STRATEGY

ASPI

Your Defence Dollar:

The 2005–06 Defence Budget

ASPI
AUSTRALIAN STRATEGIC POLICY INSTITUTE

August 2005

Mark Thomson

Prior to joining ASPI, Mark Thomson held a number of positions in Defence working in the areas of capability development and resource management. In 1999 he was Political Military Adviser to Major General Peter Cosgrove during the INTERFET operation. Prior to his time with Defence, Mark held a series of academic research and teaching positions in theoretical physics.

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Cover image: Defence personnel provide assistance after the Boxing Day tsunami, January 2005. © Defence Department

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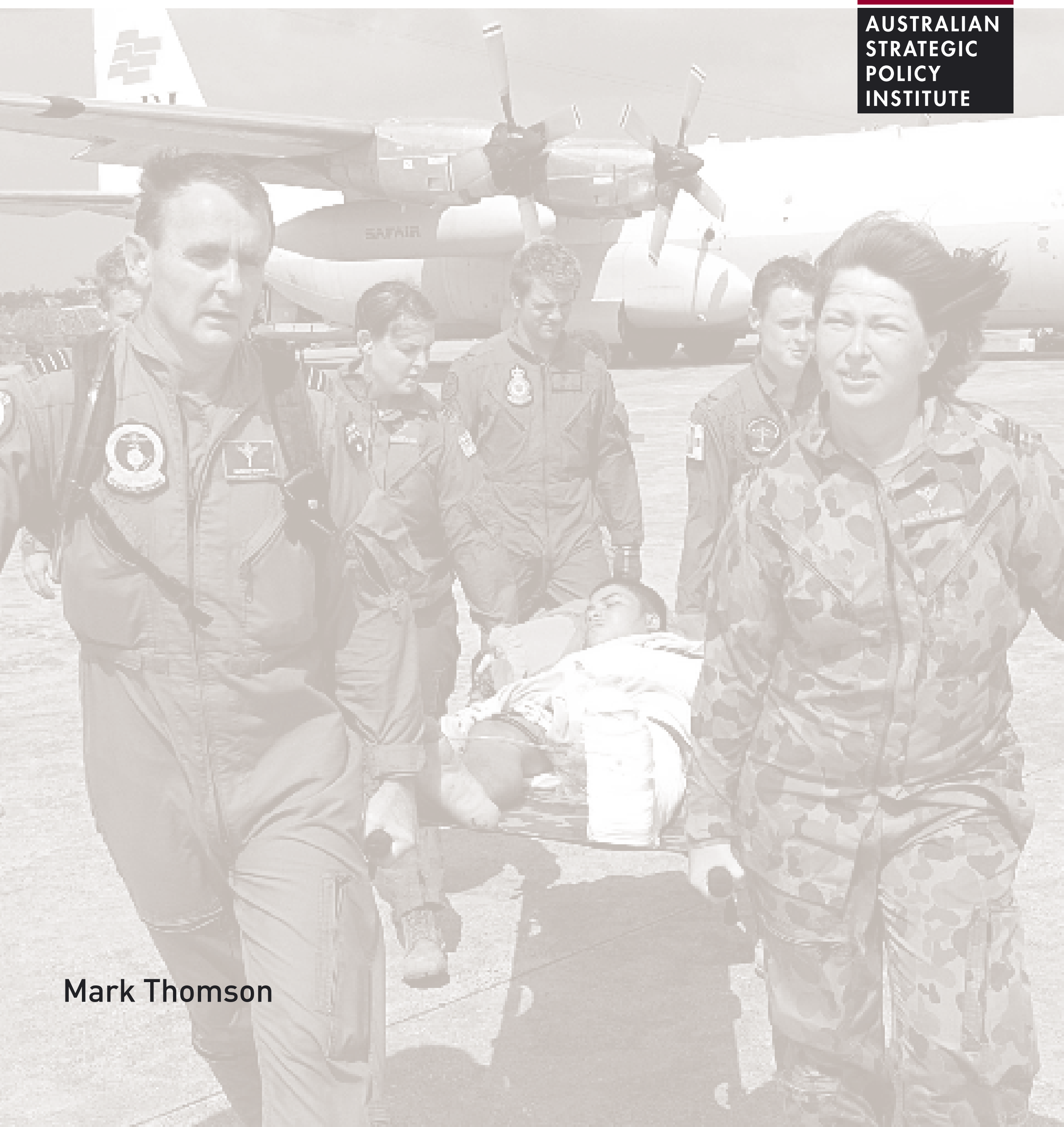

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Director's introduction

This year's federal budget was about laying the foundations for sustained prosperity in Australia in the face of an ageing population. The Treasurer's budget overview included a graph showing that, by 2020, the fiscal pressure due to health and ageing will total some 2.5% of GDP—an amount well in excess of the share of national wealth we now spend on defence. Given the scale of this projected shortfall, it's hard to see how any area of government spending will be immune from the looming squeeze. So, more than ever, it's important that every defence dollar is spent to best effect.

With this in mind, we've produced this report, *Your Defence Dollar*. It's a summary version of *The Cost of Defence* budget brief that came out two weeks after the 2005–06 Budget. This is the third year that we've produced such a summary. Our aim remains to inform discussion and scrutiny of the Defence budget and the policy choices it entails.

As in previous years, many people helped with the production of this report. As well as all the team at ASPI, Karla Bogaart from Optimum Business Consulting provided invaluable assistance on accounting matters. In addition, Defence was kind enough to look over a preliminary draft and make valuable comments. This helped to clarify some important points and resulted in improved accuracy in many areas. Of course, this does not in any way imply that Defence endorses this document or supports its conclusions.

My colleague Dr Mark Thomson, who is the manager of ASPI's Budget and Management Program, has written this report. As always, responsibility for the judgments in it lies only with Dr Thomson and me.

Finally, we acknowledge that we at ASPI are not disinterested observers of the Defence budget, because our funding from government is provided through Defence. Details can be found in our annual report.

Peter Abigail
Director

Photo opposite: Treasurer Peter Costello delivers his 10th budget speech 11 May 2005.
AAP/Alan Porritt © 2005 AAP


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Executive summary

In his 2005–06 Budget speech, the Treasurer didn't get around to national security until the second last item, and defence didn't rate a mention anywhere. Nonetheless, it was an important budget for Defence, in that it delivered the fifth tranche of $2.3 billion in funds promised by the 2000 White Paper. This, and a number of new initiatives, will see defence spending reach $17.5 billion in 2005–06. This amounts to 1.9% of gross domestic product and 8.5% of Commonwealth payments.

New initiatives in the Defence budget will account for more than $1.2 billion in spending across the next four years. The largest single item is $420 million to fund Australia's ongoing military presence in Iraq. This brings the total cost of our role in the invasion, stabilisation and rehabilitation of Iraq to $1.2 billion. Other significant initiatives include the reprogramming of an additional $300 million for capital investment in 2005–06, and $252 million over four years for a variety of security enhancements as part of the government's $1.1 billion budget package of measures entitled *Providing for Australia's Security*. This includes two additional Armidale Class patrol boats for enhanced surveillance of the North-West Shelf oil and gas infrastructure.

But there was also some stringency built into this Budget. Not only is Defence required to deliver $221 million in efficiency dividends and administrative savings over the next four years, but fully $218 million worth of the new initiatives were unfunded. The overall result is that Defence has to deliver $1.2 billion worth of initiatives with only $780 million in new funds—a shortfall of $439 million over four years.

This shouldn't be too great an impost. Over the past several years, the government has funded Defence for additional logistics, facilities and personnel costs, with a clear imperative to achieve effectiveness. Now, with the operational tempo of the Australian Defence Force (ADF) a little less hectic, the spotlight has returned to efficiency. This is appropriate at a time when other government agencies are being asked to tighten their belts. Fortunately, over the past several years Defence has been actively developing its budget processes and exploring more efficient ways of delivering corporate services. This makes it well placed to deliver the required savings.

That's not to say that the trials and tribulations surrounding Defence's financial management are over. The qualification of Defence's 2003–04 financial statements by the auditor was accompanied by media reports of an $8 billion black hole and missing inventory. Fortunately, things are nowhere near that bad. The qualification reflects the difficulty in valuing some of the vast inventory held by Defence and, more seriously, accounting for the quantities of some types of stores (fortunately *not* including explosive ordnance). A plan is now in place to remediate the financial statements, but it will take several years to fix the problem.

Another area of concern is military personnel numbers. Despite spending $500 million over five years on initiatives to improve the recruitment and retention of military personnel, the process of building ADF numbers has stalled. Not only has the size of the permanent ADF fallen for two years in a row, but the average strength achieved last financial year was almost a thousand below the target set in May 2004. While the currently strong economic climate is no doubt a factor, it may be that in the long run a more radical approach will be required to attract young 21st century Australians into the military and to retain them.

The problem isn't spread evenly. The Air Force is in the best position, benefiting from the lowest separation rate in over a decade plus strong recruitment. The Navy—which has traditionally had the hardest time attracting and retaining personnel—is in a better position than for quite some time, although it's reported a recent increase in separation rates and falling recruitment. The Army is in by far the least favourable situation, especially given that it will soon have to start introducing new capabilities into service, including the aerial fire support and reconnaissance helicopters and additional troop-lift helicopters.

On the positive side, good progress is being made in the Defence Materiel Organisation (DMO) following the 2003 Defence Procurement Review. DMO became a quasi-autonomous 'prescribed agency' on 1 July 2005, and purchaser–provider agreements are now in place between Defence and DMO for acquisition and sustainment services. This is the most fundamental change to Defence management since the Defence Reform Program of the late 1990s. If all goes to plan, this will deliver a much more businesslike arrangement, with greater visibility of costs and better definition of performance standards.

In terms of actually delivering new equipment, it looks like the reforms of DMO are gaining early traction. Last year, around $2 billion in planned capital investment was deferred to beyond 2008 because DMO was unable to spend the money. This year, spending on projects has picked up significantly and is projected to exceed the budgeted target. Moreover, $300 million of deferred spending has been reinstated into the budget for 2005–06. This is a significant boost for the prospect of delivering the government's $50 billion decade-long program of capital investment, the Defence Capability Plan (DCP).

Unfortunately, at the same time, the approval of new projects by the government has stalled in the eighteen months since it released a revised DCP in 2004, and unless projects are approved there's no way they can be delivered. Comparing the projects planned for approval in 2004–05 and 2005–06 with what's occurred and what's now planned to occur, we're already at least a year behind schedule. Thus, one way or another, it looks like the ADF will have to wait for the capability it needs.

There are probably a number of reasons for this delay, including the hesitation borne of uncertainly over strategic and capability priorities (including the much-heralded but as yet unendorsed 'networked and hardened' Army) and, more importantly, the time taken to establish the more stringent process of project approval that's integral to the reform of Defence procurement. However, if this means that we avoid schedule delays and cost blowouts in the future, then the delays may be a burden worth carrying (for a while).

The mounting delays in approving projects in the DCP are rapidly rendering the current version of the plan obsolete. This introduces further uncertainty into an already opaque situation in which our strategic priorities remain unresolved and long-term Defence funding is undecided past the end of the decade (despite a promise last year that the issue would be resolved in the 2005–06 Budget). This last point is particularly important. It makes no sense to try to run a ten-year program of capability development on a five-year funding profile.

This trinity of uncertainty (policy, priorities, funding) has led to calls from many quarters for a new White Paper—calls that the government has consistently resisted. The government has now relented, at least in part, with the recent announcement by the Defence Minister of a new Strategic Update and a revised Defence Capability Plan before the end of this calendar year. Moreover, we understand that this will be accompanied by a decision on long-term Defence funding for release in the next budget. Thus, despite all the challenges that this year's budget revealed, we can be cautiously optimistic that long-term defence plans will soon be put back onto a coherent basis. While this is encouraging, it raises the question of why Defence's overall strategic planning remains aperiodic and ad hoc. Given the excellent progress made in recent years in improving Defence's annual budgeting and reporting, the time is right to apply the same rigour and discipline to long-term strategic planning.

Chapter 1

STRATEGIC CONTEXT FOR THE BUDGET

The tragic loss of nine Australian Defence Force (ADF) members when a Navy Sea King crashed on Nias Island earlier this year was a sobering reminder that military operations—even humanitarian operations—are never routine or risk free. But while ADF deployments can never be considered routine, they've become surprisingly frequent in recent years.

Over the past six years, the ADF has deployed to East Timor, Afghanistan and Iraq, and provided substantial support to the Australian Federal Police in their mission to Solomon Islands, as well as undertaking two humanitarian relief operations in Indonesia and maintaining an ongoing role in border protection. Over this period, the number of deployed personnel has rarely dropped much below 1,000 after peaking at around 6,000 during the INTERFET operation in late 1999.

Compared with earlier years, this is a big jump in the scale and tempo of deployments. Indeed, our armed forces were effectively kept in stasis for almost two decades between our withdrawal from Vietnam in 1972 and the end of the Cold War. For most of the 1990s, deployments were largely restricted to a series of UN peacekeeping missions that tended to be both small and short. The notable exception was the first Gulf War in 1991, although in retrospect even there our involvement was relatively limited and cautious.

So it's not surprising that the past six years have also seen a lot of changes within Defence, most of which date back to the 2000 White Paper (*Defence 2000*), which was written in the aftermath of East Timor. Initiatives have included elevated targets for military personnel numbers, a build-up of war stock munitions, substantial increases to

Photo opposite: Defence providing assistance after the tsunami, 4 January 2005.
© Defence Department

logistics funding and, most importantly, the filling of capability gaps through the $50 billion Defence Capability Plan (DCP). All of this is backed up with a decade-long commitment from the government for 3% annual real growth in the Defence budget. The result is that the ADF is moving from the peacetime 'fitted-for-but-not-with' force of the 1980s and 1990s to what *Defence 2000* called 'fully developed capability'—capability that's ready to go at short notice.

Given our strategic environment, this move was none too soon. The attacks of 9/11 and the subsequent deployments to Afghanistan and Iraq showed how quickly new challenges could arise. And earlier this year we saw just how easily Coalition operations can transform into longer term commitments despite our best laid plans to the contrary. Meanwhile, the threats of terrorism and weapons of mass destruction proliferation remain with us still, at the same time as conventional inter-state tensions are slowly re-emerging in North Asia and, closer to home, we continue to face challenges with weak states on our doorstep.

If there's one thing that we've learned from the past six years, it's that the foreseeable future is a very short time indeed.

How any of this might manifest into another ADF deployment remains to be seen. If there's one thing that we've learned from the past six years, it's that the foreseeable future is a very short time indeed. We had less than nine months warning before East Timor, and ultimately less than a month once the full extent of the task became apparent. And while the warning lights were flashing for Iraq as early as two years ahead, Afghanistan came with almost no warning at all. Whatever the next job for the ADF might be, it will more than likely arrive with little notice. The imperative for our armed forces to be ready and able to deploy has not been this compelling since at least the late 1960s.

Unfortunately, the transition to 'fully developed capability' is far from complete. Military capabilities take a long time to develop, and it will be years before some—like the naval air-defence capability—are up and running. Even logistics and munitions war stocks will take several more years to fix, given the long procurement lead times for many items.

One way or another, it looks like the ADF will have to delay its modernisation plans.

And none of this is assured. The program of capability development set out in *Defence 2000* faltered over the first three years of this decade when it became clear that Defence and its suppliers wouldn't be able to deliver to the original schedule—especially as the cost of individual projects blew out. Although reforms to the Defence Materiel Organisation (DMO) are now improving the delivery of existing projects, the approval of new projects has fallen behind schedule over the past year. One way or another, it looks like the ADF will have to delay its modernisation plans. Just as worryingly, poor recruitment and retention in 2003–04 and 2004–05 saw the ADF shrink rather than grow two years in a row.

Recruitment and retention could well emerge as the Achilles heel of plans for a larger and stronger ADF.

Beyond problems with personnel and procurement, two big strategic issues are looming for Defence.

First, the government's reluctance to clarify its strategic priorities has cast uncertainty over the planning of future capability. Although most public utterances from the government and Defence toe the line set in *Defence 2000* and the subsequent 2003 *Defence Update*, some don't. Indeed, while the development of naval and air capabilities remains focused on controlling our air and maritime approaches, as set out in official policy, the Army appears to have moved beyond declared government policy.

The Army's plan to transform into a 'networked and hardened' combined arms force is set out in the concept document *Complex Warfighting*, which specifically rejects the force structuring principles of *Defence 2000* and instead focuses on urban warfare and medium-intensity coalition operations. Trouble is, restructuring the Army in this way is hard to reconcile with a stated policy of giving priority to the defence of Australia.

Second, although we're about to commence the fifth year of the White Paper funding period, the government is yet to decide whether to extend the 3% real growth in defence spending beyond 2010–11 (despite promising to do so in last year's budget papers). Not only does this uncertainty impede medium- and long-term capability planning, but it also opens the possibility that Defence will once again find itself hobbled with a 'constant-in-real-terms' funding profile. Last time this happened, from the mid-1980s through to 2000, the ADF's capabilities slowly eroded as the underlying cost of maintaining modern military capabilities, including personnel, steadily outpaced inflation.

Of course, these two issues can't be resolved in isolation; the long-term budget depends on the future goals set for the ADF, and vice versa. You can't have one without the other. Moreover, because the nexus between budgets and the ADF of the future is the DCP, this needs to be adjusted in tandem.

Fortunately, it looks like the government is at last ready to resolve the uncertainties over policy, priorities and funding that hang over defence planning. The Defence Minister has promised both a new Strategic Update and a revised DCP before the end of this year. Moreover, we understand that this will be accompanied by a decision on long-term defence funding for release in the next budget.

While the result won't be a new White Paper, this is potentially the most comprehensive review of defence policy since 2000.

So all the building blocks are falling into place to put Defence planning back onto a coherent basis. While the result won't be a new White Paper, this is potentially the most comprehensive review of defence policy since 2000.

Chapter 2

FUNDING, ORGANISATION AND COMMAND

Defence is a complex beast, not just because it's a vast entity with more than 90,000 employees spread from one end of the continent to the other, but because it's organised, funded and commanded through three largely separate arrangements. This chapter takes on the daunting task of describing these three frameworks and how they work in concert.

How Defence is funded: outcomes and outputs

The Defence budget is set out according to a framework of 'outcomes' and 'outputs'. This framework was introduced by the Commonwealth in 1999, and is applied to all Australian Government agencies. It works like this:

- **Outcomes** are the results or benefits that the government aims to deliver to the community through the work of its agencies. Outcomes are specified for each agency, and are meant to express the purpose or goal of the agency's activities.
- **Outputs** are the goods and services that the agency produces to achieve its outcomes.

Under the framework, the performance of agencies is measured to assess both how much output they're generating, and the extent to which that output is actually delivering the intended outcomes. So the aim is to show not only how much an agency is *doing*, but how much it's actually *achieving*.

The outcomes and outputs framework isn't just an accounting device. It's intended to provide a structure for management decision-making and resource allocation throughout national agencies. So the way the

Photo opposite: Energy paths. © CORBIS/Australian Picture Library framework is applied in an agency, such as Defence, is very important to the agency's management and performance.

The key to the effective application of the framework is the specification of the outcome or outcomes. Defence has six outcomes:

1. Command of operations in defence of Australia and its interests
2. Navy capability for the defence of Australia and its interests
3. Army capability for the defence of Australia and its interests
4. Air Force capability for the defence of Australia and its interests
5. Strategic policy for the defence of Australia and its interests
6. Intelligence for the defence of Australia and its interests.

There's actually a seventh outcome, mainly covering superannuation payments for current and former ADF personnel and housing subsidies provided under the *Defence Force (Home Loans Assistance) Act 1990*. This money is channelled through Defence as an administrative convenience, and we shan't consider it further.

One or more outputs contribute to the delivery of each outcome. The cornerstone of defence funding is the so-called 'output appropriation' that gives Defence enough money to cover the net cost of delivering the twenty-eight outputs that the government 'buys' from Defence. These are listed in Table 1, along with the budgeted net costs for 2005–06.

The funds appropriated annually for the net cost of the outputs exceeds the amount of cash spent to deliver them by around three billion dollars every year. This is because Defence is funded on the basis of an accrual budget that recognises non-cash expenses like depreciation. Put simply, Defence gets cash revenue for non-cash expenses. But don't worry; this cash surplus doesn't go to waste. Instead, it's used to partly fund Defence's Capital Investment Program with the remainder made up through an additional 'equity injection' appropriation, counterbalanced as necessary by a 'capital withdrawal'. In recent years, Defence has also supplemented its investment program through the sale of assets, including (especially) property. If you want to grapple with the intricacies of how this complex arrangement works, our annual budget brief *The Cost of Defence* has an extended discussion.

… all this accounting gymnastics can seem contrived and artificial, but it's really a serious attempt to make visible the true cost of delivering military capability.

At first glance, all this accounting gymnastics can seem contrived and artificial, but it's really a serious attempt to make visible the true cost of delivering military capability. It would be wrong to ignore the depreciation on billions of dollars worth of equipment as it is used. The accrual approach tries to capture everything that's being consumed—both cash spent and assets used up.

Table 1: The Defence outputs

Outcome	Output	Cost $m
1. Defence Operations	Command of Operations	372
	Defence Force Military Operations and Exercises	499
	Contribution to National Support Tasks	10
	Subtotal	**881**
2. Navy Capabilities	Capability for Major Surface Combatant Operations	1,606
	Capability for Naval Aviation Operations	505
	Capability for Patrol Boat Operations	278
	Capability for Submarine Operations	780
	Capability for Afloat Support	214
	Capability for Mine Warfare	356
	Capability for Amphibious Lift	370
	Capability for Hydrographic, Meteorological and Oceanographic Operations	241
	Subtotal	**4,349**
3. Army Capabilities	Capability for Special Operations	500
	Capability for Medium Combined Arms Operations	926
	Capability for Light Combined Arms Operations	1,031
	Capability for Army Aviation Operations	577
	Capability for Ground-based Air Defence	130
	Capability for Combat Support Operations	385
	Capability for Regional Surveillance	124
	Capability for Operational Logistic Support to Land Forces	576
	Capability for Motorised Combined Arms Operations	551
	Capability for Protective Operations	613
	Subtotal	**5,413**
4. Air Force Capabilities	Capability for Air Combat Operations	1,769
	Capability for Combat Support of Air Operations	762
	Capability for Surveillance and Response Operations	1,105
	Capability for Airlift Operations	1,019
	Subtotal	**4,655**
5. Strategic Policy	International Policy, Activities and Engagement	188
	Strategic Policy and Military Strategy	43
	Subtotal	**231**
6. Intelligence	Intelligence	**467**
TOTAL		**15,997**

Source: 2005–06 Defence Budget Papers. Figures have been rounded

So, despite all the complications, the output framework makes sense. Unfortunately, over the past six years Defence has had a lot of trouble working out the net cost of the outputs. This has led to substantial volatility in the costs ascribed from year to year. Hopefully, recent accounting initiatives within Defence will lead to more robust and enduring figures in the future.

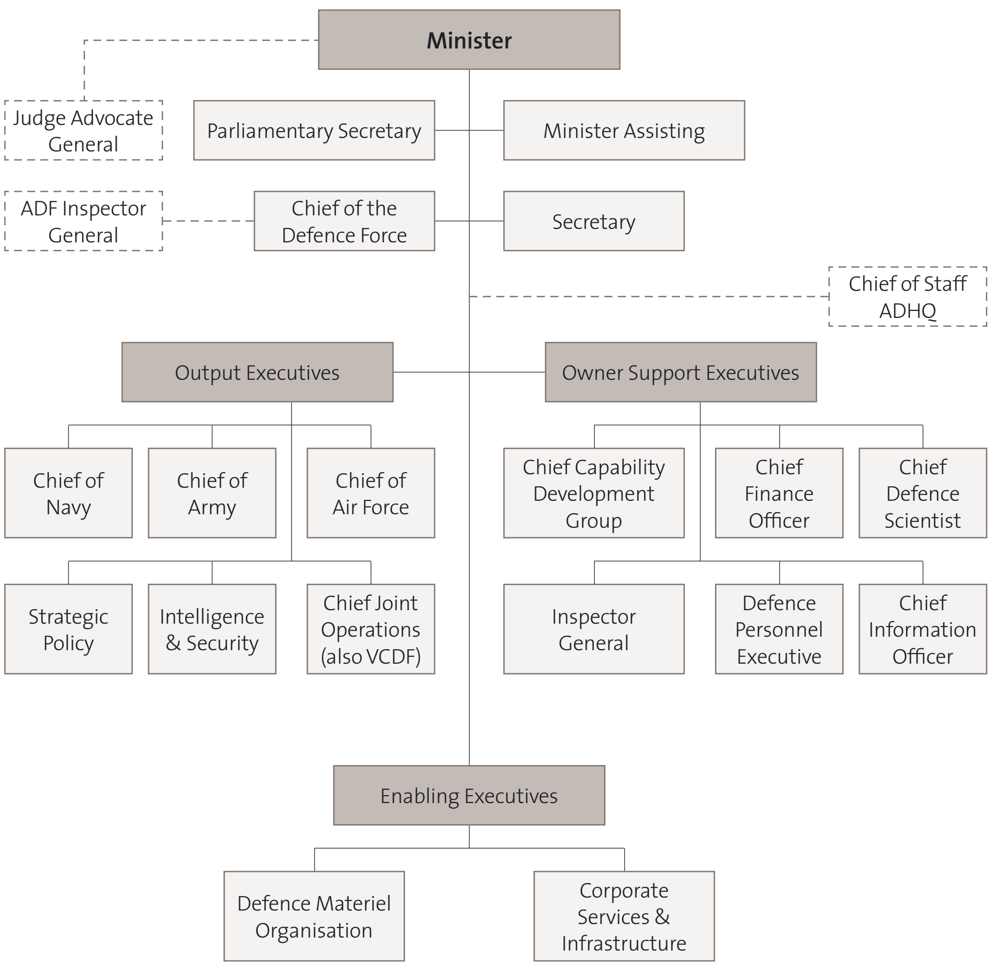
Until such time as Defence's output costing methodology stabilises, the output costs will remain of limited use. So it's not surprising that, in practice, both Defence and the Department of Finance remain as focused as ever on the cost of inputs like personnel, facilities and logistics, with only scant regard to the cost of outputs.

How Defence is organised: groups

The traditional concept of Defence's organisational structure is that it consists of three services—Army, Navy and Air Force—and the Department of Defence. This impression is reinforced by the output structure, focused as it is on Army, Navy and Air Force capability outputs.

In fact, the Defence organisation isn't organised like this at all. It's divided into fifteen 'groups'; these are the entities between which the Defence budget is divided. The arrangement of the groups is set out in Figure 1. Perhaps the most striking feature is that, below the Minister, no single person is in charge. The departmental secretary and the Chief of the Defence Force share control of Defence through a diarchy in which they each have separate and overlapping responsibilities.

Figure 1: The Defence organisation



Source: 2005–06 Defence budget papers

The groups fall into three categories:

- **Output Executives groups** are (mostly) responsible for delivering Defence's outputs to the government (the customer).
- **Owner Support Executives groups** are responsible for protecting the government's interest as the owner of Defence, including by ensuring its long-term viability.
- **Enabling Executives groups** are responsible for providing business services, such as asset procurement and facilities management, to the other two types of groups.

The groups and their executives are responsible for spending Defence's money and doing its business. Consequently, financial accountability occurs within the group structure. Unfortunately, there's no simple correspondence between the groups where money is actually spent and the outputs that form the basis of Defence funding. This fundamental 'disconnect' is why Defence has trouble determining the net costs of its outputs. Ultimately, the net costs of outputs are entirely derived figures that don't correspond to the allocation of funds within Defence.

Table 2 gives the breakdown of the total attributed net cost of the Defence outputs across the fifteen groups for 2005–06.

Table 2: Allocation of the cost of outputs to groups

		2005–06 $ million	2005–06 % of total
Output Executives			
Joint Operations/Vice CDF		329	2.1%
Navy		2,115	13.2%
Army		2,632	16.5%
Air Force		2,212	13.8%
Intelligence		367	2.3%
Strategic Policy		127	0.8%
	Subtotal	**7,783**	**48.7%**
Owner Support Executives			
Defence Personnel Executive		634	4.0%
Defence Science and Technology		310	1.9%
Capability		25	0.2%
Chief Finance Officer		354	2.2%
Chief Information Officer		517	3.2%
Secretary/CDF Force		28	0.2%
Inspector General		14	0.1%
	Subtotal	**1,882**	**11.8%**
Enabling Executives			
Defence Materiel Organisation		3,226	20.2%
Corporate Services and Infrastructure		2,300	14.4%
	Subtotal	**5,526**	**34.5%**
	Portfolio	805	5.0%
TOTAL		**15,997**	**100.0%**

Source: 2005–06 Defence Budget Papers. Figures have been rounded

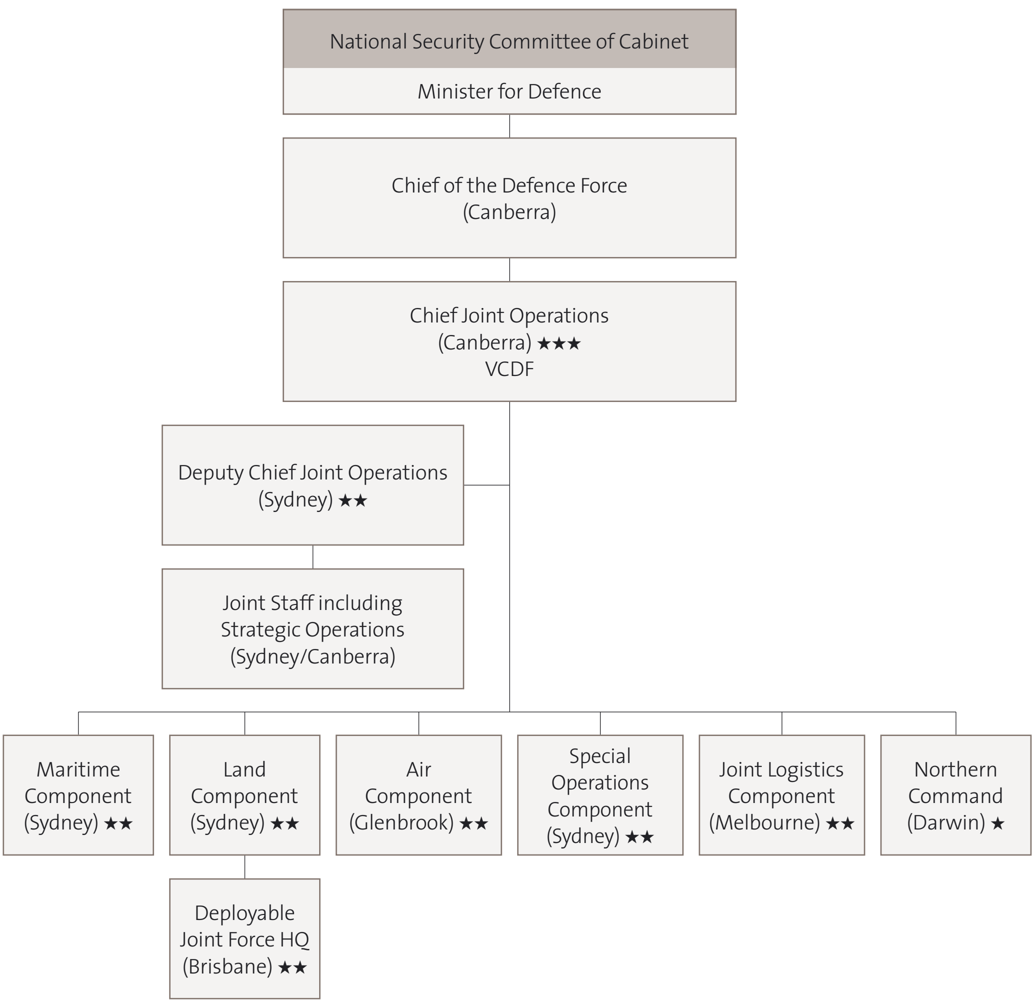
Two important changes have occurred to the group structure since last year. First, responsibility for information technology policy and delivery has been consolidated under the Chief Information Officer. Previously, information technology infrastructure was controlled by the Corporate Services and Infrastructure Group. Second, as part of the ongoing Defence procurement reform program, the DMO has been hived off as a quasi-independent 'prescribed agency'. This is an important move, the consequences of which we explore in Chapter 6.

ADF command structure

It's important not to confuse the day-to-day management of the Department of Defence with the command of military operations. The former occurs through the diarchy and group/output arrangements, the latter through a formal command chain and dedicated headquarters structure. In this parallel arrangement, units are temporarily reassigned from the services to be commanded on operations and exercises as required.

In early 2003, the ADF command arrangements were revised through the creation of Joint Operations Command under the Chief of Joint Operations, who also happens to be the Vice Chief of the Defence Force. In this rearrangement, the old Headquarters Australia Theatre became part of the Joint Staff. Figure 2 outlines the arrangement.

Figure 2: Defence command arrangements

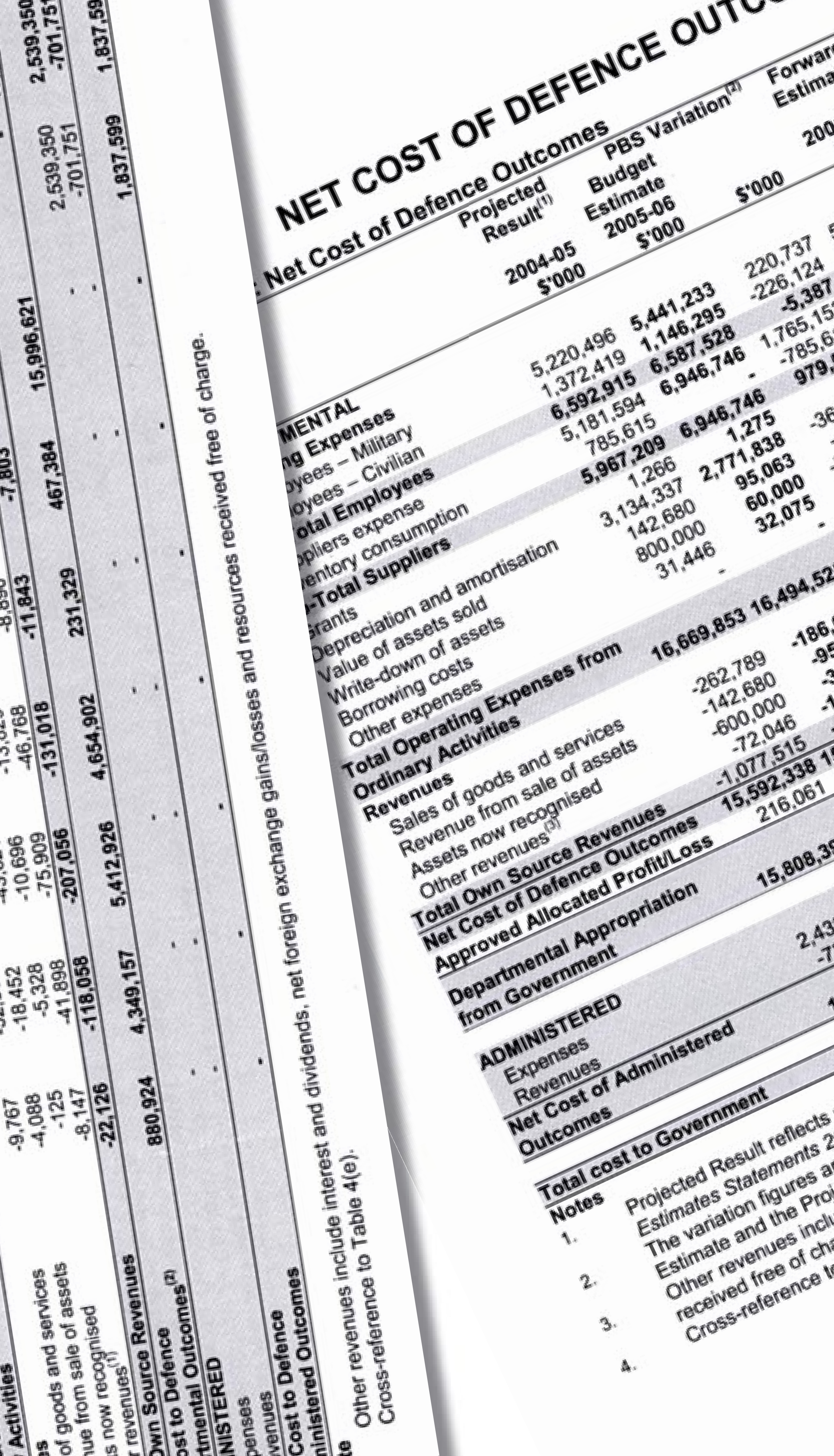


Two points are worth noting. First, notwithstanding what might be implied by a naive reading of the Australian Constitution, the actual control of the ADF resides with the executive government through the National Security Committee of Cabinet. The Governor-General's role of commander-in-chief is entirely titular. Second, while many aspects of the management of Defence are shared between the Chief of the Defence Force and the Secretary of the Defence Department, the Secretary plays no formal role in the command of the ADF, although he or she is integral to the formulation of advice to the government on the employment of the ADF.

How does this all hang together?

At the risk of oversimplification, Defence is funded and reports on the basis of twenty-eight outputs, organised and budgeted internally on the basis of fifteen groups, and is commanded on operations through an entirely separate arrangement of cascading headquarters.

Viewed this way, it's surprising that things work as well as they do, but of course there's a price to be paid. All these overlapping arrangements require both orchestration from above and lateral coordination. As a result, a lot of energy is devoted to keeping Defence's internal bureaucratic processes ticking over.



NET COST OF DEFENCE OUTC
Net Cost of Defence Outcomes
Projected Result
Budget Estimate 2005-06
PBS Variation
Forward Estima
2004-05 $'000
Total Operating Expenses from Ordinary Activities
Revenues
Sales of goods and services
Revenue from sale of assets
Assets now recognised
Other revenues
Total Own Source Revenues
Net Cost of Defence Outcomes
Approved Allocated Profit/Loss
Departmental Appropriation from Government
ADMINISTERED
Expenses
Revenues
Net Cost of Administered Outcomes
Total cost to Government
Notes
Other revenues include interest and dividends, net foreign exchange gains/losses and resources received free of charge.
Cross-reference to Table 4(e).

Chapter 3

THE 2005–06 DEFENCE BUDGET

In the arcane world of Australian Government finances, several different figures are given for the size of the Defence budget, with each measuring different things. The figure that's most useful is the one for 'total departmental funding' in the Defence budget papers. It represents the funds available to Defence to deliver the six departmental outcomes and maintain the ongoing program of investment in new equipment and facilities. It's also the figure commonly used to measure movements in Defence's funding and is therefore the one to focus on. For 2005–06, it's $17.5 billion dollars. This is an increase of $880 million, or 5.3%, on last year's figure. After inflation is taken into account, the real growth comes out at 0.8%. Note that DMO has now been established as a prescribed agency, and will separately receive around $238 million that isn't counted in these figures.

As a share of national wealth, Defence spending is budgeted at 1.9% of gross domestic product (GDP) for 2005–06, amounting to around 8.5% of overall Commonwealth payments. These statistics and those for recent years appear in Table 3, along with the projected figures out to 2008–09.

The 2000 White Paper committed the government to a decade-long program of 3% real growth in the underlying level of defence funding. This isn't apparent in Table 3 for two reasons. First, substantial extra funding has been provided in the early years of the decade for logistics, personnel, overseas deployments and security initiatives since 9/11. This reduces the rate of growth from what it would otherwise have been. Second, some of the originally planned spending on new capital equipment has been deferred until after 2007–08. Although the total amount of money to be spent on new equipment remains unchanged, this means that some of the originally planned growth in funding has been deferred until near the end of the decade.

Photo opposite: From Portfolio Budget Statements 2005–06

Table 3: Defence budget statistics									
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Funds (nominal)	12,648	14,500	14,738	15,873	16,615	17,495	17,914	18,861	19,717
Growth (nominal)	1.63%	14.65%	1.64%	7.70%	4.68%	5.29%	2.40%	5.28%	4.54%
Growth (real)	–2.74%	12.12%	–1.51%	3.96%	0.65%	0.76%	0.39%	3.22%	2.49%
% of GDP	1.89%	2.03%	1.94%	1.95%	1.92%	1.88%	1.85%	1.87%	1.95%
% payments	8.17%	8.87%	8.74%	8.87%	8.59%	8.53%	8.41%	8.46%	8.43%

Note: real growth is calculated relative to the implicit non-farm GDP deflator.

What's new in this year's Budget?

The Commonwealth Budget process is all about marginal changes to pre-existing funding levels. These take the form of budget 'measures' and funding adjustments. The key initiatives contained in this year's Defence budget are listed in Table 4. All figures refer to the total budget impact over the next four years.

In summary, Defence has been directed to undertake $1,219 million worth of new initiatives but has only received $880 million in additional funding. The shortfall of $439 million is due to an efficiency dividend of $79 million, new administrative savings of $142 million, and $219 million in 'unfunded' initiatives. Thus, fully one-third of the cost of new initiatives will have to be absorbed from within Defence's existing funding base.

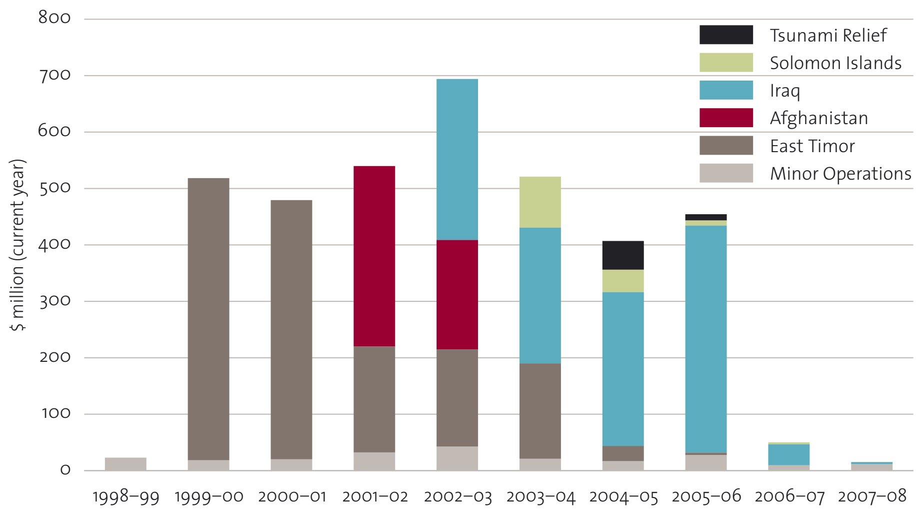
Table 4: Initiatives in the 2005–06 Defence budget	Total 2005–06 to 2008–09 ($ million)
Deployments—Iraq	421
Capital investment reprogrammed	300
North-West Shelf security	139
Other security enhancements	113
Defence industry skills development	75
US–Australia Free Trade Agreement	42
Capability technology demonstrators	41
Deployments—non-Iraq	28
Joint combined arms training centres	23
APEC forum 2007	20
Other initiatives	19
Total cost of new initiatives	**1,219**
Efficiency dividend	–79
New administrative savings	–142
Cost of unfunded initiatives	–218
Total savings to be found	**–439**

Source: 2005–06 Defence budget papers

Deployments

The biggest slice of new initiatives in the 2005–06 Budget covered the net additional cost of overseas deployments. This includes the continuation of pre-existing operations in Iraq ($205 million) and the deployment of a 450-troop task group to Al Muthanna province ($215 million), both for a period of twelve months. In addition, there was $11 million for the tail-end of the tsunami relief operation, and a one-year extension of the elevated ADF contribution to coastal surveillance ($16 million). Figure 3 shows the costs of recent Defence deployments. The deployment of a 150 strong SAS contingent to Afghanistan was announced after the budget, at an unknown cost.

Figure 3: The cost of war



Source: Defence budget papers and annual reports

Capital investment reprogramming—great news!

The largest initiative in last year's Budget was the reprogramming (read deferral) of $884 million of funds previously earmarked for investment in new equipment. This came on top of $1.3 billion reprogrammed over the previous two years, yielding a total of $2.2 billion in deferred capital investment. The inescapable impact was that this amount of previously planned equipment acquisitions would arrive years late.

The great news in this year's Budget is that DMO is on track to deliver the 2004–05 investment target (and then some), and—better still—$300 million of deferred spending has been reinstated for 2005–06. This reflects both the improved performance of DMO and a reassessment of the cash-flow requirements of recently approved projects. We explore the capital investment program further in Chapter 4.

North-West Shelf security

The 2005–06 Budget once again delivered big money for domestic security. In total, $1.1 billion was provided over four years in a package of measures entitled *Providing for Australia's Security*. The money is spread across a large number of portfolios, mostly outside of Defence.

The largest initiative for Defence was $139 million over four years to improve the security of Australia's offshore oil and gas facilities on the North-West Shelf, including $117 million to buy two Armidale Class Patrol Boats and meet associated support and ancillary costs (thereby increasing the fleet from twelve to fourteen boats). The two new boats will work out of either Dampier or Port Hedland and will provide a dedicated surveillance and monitoring capability for the North-West Shelf. Defence will also undertake a trial of unmanned aerial vehicles to assess their maritime surveillance potential, at a cost of $23 million over two years.

Other security enhancements

Other security initiatives for Defence include:

- $74.8 million over two years for enhanced protective security measures for Defence personnel and facilities, including increased guarding, patrolling and protective searches.
- $15.9 million over four years as part of improving Australia's counter-proliferation intelligence effort by enhancing intelligence collection, analysis and coordination.
- $12.6 million over four years to meet increased operational demands in intelligence coordination and analysis.
- $4.5 million over two years for upgrades to Defence business and information systems, including electronic document management, security and data extraction.
- $3 million in 2005–06 to maintain the *Continuity of Government Plan*, including through an annual exercise and testing program. The plan outlines measures to minimise the impact of a national security emergency on critical government operations.

Other measures

The remaining significant initiatives in the 2005–06 Budget include:

- $74.5 million over four years to increase the quality and quantity of specialist skills in Australia's defence industry. This represents a diversion of around 0.5% of the annual capital investment program to industry for training. It's hoped that a better skilled defence industry sector will be able to deliver projects more cost-effectively, leading to long-term cost neutrality, if not savings.
- $41.9 million over four years to implement the revised Commonwealth Procurement Guidelines resulting from the United States–Australia Free Trade Agreement.
- $40.9 million over three years to increase funding for the longstanding Capability and Technology Demonstrator Program, which assists the Australian defence industry to explore advanced technology-driven capabilities.
- $22.9 million over three years to develop training facilities for joint Australian–US military exercises.
- $19.7 million over two years to support Australia's hosting of the Asia Pacific Economic Cooperation (APEC) forum in 2007.
- $12.6 million over four years to introduce the Australian Defence Medal, which will recognise volunteer service in the Australian Defence Force.

Price, exchange and other adjustments

Defence will also receive an extra $1,664 million over four years as a price adjustment, and will hand back $340 million in 2005–06 for foreign exchange movements. These changes don't represent more or less spending, but are simply adjustments to maintain the buying power of the Defence budget. In addition, there was also a purely administrative transfer of $182 million as part of the establishment of DMO as a prescribed agency.

Savings to be found

This year's savings measures come on top of the four-year-old White Paper savings initiatives and the administrative savings program that commenced two years ago. Table 5 shows the cumulative impact of the initiatives since 2001–02. What makes this year's tranche of austerity different is that the new administrative savings, efficiency dividend and absorbed measures have effectively been sliced off Defence's bottom line, whereas the 2003–04 administrative savings program was an internal measure to offset emerging cost pressures.

Table 5: Defence savings targets ($ million)

	01–02	02–03	03–04	04–05	05–06	06–07	07–08	08–09
White Paper savings initiatives	50	200	200	200	200	200	200	200
Administrative savings targets	–	–	50	100	150	175	200	200
New administrative savings	–	–	–	–	–	70	60	12
Efficiency dividend[a]	–	–	–	–	3	12	25	39
Absorbed Budget measures	–	–	–	–	65	78	46	28
Total	**50**	**200**	**250**	**300**	**418**	**535**	**531**	**479**

a After 2008–09, the efficiency dividend will continue to grow at around $20 million per year.

Source: Defence budget papers and annual reports

… what we're seeing is the imposition of successive savings programs to stem the ongoing growth in overheads.

Adding up the various initiatives yields a somewhat forbidding figure approaching half a billion dollars per year. This is all the more impressive when you note that the estimated size of 'civilian and non-operational' spending on which the efficiency dividend is based amounts to only $1.4 billion per year, or about 8% of the Defence budget. Based on these figures, one could naively conclude that Defence's non-operational overheads are planned to shrink by more than a third across the decade. Of course, this is highly unlikely. Instead, what we're seeing is the imposition of successive savings programs to stem the ongoing growth in overheads. Just as in gardening, the job of weeding never ends.

Defence will deliver these savings in a variety of ways. The budget papers list twenty-two separate initiatives that have or will deliver savings under the existing administrative savings program. Encouragingly, Defence has been doing a little better than required so far. For example, in 2003–04 it exceeded the target for administrative savings by $10 million, or 20%.

One of the reasons for this is that Defence continues to improve its housekeeping through reduced administrative spending and better day-to-day business processes. The delivery of corporate services was reviewed by the Business Improvement Project in 2003–04, and eight improvement initiatives are now underway, including the consolidation of travel and accounts processing. The new travel management system is expected to provide savings of up to $21 million a year. Feasibility studies are underway in various other areas, including relocations, office supplies, hospitality and catering. More broadly, over the past couple of years we've seen a disciplined approach taken to the numbers of civilian and professional service providers employed within Defence. Both numbers are now reducing after a burst of unplanned growth early in the decade.

Ultimately, it's for Defence to work out how to deliver the savings. With the more stringent internal budgeting framework that's developed over the past several years, it's much better placed to do so than in the past. And remember that the savings outlined in Table 5 are cumulative, so Defence has already clocked up more than $300 million in savings so far. This substantially reduces what has to be found in future years.

So what will we get for our money?

The Budget isn't just about money: it's equally about what's going to be delivered for the money. In the case of Defence, this comes down to performance targets for the twenty-eight outputs. The Budget papers set broad targets for the preparedness, core skills and quantity of the outputs.

Preparedness

Preparedness refers to the readiness of the ADF to undertake and sustain operations, be they national support tasks, peacekeeping or war. For example, the light infantry output might be required to 'be prepared to deploy a battalion at ninety days notice to assist in a regional peacekeeping operation and to maintain the deployment for twelve months' (this is a figurative example, not a real one).

Core skills

To take into account possible longer term tasks and the requirement to retain broad expertise in the three services, an enduring performance target for nearly all the outputs is to 'achieve a level of training that maintains core skills and professional standards across all warfare areas'.

Quantity

Most of the outputs include one or more 'quantity' measures that try to capture some aspect of *how much* capability will be delivered. Each of the three services uses a different type of measure. For the Navy, it's usually the availability of ships and their crew to undertake a mission; for the Army, it's the presence of adequate quantities of trained personnel and equipment; and for the Air Force (and Army and Navy aviation), it's the number of hours flown.

Recent performance

The past four Defence annual reports have consistently reported against performance targets at the output level, making year-to-year comparisons possible. Table 6 summarises the results from the 2003–04 annual report and tracks the changes from the year before. Defence uses a four-point performance scale for preparedness and core skills: *achieved*, *substantially achieved*, *partially achieved* and *not achieved*. To aid presentation, we've mapped the numerical 'quantity' results according to the key at the bottom of the table.

Between 2000–01 and 2001–02, performance levels remained largely static. In 2002–03, aggregate performance against targets improved substantially, and this positive trend continued in 2003–04. In detail, the Navy's already good performance showed a slight further improvement, while the Air Force posted solid improvements for the second year in a row; only the Army's performance remained largely static. Meanwhile, Defence Operations and Strategic Policy continued to meet their targets but the reported performance of Intelligence declined.

Overall, it appears that the substantial extra funding provided to Defence in recent years for logistics and other initiatives is making a real difference to the delivery of capability, notwithstanding the high operational tempo that has been maintained over the same period.

Table 6: Recent performance

Output	Preparedness	Core skills	Quantity
1. DEFENCE OPERATIONS			
1.1 Command of Operations		↔	
1.2 Military Operations		↔	
1.3 National Support Tasks		↔	
2. NAVY			
2.1 Major Surface Combatants	↔	↔	↑
2.2 Naval Aviation	↔	↑	↔
2.3 Patrol Boats	↔	↓	↔
2.4 Submarines	↑	↔	↔
2.5 Afloat Support	↔	↔	↓
2.6 Mine Warfare	↔	↔	↔
2.7 Amphibious Lift	↔	↑	↔
2.8 Hydrographic	↔	↑	↓
3. ARMY			
3.1 Special Forces	↔	↑	↔
3.2 Mechanised Ops	↔	↔	↔
3.3 Light Infantry Ops	↔	↔	↔
3.4 Army Aviation Ops	↔	↔	↔
3.5 Ground-based Air Defence	↔	↔	↔
3.6 Combat Support Ops	↔	↔	↔
3.7 Regional Surveillance	↔	↔	↔
3.8 Operational Logistics Spt	↔	↔	↔
3.9 Motorised Ops	↔	↔	↔
3.10 Protective Ops	↔	↔	↔
4. AIR FORCE			
4.1 Air Combat Ops	↔	↔	↔
4.2 Combat Spt of Air Ops	↔	↑	↑
4.3 Strategic Surveillance	↑	↑	↔
4.4 Maritime Patrol	↔	↔	↔
4.5 Airlift	↔	↔	↑
5. STRATEGIC POLICY			
5.1 Strategic Engagement		↔	
5.2 Military Strategy & Cmd		↔	
6. INTELLIGENCE		Partially/Substantially Achieved ↓	

Improved since 2002–03: ↑	Static since 2002–03: ↔	Declined since 2002–03: ↓
Achieved	Substantially Achieved	Partially Achieved

Quantity: Above 95% = Achieved; 95% to 75% = Substantially; Below 75% = Partially

Source: 2002–03 and 2003–04 Defence annual reports

Chapter 4

CAPITAL INVESTMENT

An essential component of Defence spending is the investment made in new equipment, facilities and upgrades that allows the ADF to maintain credible military capabilities while other nations continue to modernise their forces. Table 7 shows Defence's planned Capital Investment Program. The table does not include the provision of between $300 million and $380 million per year held in reserve for foreign exchange exposure in the final three years.

Table 7: The Capital Investment Program ($ million)

	2004–05 Projected	2005–06	2006–07	2007–08	2008–09
Major capital equipment	3,062	3,565	3,555	3,895	4,255
Capital facilities	400	447	400	372	366
Other capital	686	583	544	518	489
Capital Investment Program	**4,148**	**4,595**	**4,499**	**4,785**	**5,110**

Source: 2005–06 Defence budget papers

There are three components to the Capital Investment Program.

Major capital equipment projects are worth more than $20 million each and mostly involve the purchase of military equipment. They range from small projects to acquire specialist communications equipment through to massive undertakings, like the $10 billion plus project to replace the F/A-18 tactical fighter fleet.

Capital facilities projects include everything from new barracks to upgrades of existing facilities. The Defence estate includes about 25,000 individual buildings, so upgrading and development never end.

Other capital includes minor capital equipment (projects costing less than $20 million), repairable items, non-capital facilities, plant and equipment, and software and intangibles.

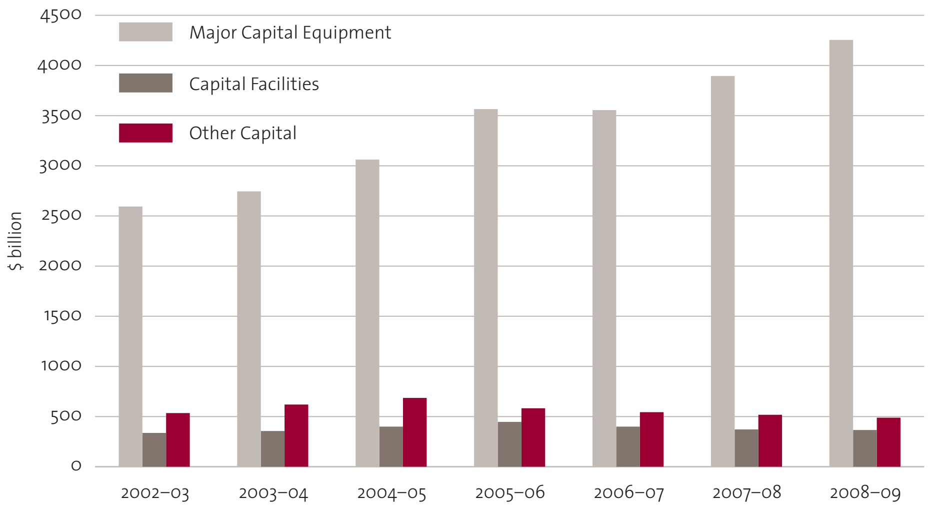
Photo opposite: Newly acquired Australian Army tiger armed reconnaissance helicopter, 2004.
© Defence Department

These three items together make up the total capital program. But not all of this money actually represents capital investment. Around 13.5% is used in the process of acquiring the assets. This includes project office costs, studies, research and development, travel, professional service providers and other overheads. This is in addition to the overhead represented by the infrastructure division in the Corporate Services and Infrastructure group and the DMO, who are responsible for the acquisition processes.

What are the trends in the Capital Investment Program?

The trend across the next four years is for a steady increase in the Capital Investment Program from $4.1 billion in 2004–05 to $5.1 billion in 2008–09 (a 20% increase in nominal dollars). Within these amounts, expenditure on capital facilities and other capital falls slowly, while the total spending on major capital equipment grows (Figure 4). Clearly, even after the reprogramming of capital investment funds, significant growth in spending on major capital equipment is still planned. This won't be an easy task for DMO, even given recent improvements.

Figure 4: Planned trends in the capital budget



Source: 2004–05 Defence budget papers

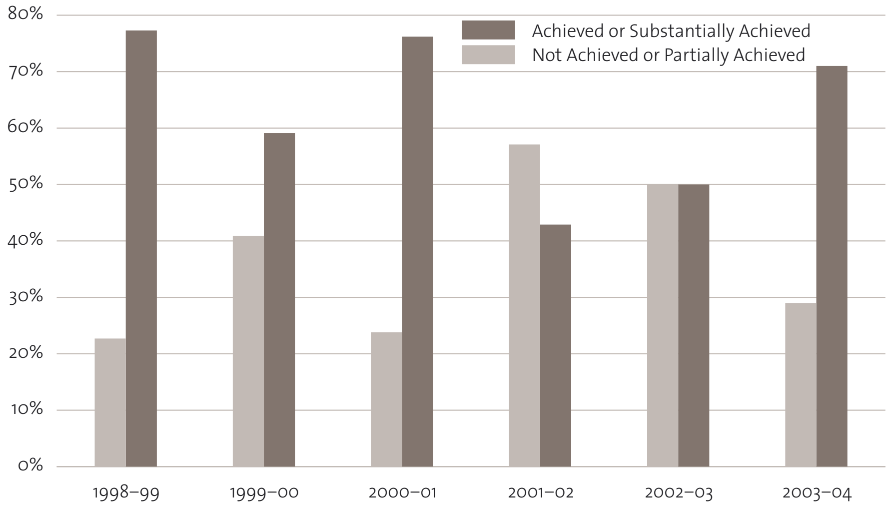
Major capital facilities projects

There are currently thirty-nine approved capital facilities projects. This includes eleven major projects of more than $6 million (totalling $840 million) and twenty-eight medium projects worth from $250,000 to $6 million (totalling $95.5 million). In the 2005–06 Budget, the government foreshadowed fourteen new major capital works projects and sixteen medium projects for parliamentary consideration.

The largest of the current projects are the barracks redevelopments in Townsville ($171 million), the development of facilities for the airborne early warning and control (AEW&C) aircraft capability at Williamstown ($129 million), the redevelopment of HMAS *Albatross* at Nowra ($110 million) and the relocation of the 1st Aviation Regiment to Darwin ($82 million).

The Defence annual report assesses the achievement or otherwise of significant facilities projects. Figure 5 shows the results for the six years to 2003–04. The performance in 2001–02 and 2002–03 wasn't nearly as good as in the previous three years. Pleasingly, performance in 2003–04 shows a return to form.

Figure 5: Recent achievement in significant facilities projects

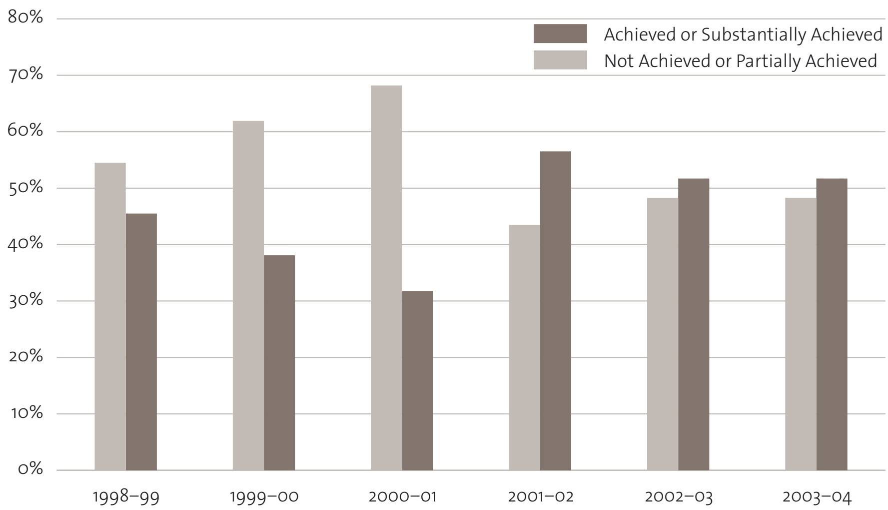


Source: Defence annual reports

Major capital equipment projects

According to recent Defence annual reports, there has been a dramatic improvement in delivery of the 'top twenty' individual projects in the three years to 2003–04 (see Figure 6). It's important to remember that this is a measure of achievement of goals set in that year, rather than long-term progress, and it only applies to the top twenty projects. Nevertheless, it's an encouraging sign.

Figure 6: Recent achievement in major capital equipment projects



Source: Defence annual reports

Looking back at the most recent data from 2003–04, it's still a very mixed bag. Newer projects like the AEW&C aircraft are doing well, as are some of the older tried and true successes like the Anzac ship project. Some old 'problem' projects like the lead-in fighter remain behind schedule, and the high-frequency modernisation project continues to be a matter for concern.

Are well-performing recent projects merely showing the benefits of youth, or are DMO's new business methods paying off? Only time will tell. In any case, while the delivery of some individual projects may have improved, the reality is that the aggregate performance of the major capital equipment program is yet to meet the goals of the 2000 White Paper and its $50 billion Defence Capability Plan of equipment acquisitions.

Delivering the Defence Capability Plan

The White Paper added a lot of money to the Defence budget. In the early years of the decade, most of it was earmarked to boost investment in major capital equipment. Unfortunately, it quickly became clear that the planned program of investment couldn't be achieved on schedule. As a result, last year more than $2.2 billion of previously planned investment was cut from the first part of the decade and reprogrammed to the period 2008–09 to 2013–14. This amounted to the delay of 20% of the planned additional investment in major capital equipment in the first seven years of the White Paper. These delays and other changes were reflected in a revised DCP released in February 2004.

The failure to deliver major capital equipment projects according to the original schedule reflected a number of factors, including the aggressive goals set by the White Paper, ongoing organisational volatility in DMO, and the performance of those in industry contracted to deliver projects. Whatever the reasons, the government commissioned a review of Defence procurement in 2003, the recommendations of which are now being implemented—with some encouraging initial signs.

Some good news!

The past twelve months have seen a turnaround in the performance of DMO. To start with, the organisation is on track to exceed its spending target in 2004–05, and money has been redirected from military personnel ($62 million) and capital facilities ($70 million) to boost the investment budget. Better still, there's sufficient confidence that DMO can deliver projects for $300 million to be reinstated into the investment program for 2005–06. This is an encouraging sign that the DMO reforms are quickly gaining traction.

> … no one has yet suggested that any of the current crop of projects will be delivered early.

Having said this, we need to take care before concluding that all the worries about delivering new capability are over. Some relatively young projects begun in the past several years are now beginning to spend—and projects often do well in their initial stages. Moreover, there are some signs that the increased spending resulted (at least in part) from a reassessment of the cash-flow demands of recent projects. Indeed, the additional troop-lift helicopter project required the redirection of $85 million from the new tank project in

2004–05, along with $70 million from the capital facilities program. Importantly, no one has yet suggested that any of the current crop of projects will be delivered early.

Nonetheless, the ADF's chances of getting the equipment it needs are looking better than at any time in the past four years. And with the recent entry into the program of several large (almost off the shelf) projects, including air-to-air refuelling and additional troop-lift helicopters, the prospects look good for the next couple of years.

The critical patch for DMO will be later this decade, when it begins some of the larger domestic projects, such as the air warfare destroyers and various aircraft upgrades. Not only will these projects be technically challenging, but they'll stretch the limited capacity of the local industry skill base as investment spending climbs steadily higher. And further trouble could be ahead with the planned spending profiles of these big projects. We have no guarantee that they're any better than some that have caused problems recently.

Without projects being approved and transferred on schedule to DMO for delivery, it will be impossible for the capabilities to be delivered on time.

Some bad news

Just as worrying as any of this, if not more so, are the clear signs that the approval of new projects has stalled substantially compared with the goals of the 2004 revised DCP. Without projects being approved and transferred on schedule to DMO for delivery, it will be impossible for the capabilities to be delivered on time.

In May 2004, the situation was as follows. Of the hundred-odd projects in the first three years of the original DCP, all but a handful had been approved and handed over to DMO more or less on schedule. In contrast, DMO was finding it very difficult to spend money (and deliver projects) according to plan.

Twelve months later, the situation is completely reversed. DMO is doing well in delivering (or at least spending) on approved projects, but the approval of projects in the first three years of the 2004 DCP has stalled to a trickle. Of the thirty-five projects slated for approval in 2004–05 and 2005–06, the best we can hope for is that around ten will be approved on schedule. This amounts to several billion dollars in projects that will commence later than planned. Notwithstanding the introduction of some new projects and the acceleration of a couple of others, this means that the approval of new projects is now about a year behind schedule. And remember that this is relative to a plan that was released in February 2004—only eighteen months ago.

What's the problem?

As near as we can determine, there are four reasons why the approval of projects has stalled.

First, the introduction of the new two-pass process of project approval has caused a hiatus while the new system is bedded down. Even though the 2004 DCP was written after the release of the report from the 2003 Defence Procurement Review, it appears that the time and resources required under the new arrangements weren't fully appreciated.

The new process imposes much more stringent demands for information before a project is approved, and it's probably taking longer than first anticipated to gather that information. Or, to put it another way, projects that are too immature to commence are not getting approval. While a delay of this sort is disappointing, it may eventually lead to better results in the long run. Arguably, it's better to delay a project in the early stages to get it right, than to rush in and face delays and cost overruns due to inadequate planning and attention to detail. Hopefully, these delays are a one-off pause on the road to the new regime, although it may be that additional resources will be needed to sustain an adequate flow of projects in the longer term.

Second, the 2004 election will have disrupted the process of project approvals, although at the time that the plan was pulled together the working assumption should have been for an election in 2004–05.

Third, it may be that there's insufficient money to commence new projects (even though the clear expectation with the 2004 deferral of investment spending was that it would be made available if and when it could be spent). If there's a shortage of money, it probably reflects a failure to properly anticipate project cash flow rather than escalation in the cost of individual projects. So far, there has been no sign of cost blow-outs in projects from the early years of the 2004 DCP.

Fourth, it could be that projects are being held back pending the promised Strategic Update. Indeed, as long as the future roles and capabilities of the ADF remain matters of debate, it makes sense to hold off on the approval of projects whose priority is not assured.

Chances are that all four factors have played a part in bringing us to the current paradoxical situation in which investment money is being spent faster than planned for in early 2004, but projects are being approved more slowly.

Sorting it all out

In early 2005, Defence's public position was that it hoped to release a revised DCP mid-year at the annual Defence + Industry conference. This would have been timely. With the 2004 DCP severely disrupted, it's time to put things back on track. Not only is this important from a defence industry perspective, but Defence needs to reconsider its plans in the light of what's been learned about the practicalities of the new project approval process.

... we can be cautiously optimistic that long-term defence plans, and in particular the DCP, will soon be put back onto a coherent basis.

This introduces further uncertainty into an already opaque situation in which our strategic priorities remain unresolved and long-term Defence funding is undecided past the end of the decade (despite a promise last year that the issue would be resolved in the current budget). This last point is particularly important. It makes no sense to try to run a ten-year program of capability development on a five-year funding profile.

This trinity of uncertainty (policy, priorities, funding) has led to calls from many quarters for a new White Paper—calls that the government has consistently resisted. The government has now at least partly relented, with the Defence Minister's recent announcement of a new Strategic Update and a revised DCP before the end of this calendar year. Moreover, we understand that this will be accompanied by a decision on long-term defence funding for release in the next Budget. Thus, we can be cautiously optimistic that long-term defence plans, and in particular the DCP, will soon be put back onto a coherent basis.

In the longer term, there's an important lesson in all this. It doesn't make sense to stagger from one ad hoc Strategic Update to another, and ditto for the DCP. These should be annual events that are explicitly linked to each other and the budget process. This was what was envisaged back at the time of the 2000 White Paper, and it makes even more sense today. Nobody would suggest that Treasury delay the Budget because of uncertainty in the economic environment, so why don't the same rigour and discipline apply to defence capability planning?

Chapter 5

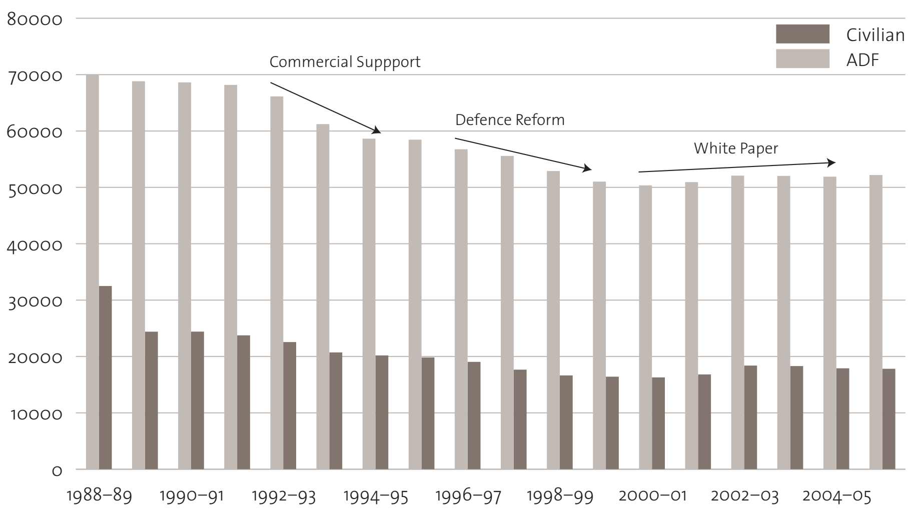
PERSONNEL

In this chapter, we look at the raw numbers and cost of the Defence workforce. This is an unashamedly limited view of the complexities of Defence personnel, but one that is appropriate for a budgetary report.

Personnel numbers

In the decade following the Force Structure Review in 1991, ADF numbers dropped from around 70,000 to 50,000 permanent personnel, as shown in Figure 7. Over the same period, civilian numbers dropped from around 25,000 to 17,000.

Figure 7: Defence workforce, 1988–99 to 2005–06



Source: Defence Annual Reports and 2005–06 budget papers

Photo opposite: A Defence family commemorates Anzac Day at a dawn service held at the Darwin cenotaph, 25 April 2003. © Defence Department

The bulk of these reductions were due to outsourcing under the Commercial Support and Defence Reform programs, and reductions due to the 1991 Force Structure Review. In fact, the initial goal of the Defence Reform Program was to reduce the strength of the ADF to 43,500, but this was soon revised up to 50,000, thereby arresting the decline. The 2000 White Paper subsequently set permanent ADF numbers on a growth path towards 54,000. However, as a result of the 2003 Defence Capability Review, a long-term target of around 53,000 is in place because of planned cuts to capability later this decade. (Actually, numbers will need to rise higher in the interim, given the schedule of new capability and the retirement of old capability.) Recent personnel numbers appear in Table 8, along with the estimates for 2005–06.

Table 8: Workforce summary for Defence plus DMO (average funded strength)

	00–01 Actual	01–02 Actual	02–03 Actual	03–04 Actual	04–05 Projected	05–06 Budget
Navy	12,396	12,598	12,847	13,133	13,115	13,209
Army	24,488	25,012	25,587	25,446	25,389	25,484
Air Force	13,471	13,322	13,646	13,455	13,393	13,498
Total	**50,355**	**50,932**	**52,080**	**52,034**	**51,897**	**52,191**
Reserve	19,835	18,868	19,620	20,488	20,250	20,150
Civilian	16,292	16,819	18,385	18,303	17,906	17,818

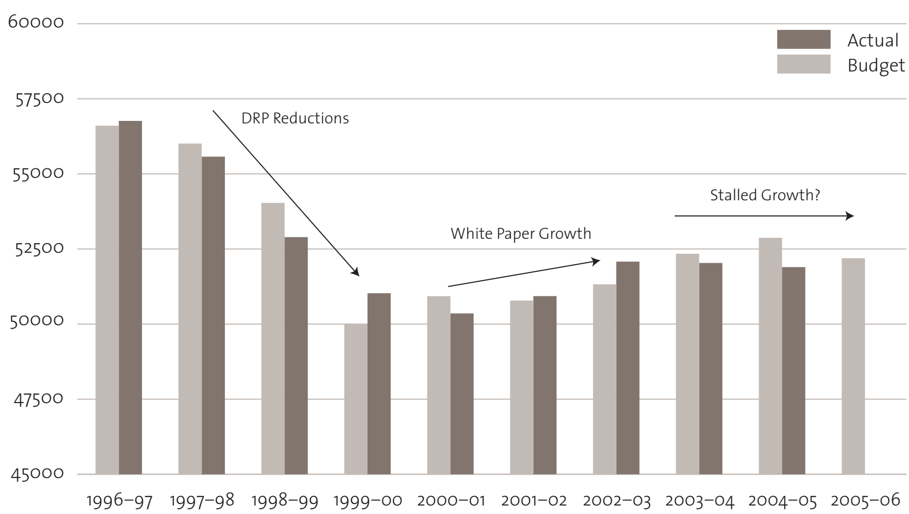
Source: Defence annual reports and 2005–06 budget papers

What are the recent trends?

Permanent ADF numbers

In 2003–04, the ADF shrank for the first time since 2000–01, albeit by only forty-six positions. But this was at a time when the goal was to increase the size of the force. Most worryingly, the Army's average funded strength that year ended up 495 positions below target. The 2003–04 Defence annual report seems oblivious to the facts when it boasts that *'This process continues to move the ADF towards the additional 3,555 average funded strength provided under the Government's commitment to an Army with six full-time battalions and an enhanced combat support group in the Air Force'*. The numbers say otherwise (Figure 8).

Figure 8: ADF personnel, 1996–97 to 2005–06 (average funded strength)



Source: Defence annual reports and budget papers

Unfortunately, these adverse trends have flowed on into 2004–05, with the projected average funded strength almost a thousand personnel below target. This includes a shortfall of 52 in the Navy, 646 in the Army and 277 in the Air Force. The net result was that, once again, the ADF shrank—this time by 147 personnel. Consistent with this, a more realistic target of 52,191 has been set for next year.

The annual change in ADF strength is the difference between the numbers of people recruited into and separated from the force (typically around 5,000 in each case). Since the planned change in strength is usually a much smaller number, the outcome is finely balanced. With this in mind, we turn now to examine ADF recruitment and separations.

Table 9 shows the percentages of recruitment targets that have been met over the nine years to 2003–04. Following solid improvements earlier this decade, which saw the rate grow from 76% to 93% in 2001–02, performance dropped back to the mid-80% level in 2002–03 and 2003–04. This is a long way short of the healthy 90% plus figures from the mid- to late-1990s.

Table 9: Recruitment targets met (per cent)

	95–96	96–97	97–98	98–99	99–00	00–01	01–02	02–03	03–04
Navy	98	92	98	76	57	74	85	84	86
Army	99	98	94	78.5	83	79	100	79	84
Air Force	86	93	101	90.5	83	88	87	94	90
ADF	**96**	**94**	**97**	**80**	**76**	**80**	**93**	**84**	**86**

Source: Defence annual reports

Table 10 shows the percentages of ADF personnel who separated from full-time military service over the same nine years. Some care must be taken with this data because figures for earlier years were affected by the deliberate reduction in the size of the ADF between 1997 and 2001 under the Defence Reform Program. Nevertheless, separation rates from 2001–02 to 2003–04 were lower than in 1995–96 before the cuts began. Note the historically low figures achieved by the Navy and the Air Force.

Table 10: ADF separation rates (per cent)

	95–96	96–97	97–98	98–99	99–00	00–01	01–02	02–03	03–04
Navy	13.0	11.5	11.1	12.6	13.3	13.2	11.5	11.6	10
Army	12.5	10.4	10.9	12.9	13.0	13.2	11.5	9.8	11
Air Force	9.0	9.0	10.0	11.9	11.6	15.6	10.4	8.1	7
ADF	**11.6**	**10.3**	**10.7**	**12.6**	**12.7**	**13.8**	**11.2**	**9.8**	**10**

Source: Defence annual reports

In summary, the plan to grow the ADF stalled in 2002–03 as adverse recruiting trends began to outweigh favourable retention figures and, as a consequence, personnel numbers have fallen over the past two years. All the services are concerned about personnel numbers, although the Navy and especially the Air Force appear to be in a much better position than the Army. But things can change quickly: although the Navy is probably in the best position it's been in for many years, the 2005–06 budget papers say that it's recently experienced an increase in separation rates and lower recruiting achievement.

Moreover, it's worth remembering that all the services have shortages in specific skill categories and rank levels. It takes a long time to rectify shortages once numbers fall below target because it takes years for personnel to be trained and gain sufficient experience to take up jobs at more senior levels, even (or especially) among the other ranks. It's likely that the Navy is still working to make up for the difficult period it experienced at the start of this decade.

What's the cause?

There's probably much more to the problem of ADF recruitment and retention than that unemployment has reached a new low. In fact, the fall in unemployment has not been that dramatic, going from 6.4% to 5.8% between 2000–01 and 2003–04. There's little doubt that changing expectations among young people are making it more difficult to attract them into the ADF, and to retain them once they join.

> … over the past five years, half a billion dollars has been directed towards improved conditions for military personnel.

It's not that Defence hasn't tried to address the problem. It's developed a decade-long Workforce Plan and an accompanying People Plan that seek to define the workforce needed and take the action necessary to deliver it. Importantly, more than planning has occurred; over the past five years, half a billion dollars has been directed towards improved conditions for military personnel. And the 2005–06 Budget contained modest but specific measures for recruitment and retention initiatives.

In the fullness of time, these measures might gain traction and deliver a sustainable workforce. But can we afford to make that bet? Perhaps now is the time to start considering more radical approaches—certainly that's what it took to get DMO back on track. In many ways, the standard twenty-year military career is an anachronism that parallels civil employment practices of the last century, not this one. To change this will demand a fundamental rethink about the nature of military careers and some innovative ideas for alternatives.

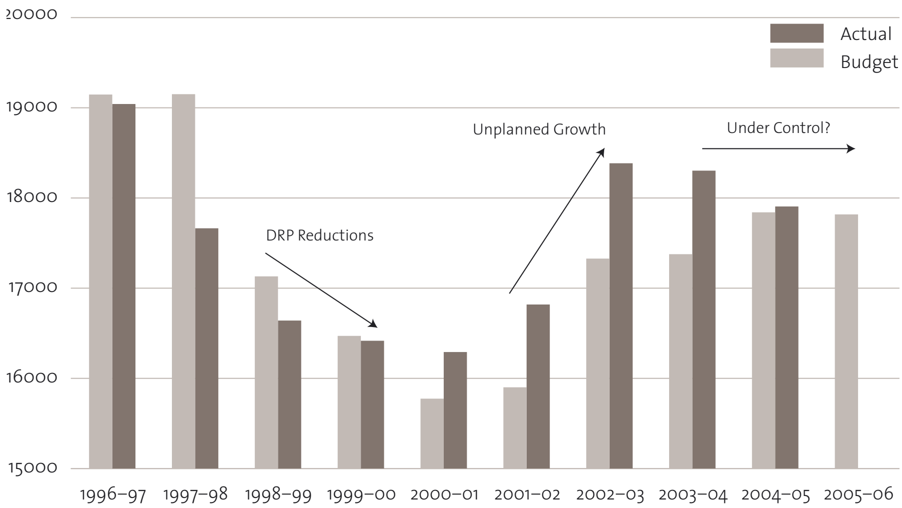
Civilian numbers

Although civilian numbers fell quickly under the Defence Reform Program, they grew back very rapidly in the first two years of White Paper implementation—three times more quickly than military numbers grew. What's more, the growth was largely unplanned (Figure 9). Following a freeze on civilian recruitment in 2003, the growth was finally brought under control in 2004–05. This is important: unplanned growth in civilian personnel numbers represents an increase in administrative overheads, which inevitably diverts resources away from military capability.

Reserve numbers—declining again

Reserve numbers increased by 752 personnel between 2001–02 and 2002–03, and 868 between 2002–03 and 2003–04. This compared favourably with the decline of around 1,000 between 2000–01 and 2001–02. However, in 2003–04 numbers fell by 238 and are budgeted to fall by another 100 in 2005–06 due to lower Army recruiting. Consistent with this, the Army's Protective Operations output, which employs most of the reserve personnel, mentioned personnel shortages as a problem in the 2003–04 Defence annual report.

Figure 9: Civilian personnel, 1996–97 to 2005–06 (average funded strength)



Source: Defence annual reports and budget papers

How much do personnel cost?

Personnel expenses in 2005–06 will be around $6.7 billion, rising to $7.2 billion in 2008–09. At about 41%, this makes personnel the largest single slice of the Defence budget.

In the past, growth in military personnel costs has created pressure on the Defence budget not because growth in remuneration has been out of step with civilian sectors, but because Defence didn't receive indexation to cover real growth in personnel costs. To remedy this, the White Paper provided funding for 2% real growth in per capita military and civilian personnel costs (although this extra funding did not commence until 2004–05). Following the 2004–05 Budget, the additional supplementation for military personnel cost growth was increased to 2.5% per year.

… more civilians are gradually being employed at more senior levels, resulting in upward pressure on per capita expenses.

According to data in this year's budget papers and past annual reports, per capita military personnel costs have been growing in real terms by around 1.3% a year over the past six years, which is well within the supplementation being provided. In contrast, civilian per capita personnel costs have been growing by around 2.9% in real terms, which exceeds the supplementation provided. This latter figure can't be the result of faster rates of wage growth for civilian employees because wage increases for civilians and military personnel have, on average, been identical for more than a decade. Most likely, it's because more civilians are gradually being employed at more senior levels, resulting in upward pressure on per capita expenses. We expect this to occur with the transfer of expensive short-term contractor jobs to civilian personnel, especially in the health service area where salaries will be relatively high because of the shortage in medical professionals in Australia.

Chapter 6

DEFENCE MANAGEMENT

The 2003 ASPI policy report *Sinews of War* charted the recent history of financial management in Defence, with emphasis on the particularly turbulent years of 2000 and 2001. During that period, several factors conspired to cause nothing less than a serious breakdown in fiscal discipline and budgeting within Defence.

Things have changed a lot since then and, although some serious problems remain, there have also been some real improvements. In this chapter, we look at the state of play in Defence financial and business management and examine what's been achieved in implementing the recommendations of the 2003 Defence Procurement Review.

The qualification of the 2003–04 financial accounts

Media reports of an '$8 billion Defence black hole' gave the impression that the department had somehow misplaced, or perhaps lost outright, assets worth around half of its annual budget. The truth, while worthy of concern, is hardly that dire.

At the centre of the matter was the qualification of Defence's financial statements for 2003–04 by the Australian National Audit Office (ANAO). This followed similar but less serious problems in Defence's financial accounts in the previous two years.

Put simply, Defence and the ANAO were unable to resolve significant uncertainties in assets and liabilities worth around $8 billion—hence the horror headlines about 'black holes' to that amount. Fortunately, the $8 billion figure isn't a measure of the uncertainty in the financial accounts, but rather of the amount over which there is (according to accounting standards) an unacceptable uncertainty. In most cases, the threshold is set at 5% of the total value. Roughly speaking, Defence's

Photo opposite: Russell Offices, Canberra. © Defence Department statements were qualified because the uncertainty surrounding $8 billion of assets and liabilities exceeded $400 million (actually, the indicative uncertainty in several of the categories was closer to 10%, or around $800 million). A serious matter, to be sure, but not the same as misplacing close to 1% of the nation's GDP—as was sometimes implied by the $8 billion figure in the media.

It's hard to see what will really have been gained once the battle to tame Defence's rogue balance sheet is won.

Does it really matter?

Yes and no. In one sense, whether Defence can precisely account for the *value* of all its assets and liabilities is of little importance. In four years of closely watching the Defence budget, this author has yet to see a single datum emerge from the accounting of assets and liabilities that might usefully inform the management of the defence dollar. After all, if Defence's property holdings were to rise in value by 50% or its military equipment were to fall in value by 50%, what action would need to be taken? It's hard to see what will really have been gained once the battle to tame Defence's rogue balance sheet is won.

But in another sense, it matters a very great deal. Although much of the uncertainty derived solely from the valuation of individual items, this wasn't true in every case. The audit also revealed weaknesses in internal controls over the stocktaking and accurate recording of physical inventory quantities. This is concerning—if Defence can't account for the assets it has on hand, it can't possibly be managing its assets in a strategically prudent manner.

These problems reflect longstanding and systemic problems with the key management information systems in Defence as well as overall financial business processes. Of course, this is far from a unique position for a Western military to find itself in. The US Department of Defense can't complete auditable accounts, and the UK and Canadian defence ministries are both heavily qualified in some of the same ways as Australia's Defence Department.

So why did it happen this year?

There are several reasons why the 2003–04 financial accounts were more severely qualified than previously, including that the auditor devoted 60% more resources to the audit than in the previous year. Moreover, the audit built on the accumulated understanding of several years of ongoing scrutiny by the ANAO.

At Senate Estimates hearings in February 2005, Defence gave four reasons for its problems with inventory accounting:

- the accumulated impact of a number of years of suboptimal stocktaking practice, some resulting from structural changes in the organisation, and inadequate discipline in stock recording over many years
- high levels of stock and equipment movement over several years due to high operational tempo
- the prolonged introduction of the Defence Integrated Distribution System warehousing and distribution contract

- disruption due to ongoing upgrades of Defence's logistics management information system.

... it will probably take at least two or three more years before an unqualified audit report can be achieved.

When will it be fixed?

Defence has been working to fix its management information systems and bed down its business processes since the late 1990s, following the Defence Efficiency Review. It's a story of repeated underestimation of the task, growing delays and increasing costs. In early 2005, Defence said that it will probably take at least two or three more years before an unqualified audit report can be achieved.

Significant resources are being devoted to the task. In 2004–05 alone, some 600 staff years costing around $50 million will be consumed, plus at least another $12 million on remediation and reform work. This includes performing 100% stocktakes in major defence warehouses, which is itself a significant undertaking.

This is just the start of the work to be done. Defence's plethora of management information systems remains inefficient and ineffective—the whole being somewhat less than the sum of the disparate parts. Funding of between $50 million and $85 million has been earmarked to fix the overall management information system over the period 2004 to 2007, and a further $60 million to $100 million is pencilled in for the next decade. In addition, around $125 million has been allocated specifically to improve the logistics information systems towards the end of this decade. Unfortunately, the remediation of Defence's management information systems has slipped behind schedule. Less than $10 million dollars of capital funding was approved for the task in 2003–04, against the $50–80 million originally planned.

In a positive move, this year's budget papers devoted an entire section to the remediation of the financial statements, detailing the activities and major outcomes planned over the next two years. While this isn't a guarantee of success, it's a sign that Defence is tackling the problem head on.

DMO reform

For anyone watching Defence over the past eighteen months, the big news has been the reform of DMO following the 2003 Defence Procurement Review. This program is being overseen by a Defence Procurement Advisory Board with high-level private and public sector membership.

The most visible changes relate to the risky billion-dollar business of equipment procurement, but this is only half the story. There are some equally important moves afoot in the way DMO provides materiel support services like repair, maintenance and supply to the military—moves that are fundamentally changing the way Defence is managed internally.

Tidying up the Q-store: procurement reform

Following the 2003 Procurement Review, a new CEO was appointed to the DMO and a new three-star position (Chief of Capability Development Group) was created in the HQ to take responsibility for developing new capability proposals. They both have key roles in changing the way Defence procures new equipment.

Capability definition

The three-star capability supremo has to make sure that future acquisition proposals can deliver the capabilities the government wants on time, within budget and at acceptable risk. This task, called 'capability definition' in Defence-speak, is done within a strengthened 'two pass' system of government project approval that has been codified into the Cabinet Handbook. In addition, the Department of Finance and Administration now has a more prominent role in project scrutiny and assurance. And to improve the financial analysis of projects, both Defence and Finance are establishing centres of expertise.

Capability delivery

Once a project is approved, DMO's CEO becomes responsible for delivering it via a formal Materiel Acquisition Agreement. To improve DMO's capacity to deliver projects on time, within budget and to specification, the organisation has been re-established as a 'prescribed agency' that's independent of Defence in some important ways. This will help DMO to become a more commercially oriented organisation that's better able to deal with industry.

For this new arrangement to work effectively, DMO and Defence have to work closely together. It's impossible to make an informed decision about what to buy (capability definition) without understanding the practicalities of delivering it (capability delivery). Moreover, it's also envisaged that industry will be involved early in the process to help refine cost, schedule and risk. This makes good sense. It's hard to see how anyone is better placed than industry to provide the data needed for informed cost–capability trade-offs.

… industry grumbling is at about the right level to demonstrate that DMO is protecting the taxpayer's dollar with an appropriate degree of care.

Significant progress has been made. The organisational changes to DMO and Defence are well developed. The DMO was established as a prescribed agency, with its own budget papers and financial statements, on 1 July 2005. The whole-of-government framework for project approvals is in place, and Cabinet has been looking more closely than ever before at the details of projects. DMO has an extensive internal reform program underway, and a number of new appointments have been made at senior levels. Internal reporting on acquisition projects is robust, regular and standardised, and Defence and DMO are working closely on developing proposals for new projects. Best of all, industry grumbling is at about the right level to demonstrate that DMO is protecting the taxpayer's dollar with an appropriate degree of care.

As far as actual results go, as we saw in Chapter 4, the news has been mixed. For DMO's part, the delivery of projects has improved in the past twelve months to the extent that

$300 million of previously deferred investment funds have been clawed back for 2005–06. Results are less positive on the capability definition side, with a very substantial delay now hanging over the approval of new projects.

We should be neither too optimistic about the improvement in DMO's delivery of projects, nor too pessimistic about the delayed project approvals. It's early days yet in delivering the very large increase in investment planned for the rest of the decade. If nothing else, industry capacity constraints will make this a difficult job. And while the delay in project approvals is disappointing, it reflects—in part at least—a structural shift as projects undergo a much closer level of scrutiny than ever before.

Tidying up the workshop: materiel sustainment reform

Far less visible than the changes to procurement is the transformation underway in how DMO sustains the current fleets of platforms and other equipment in the ADF. This includes everything from the maintenance of ships, aircraft and vehicles to the provision of munitions, fuel and other consumable items that keep the ADF running.

One of the byproducts of establishing DMO as a prescribed agency is that the support that it provides to the three services has had to be identified, costed and matched to the specific force elements receiving the support. This has resulted in a much clearer picture of where resources are going and to what end. This is formalised through a series of Materiel Sustainment Agreements, the total value of which is around $3 billion per year. Each month, DMO reports in detail to Defence on the status of materiel sustainment.

This is a much more businesslike arrangement for materiel sustainment than has been in place before. In fact, it's arguably what the 1997 Defence Efficiency Review had in mind when it took materiel sustainment away from the individual services and centralised it in Support Command (which became part of DMO in 2000). Pity it took this long.

In the 2004 ASPI policy report *A Trillion Dollars and Counting*, we argued that Defence needed to move away from Soviet-style central planning, and give the service chiefs and other output executives control over the resources needed to deliver their outputs. In a very tangible way, the reforms to materiel sustainment wrought by the prescription of DMO are a solid step in this direction.

Acronyms and abbreviations

ADF	Australian Defence Force
CDF	Chief of the Defence Force
DCP	Defence Capability Plan
DMO	Defence Materiel Organisation
GDP	gross domestic product

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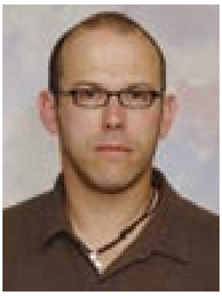

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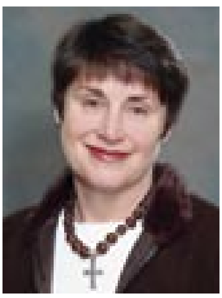

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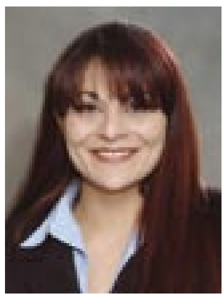

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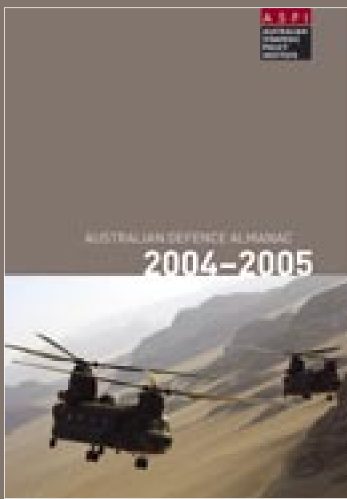

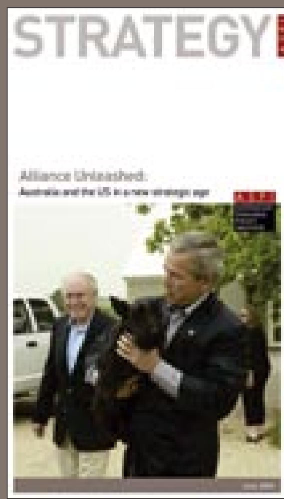

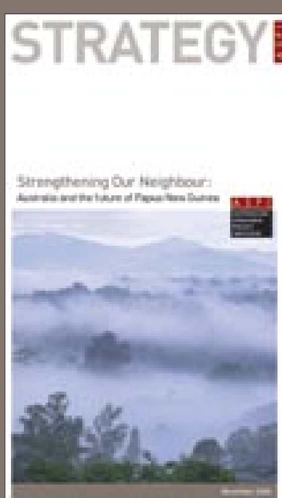

Your Defence Dollar:
The 2005–06 Defence Budget

In 2005–06, Defence will spend $17.5 billion. This amounts to 1.9% of gross domestic product and 8.5% of Commonwealth payments.%%1

New initiatives in the Defence budget will account for more than $1.2 billion in spending across the next four years. The largest single item is $420 million to fund Australia's ongoing military presence in Iraq. There's also an extra $300 million for capital investment, and $252 million for a variety of security enhancements. But Defence has to deliver all this with only $780 million in new funds—leaving a shortfall of $439 million. Fortunately, Defence is well placed to deliver the required savings following several years of disciplined budgeting.

One area of concern is military personnel numbers. Despite spending $500 million over five years on initiatives to improve the recruitment and retention of military personnel, the size of the permanent ADF has fallen for two years in a row.

On the positive side, good progress is being made in the Defence Materiel Organisation following the 2003 Defence Procurement Review. Spending on projects has picked up significantly and is projected to exceed the budgeted target for 2004-05. Moreover, $300 million of deferred spending has been reinstated into the budget. This is a significant boost for the prospect of delivering the government's $50 billion decade-long program of capital investment, the Defence Capability Plan.

Unfortunately, at the same time, the approval of new projects by the government has stalled in the past eighteen months. This introduces further uncertainty into an already opaque situation in which our strategic priorities remain unresolved and long-term Defence funding is undecided past the end of the decade.

Fortunately, the Defence Minister recently announced that we'll have a new Strategic Update and a revised Defence Capability Plan before the end of this calendar year. We understand that this will be accompanied by a decision on long-term Defence funding for release in the next budget. Thus, we can be cautiously optimistic that long-term defence plans will soon be put back onto a coherent basis.

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