs and other areas come to understand the needs of different projects and the technical perspectives of those involved
- Persuading key stakeholders based on discussion of needs, risks, priorities and implications
- Monitoring of progress and ensuring a close working relationship between those in a position to affect dependencies
- Escalating where required and where dependencies become critical.

While not strictly in scope, it is worth mentioning the progress made in some of the dependent portfolios. From the limited information we looked at and interviews we held with members of other portfolios, we got the impression that progress was occurring relatively quickly in other portfolios across NZDF. Governance has improved and more co-ordination with the Capability Management System is occurring through governance forums, project level interactions, as well as increased coordinated planning.

Aspects of the Capability Management System are starting to be applied in other portfolios, for example, Defence Estate and Infrastructure have implemented project boards, started using P3M3 methodology and similar reporting structures and have improved their relationships with the Ministry.

Opportunities

Despite the improvement, integration and dependency management are still maturing and should continue to be a focus. Integrated planning should take place as early as possible, this means planning should be as co-ordinated as possible to ensure that all plans reflect organisational priorities and core dependencies are highlighted early.

In line with the PRICIE construct, on-going processes for engagement across critical portfolios should be standardised where possible, and should occur regularly at multiple levels, especially where project co-ordination is required. Processes should also reflect a transparent risk- management culture where risks and dependencies are raised as early as possible to ensure a co-ordinated response.

We understand a wider NZDF target operating model is currently being implemented, which presents an opportunity to support greater integration across the different portfolios and a stronger focus on dependency management.

Portfolio maturity

Another area we focused on in our last review was the need to dedicate time on portfolio management. Portfolio management has been strengthened in the last year with the addition of sub-portfolio domain leads and the introduction of analytical support. A work package is now progressing to refine the design of portfolio and sub-portfolio domain management. We support the work progressing in the design of the sub-portfolio domain area. In our view, it will increase co-ordination across the different domains and the capability management system, which could have significant benefits for capability delivery in the medium to long term. Further investigation and review of portfolio maturity should continue to support the embedding developing practices.

Portfolio / project co-ordination

Externals respondents through the interview process described the lack of visibility of portfolio priorities at the project governance level. This lack of visibility means that project governance members only learn about portfolio priorities via decisions made through line management. This type of communication needs to happen in a timely manner.

Once portfolio priorities are set, project boards need to understand these priorities so they can adequately tailor their approach for each project with sufficient understanding of organisational context. Increased transparency will give board members the confidence to provide advice on do-ability and openly discuss what is practically achievable. In our view, this only requires a simple fix, ensuring that transparent conversations or communications are occurring with project governors on portfolio priorities.

Understanding the implications of trade-offs

To further support portfolio planning and investment decision-making across the Capability Management System, NZDF may need to invest to increase the available evidence base in related portfolios.

In the defence sector investment decisions always require trade-offs, and often these investment decisions need to be made in a very short period of time, with the best information available. Increasing the available evidence base will help inform decision-makers in real time of the downstream ramifications of various trade-offs and will support increased understanding of the do-ability of different proposals.

For example, Defence Estate and Infrastructure are looking to improve the understanding of asset condition in the Defence Estate. Improving the understanding of asset condition will require investment to increase data and information. Increasing this evidence base will allow Defence Estate and Infrastructure to give more accurate advice on the impact of proposed investment options on infrastructure requirements and plans. This advice will help decision-makers in the Capability Management System and the wider NZDF make informed investment choices.

Defence Estate and Infrastructure was used as a specific example to illustrate the point. We are not specifically suggesting that Defence Estate and Infrastructure is in the most need of further investment, nor have we had the time or the scope to conduct a thorough review across other portfolios. However, we do believe there is real merit in considering the available evidence base in related portfolios to support decision making in the Capability Management System and across NZDF.

Aggregated risk

We understand that portfolio risk management has been delivered as part of a revised risk management framework. We have not reviewed this material as part of this follow-up review, but

believe there is merit in ensuring that an aggregated risk assessment is taking place at the portfolio level to understand cumulative risk and how this is being managed across both Ministry-led and Defence-led portfolios. There is also merit in tracking these risks providing assurance or a number of 'lines of defence' over aggregated portfolio risk management.

A draw on Military personnel

Output classes

Currently, NZDF output classes do not reflect the level of effort, commitment and cost required in contributing to the resourcing of the Capability Management System. In our view, if there is a need to allocate a significant resource to a task, the funding structure needs to reflect this.

Some of the resourcing is covered under the project costs, but not all of it. NZDF is currently having to cover the costs of personnel supporting the Capability Management System outside of projects costs and this is a large draw on its baseline.

At present the NZDF have allocated approximately 300 staff to the Capability process – In our view, this is a very significant investment and arguably should be reflected in the structure of the Output classes currently in operation.

When IPTs were created there was a perception they were a one stop shop in terms of capability delivery. However, transition into service is a difficult phase and largely remains untested. With a lot of the major capability projects coming through DCCAP, this will be a challenge in the coming years. It is not possible to have IPTs doing everything. For example, to successfully realise the benefits of the P8s, there is a need to move 250 people and families to Ohakea. To support this move, work needs to be done to ensure there is enough schooling, housing etc. IPTs cannot be expected to do all of this, otherwise they will get distracted. NZDF needs to develop a transition team of its own and will need to ensure on-going governance and active management of capability in service, these efforts will require a bow wave of resources that is not reflected in either project costs or the structure of output classes.

Management of foreign exchange

A large number of the projects managed through the Capability Management System are significant multi-million or multi-billion dollar acquisition projects. These projects require contracts with overseas suppliers, which are often denominated in a foreign currency. Signing significant contracts denominated in a foreign currency exposes the Ministry and NZDF to foreign exchange risk, which arises when there are fluctuations in either the New Zealand dollar or the denominated currency of the particular contract. There are common hedging strategies used by financial institutions and other organisations around the world to reduce exchange risk through the use of derivatives and other methods. In the absence of the use of hedging strategies, the consequences of currency fluctuations can be very expensive on a multi-billion dollar contract.

The Ministry is one of the only organisations in the New Zealand public sector to have this type of exposure to such a significant level. Putting in place hedging strategies to hedge against foreign currency risk is currently outside the control of the Ministry. So where risk does accrue as a result of fluctuations in foreign exchange, the Ministry is expected to allow for this, making compromises across the portfolio.

In our view, it should not be the role of the Ministry to manage foreign exchange risk. They have no levers available to manage the risk as they do not have control over the funding and do not have the right level of technical expertise (in our view, they should not be expected to employ this type of expertise).

The Ministry should work closely with the Debt Management Office at the Treasury to support the development of appropriate options and solutions to adequately manage foreign exchange risk in this portfolio. The Debt Management Office is in a better position than the Ministry to provide advice on

this matter. The consequences of not being prudent in this area are significant, and are therefore worth thorough review.

Appendix A Restrictions

This report has been prepared solely for the purposes stated herein and should not be relied upon for any other purpose.

To the fullest extent permitted by law, we do not accept a duty of care to any third party in connection with the provision of this report and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, we do not accept liability of any kind to any third party and disclaim all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

We have not independently verified the accuracy of all information provided to us, and have not conducted any form of audit in respect of the organisations. Accordingly, we express no opinion on the reliability, accuracy, or completeness of the information provided to us and upon which we have relied.

The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.

The statements and opinions expressed in this report are based on information available as at the date of the report.

We reserve the right, but will be under no obligation, to review or amend our report, if any additional information, which was in existence on the date of this report was not brought to our attention, or subsequently comes to light.

We have relied on forecasts and assumptions about future events which, by their nature, are not able to be independently verified. Inevitably, some assumptions may not materialise and unanticipated events and circumstances are likely to occur. Therefore, actual results in the future will vary from the forecasts upon which we have relied. These variations may be material.

This report is issued pursuant to the terms and conditions set out in our engagement letter and the Terms of Business.

For more information go to pwc.co.nz