

Executive Summary

Australia's \$22 billion annual spending on Defence is under intense scrutiny and constant pressure. A commitment by Government to a real increase in funding of 3% pa for the next decade seems insufficient to provide for all of Australia's defence needs. The real cost of military equipment continues to rise, the operational demands and strategic challenges for our defence forces remain high, and the call on the national budget from other priority areas is considerable. The current general economic downturn intensifies these pressures.

Many nations face a similar situation, but those with a highly effective defence budget and operations management gain a strategic and national advantage—they free up resources for investing in a sustainable strategic edge and reduce the pressures on other areas of national budgets.

The Department of Defence, the Australian Defence Force (ADF) and the Defence Materiel Organisation (DMO)—which we have collectively referred to as 'Defence' in this report—have a substantial record of management reform and, in a number of areas, are looked to by other nations as an exemplar. In recent times, the Kinnaird Review has led to major improvements in the procurement of military equipment, and the Proust Review established a substantial agenda of management improvement. There is, however, a general recognition that more reform is required. Hence, this audit has been commissioned to complement the White Paper process and a series of Companion Reviews of key areas of the Defence business.

All this work sets out a challenge to write a new chapter of reform that will keep Defence ahead of budgetary pressures—pressures which, given Australia's strategic circumstances and size, are as great as those of any Western country.

To support Defence's next chapter of reform this report:

- Explores and explains the cost pressures on Defence, and the drivers of these pressures
- Identifies the opportunities to get ahead of the cost pressures through:
 - A tighter budget process
 - Driving productivity in Defence
- Describes the required approach for reform, which will enable Defence to capture improvement opportunities.

Implementing the recommended reforms creates the opportunity for Australia to have the most lethal and productive force of its size in the world.

UNDERSTANDING THE COST PRESSURES ON DEFENCE

There are significant underlying cost pressures on the Defence budget. These pressures mean that simply to maintain today's military capability will cost more in real terms over the long run. Should Government choose to increase Australia's military capability, those costs would increase further.

The underlying cost pressures on Defence to maintain today's capability are understood best if the budget is disaggregated into three categories (military equipment, personnel, and facilities and other operating costs), each with its own particular set of long-term drivers.

- **Military equipment costs** grow in real terms because every generation of Specialised Military Equipment (SME) improves in capability. For example, a 2005 fighter aircraft has superior thrust-to-weight and radar performance compared to a 1970s model. As the generational replacement of equipment occurs so do real cost increases to maintain the same number of platforms. We have calculated that this requires a real growth rate of 3.5% in capital expenditure on SME, just to replace today's equipment. To deliver the capabilities proposed in the recommended Force Structure Option requires a real growth rate of 4.2%.
- **Personnel costs** are subject to the real cost pressure of sustaining constant levels of combat personnel, and countervailing downward pressure from the productivity savings that can be obtained from military and civilian support functions.
 - Military personnel costs increase in real terms because wages rise faster than inflation, but the number of military personnel required to maintain today's capability remains roughly the same.
 - Support personnel costs are subject to downward pressure because productivity gains more than offset the rate of wages growth. For example, real efficiency gains are possible in areas such as maintenance, supply chain and human resources functions (for example, payroll processing).

Over the long run, we calculate that this means Defence personnel costs will grow at 0.4% in real terms. If additional personnel are required, as per the recommended Force Structure Option, then costs will grow at 1.1% until the new workforce target is reached and at 0.5% thereafter.

- **Facilities and other operating costs** have a diverse set of drivers that range from construction costs, which have increased above underlying inflation, to computer service costs, which have grown below underlying inflation. This basket of drivers largely balances out and we calculate that it will grow at 0.7% in real terms.

The current funding arrangement of 3% real growth is committed until 2017/18. The weighted average real cost growth above the Non-Farm GDP Implicit Price Deflator (NFGDP-IPD) for the decade starting 2018/19 (based on the current projected mix of military equipment, personnel, and facilities and other operating costs in that decade) is:

- 1.8% just to maintain today's capability (replacing existing equipment, with no additional personnel)
- 2.2% to fund the recommended Force Structure Option.

These figures do not include the cost of remediating existing capability gaps.

The analysis reveals that for Defence to remain within, or to get ahead of, long-term cost pressures, two areas are critical:

- Tight management is required of the whole process of planning, budgeting, acquiring and sustaining. The process needs to ensure that the right funds are spent on the right capability, at the right price, and at the right time.
- Productivity gains need to be made in support costs, especially support personnel costs. Without these gains the real cost growth in Defence will be substantially higher.

MANAGING COST PRESSURES THROUGH A TIGHTER BUDGET PROCESS

Tight management of the entire budget process is essential for Defence to stay within the constraints created by long-term Defence cost pressures. There are many opportunities to tighten the management of each stage of the process.

- **Funding** that actually matches the underlying costs of Defence is essential to help manage long-term cost constraints. This requires a change from the current funding model, which does not reflect underlying cost drivers, and which results in cycles of over and under funding

This situation can be improved by a funding model that enables Defence to maintain current capability. This model is based on a tailored basket of inflators and different growth rates for the four main categories of expenditure (military equipment, personnel, facilities and other operating

costs), followed by providing additional funding for any remediation or increases in capability, plus no-win, no-loss funding for operations.

- **Strategic planning** that tightly links strategic objectives and required capability with the actual force structure is critical—this will ensure there is no leakage of expenditure on the acquisition of capability that does not match strategic requirements. If leakage occurs, Defence’s cost pressures will grow substantially.

The current risk of this leakage can be reduced by tightening the links between strategy and capability acquisition. Measures that will achieve this include: more specific and clearly prioritised strategic guidance; focusing on the delivery of whole capabilities rather than platforms; and a new unit to manage end-to-end processes.

- **Accurately forecasting** major acquisitions, and the operating costs associated with them, is necessary for developing Defence’s long-term budget. This will allow Defence to stay within cost constraints as current systematic underestimates put substantial pressure on the budget.

Defence can improve forecast accuracy by: using a more consistently applied and systematic costing methodology; better understanding today’s Defence costs; improving governance and oversight of cost estimates; and increasing the experience and expertise of those conducting the forecasting.

- **Effective planning and managing major equipment expenditure (programming)** is important because schedule delays (slippage) lead to: significant unplanned expenditure for maintaining often increasingly expensive legacy platform costs; increased project costs; and even the requirement for additional capability to fill gaps. The most significant reason for slippage today is the high proportion of developmental (36%) and Australianised (49%) versus Military Off The Shelf (MOTS) (19%) equipment that is being purchased.

Where feasible, the extent of slippage should be reduced by purchasing more MOTS equipment and improved management of the technical risk associated with leading edge and modified equipment. To reduce slippage, the practises of over planning and over programming, which are used to manage the project and cash management consequences of delays, will need to change. While some slippage is inevitable, management practices will need to move from a planning-based model to a time-based planning model. As slippage reduces, changes in contingency management and provision will be needed. Currently, there is sufficient slippage that contingency does not need to be called upon in any year; however, with reduced slippage, contingency will start to be required.

MANAGING COST PRESSURES THROUGH INCREASED PRODUCTIVITY

To successfully manage the cost pressures Defence faces, increased productivity in the way combat forces are supported and capability is delivered will be required. In some limited cases it will also require reducing the cost to provide the combat forces themselves. Productivity is not, and cannot be, about compromising effectiveness or capability, or the ability to attract and retain high-quality people. Rather, productivity in Defence is about more efficient ways to get work done and lower input costs.

More efficient ways to get work done in Defence can be achieved in three ways:

- **Creating a lean military support backbone.** Defence has an integrated 'backbone' of military support functions: maintenance of military equipment; inventory management; and supply-chain management. The opportunity exists to significantly increase the productivity of this backbone by:
 - Consolidating physical facilities and standard types of work
 - Applying the principles of lean operations to redesign the way work is done (for example, work practices and end-to-end processes)
 - Increasing cost-conscious decision making
 - Developing greater expert commercial capabilities.

These productivity improvements will save Defence between \$354 and \$615 million per year in operating costs and provide a one-off saving of \$218 to \$398 million.

In addition to cost savings, improvements in these areas will significantly enhance the effectiveness of Defence's military capability. Specific opportunities identified within the five platforms examined include:

- [REDACTED] increase in sea days for Collins Class submarines
- [REDACTED] additional serviceable F/A-18 Hornets on the flight line
- [REDACTED] increase in availability for critical Land Rover variants.

These enhancements to capability are indicative of the improvements that could be expected across other platforms.

- **Creating efficient enterprise support functions.** There is a significant opportunity to improve the efficiency of the enterprise support functions (Human Resources, Finance, Defence Support Group, ICT, and sustainment procurement) by:
 - Completing the shift to a more centralised service provision

- Introducing lean practices to the way work is done
- Reducing the use of contractors
- Shifting to a largely civilian and professionalised non-deployed workforce.

These productivity improvements will save Defence between \$363 and \$406 million per year in operating costs.

- **Capturing efficiency while reforming ICT.** A holistic ICT transformation is planned to significantly improve the quality of the ICT infrastructure provided to Defence. While the current focus on the transformation effort is primarily on quality, there should be an increased focus on capturing the significant efficiencies in the process.

These reforms could save Defence 15 to 30% per year in operating costs, dependent on the future ICT strategy. These savings are estimated at \$215 million per year, but have not been analysed in detail because the ICT strategy is beyond the scope of this review.

Reducing the cost of Defence inputs can be achieved in three ways:

- **Reducing non-equipment procurement costs.** Defence procures a wide range of commercial products and services such as building services, travel and relocation services. Clear opportunities exist to reduce these costs by:
 - Procuring more competitively priced products and services. For example, unbundling routes and removing price arbitrage on removal contracts.
 - Changing the specifications for what is required to obtain less costly products, where doing so will not compromise capability. For example, increasing the procurement requirement that military clothing is imported from low cost countries.
 - Changing patterns of use. For example, making greater use of Defence's extensive video-conference network rather than undertaking single day travel.

These improvements can save Defence between \$326 and \$518 million per year in non-equipment expenditure.

- **Reducing the cost of major equipment procurement.** Although a long-term task, there are significant opportunities to reduce the cost of major equipment procurement through:
 - Procuring a higher proportion of MOTS equipment
 - Increasing the level of competition for major equipment acquisition and sustainment contracts

- Reviewing the proportion of local sourcing which is not justified by strategic requirements.

Purchasing a greater proportion of MOTS (which the most recent Defence Capability Plan (DCP) plans for) and increasing the level of competition on major contracts (which partially overlaps with savings identified in the lean backbone section) could ease cost pressures by \$345 to \$660 million, but these are not ‘banked’ as savings.

- **Reducing the cost of combat capability through the use of Reserves.**

Beyond support functions, there is also an opportunity to deliver the same military capability at a lower cost through a flexible surge model. This model makes expanded use of Reserves and deployable contractors.

These changes could reduce the cost of combat capability by ~\$50 million per year.

The total productivity dividend from all of these measures is in the range of \$1.3 to \$1.8 billion per year, and a one-off saving of \$218 to \$398 million. The extent of reform required to capture these savings will take 3 to 5 years. The operational cost savings already identified by Defence (as part of the Defence Savings Plan, also known as ‘E2’) have been integrated with or replaced by the Audit savings, which provide analytical substance, much greater detail and show where Defence can go further to realise additional savings.

Removing the long-term structural inefficiencies of a fragmented estate. This can be achieved by starting the process of consolidating estates into an efficient superbase model, laying the foundation for the next ‘S’ curve in Defence productivity. A superbase model would dramatically reduce subscale base costs, extensive travel and relocation expenses, and the costs associated with managing a complicated supply-chain network.

The estimated yearly savings from a superbase model that would meet Australia’s strategic requirements would increase over time (assuming a staged consolidation), and could reach \$700 to \$1,050 million by 2035 (in 2008 dollars).

DRIVING DEEP REFORM IN DEFENCE

Defence has the opportunity to create a strategic and national advantage by managing a tighter budget process and driving a Defence productivity agenda. To achieve that advantage, Defence needs to establish two programs:

- **A deep reform program** aimed at fundamental changes in the way Defence conducts business. The program will be built on:

- Challenging targets and establishing a clear vision to be the world's most productive defence force
- Establishing strong line ownership and leadership
- Fundamentally redesigning the way work is done
- Creating expert commercial and high-level executive capability.

Deep reform inevitably takes time because it requires not just process change but also culture change. A realistic timeframe for this type of program is 3 to 5 years.

- **An outputs-driven budget management model.** This will create the management framework needed to support the reform program, and provide the incentives for sustained productivity improvement even after the reform program has ended.

The model creates clear accountability for the Service Chiefs to deliver defence output required by the CDF Preparedness Directive, while also substantially increasing their authority to manage their budget and operations. At the same time, the support functions are given clear accountability and authority to drive down their overhead costs by moving to more efficient service models, while also driving down the cost of their services by negotiating lower input prices.

In conclusion, a program of this scale is ambitious and wide-ranging, particularly for a Government organisation. These reforms would create:

- Transparency that brings clarity to the strategic, operational and managerial decisions taken at all levels of Defence
- Discipline in decision making and execution, due to clear, effective processes
- Efficiency in operations, due to a constant drive for improvement
- Flexibility as Defence is able to use resources, especially people, to maximum effect.

The national importance of Defence's mission, and the cost pressures Defence will continue to face, requires reform of the extent outlined above. We reiterate the prize: implementing the recommended reforms creates the opportunity for Australia to have the most lethal and productive force of its size in the world.