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"The 2011-12 Defence Budget"

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This year's defence budget caused considerable alarm in some quarters.

One commentator said that

> *'…cuts to the defence budget announced last week will cripple Australia's capacity to cope with a serious security crisis during the next quarter of a century'.*

He went on to observe that

> *'…the government has not only removed funds from priority defence acquisitions but it has also seriously damaged the trust of senior Defence personnel'.*[i]

Building on this theme, another commentator said that

> *'…the Government is, in an underhanded and duplicitous way, shredding the previously announced 2009 defence plan'.* [ii]

Given the raw facts in the budget, such assessments are perhaps not surprising:

- $2.4 billion of planned investment in equipment and facilities was deferred to beyond 2014, and
- $3.9 billion of mostly recurrent funding promised for the next decade was taken back by the government.

On the surface, it might reasonably be concluded that the government has short-changed Defence to ensure it can deliver a surplus in 2013—a political Holy Grail in the current environment.

But that's not my conclusion. Nor do I think that the government has demonstrated a reduced commitment to achieving the goals of the 2009 White Paper in this budget.

Instead, I see what's happened as symptoms of serious and long-standing problems with Defence's financial management and capability planning. My aim today is to explain what these problems are and to propose solutions.

But first, to provide context for what follows, I need to finish describing this year's defence budget.

Next financial year the Department of Defence will spend $26.5 billion representing 1.8% of Australia's GDP. That's an increase in real dollar terms of 4.2% on what they've spent this year.

But there's a catch. Next year's increase only arises because $1.5 billion from the current year is going to be handed back; including $1.1 billion of investment funding and $400 million of recurrent funding.

And it could have been worse, without the last-minute opportunity buys of an extra C-17 *Globemaster* aircraft and the second-hand HMS *Largs Bay* from the United Kingdom, the hand back of funds would have been closer to $2 billion.

Here's the critical point; the cuts and deferrals in this year's budget are simply an acknowledgement that Defence cannot spend the money it asked for back in 2009.

On the investment side, the deferrals reflect the poor delivery of projects by industry and the tardy approval of projects by government.

On the recurrent spending side, the cuts largely reflect a systematic overestimate of the resources needed—though delays to the arrival of new capability are also a factor.

So where does this leave us?

On the basis of this year's budget, and new information that has become available over the past twelve months, we can now assess the progress in implementing the government's *2009 Defence White Paper,* and its attendant *Defence Capability Plan* and *Strategic Reform Program*.

Slide 1: Force 2030, the Defence Capability Plan and the Strategic Reform Program

The *Defence Capability Plan* and *Force 2030*

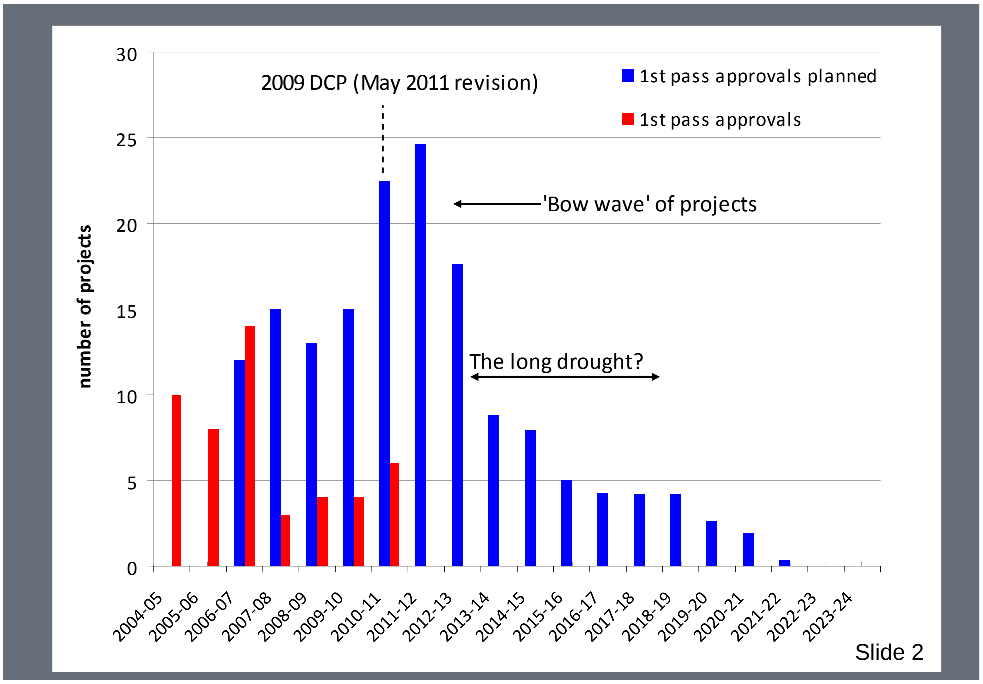
Since 2000, the development of the defence force has been based around a long-term program of investment in new equipment; the *Defence Capability Plan* (DCP). The latest public version of the plan was released in December 2010 and covers the decade to 2019.

It tells us about the acquisition projects that Defence plans over the next decade in pursuit of *Force 2030*, the defence force envisaged in the 2009 White Paper. Given the inherently extended time needed to deliver defence projects, the current ten-year plan should contain around 75% of the additional equipment that will be in the defence force in 2030.

Defence's incoming government brief from late last year said that the 'implementation of *Force 2030* is on track but under pressure'. No such claim appears anywhere in this year's budget.

Instead, Defence say that the 'majority of adjustments to funding for *Force 2030* projects in the Budget involve projects commenced before the 2009 Defence White Paper'—as if only projects commenced after the 2009 somehow count.

They can change the goalposts all they like, the fact is that the implementation of *Force 2030* has fallen steadily behind schedule over the past two years. First-pass approvals—the lead indicators of future activity—are most telling. Over the past 24 months, a mere ten projects have been given the nod, whereas more than three times that number was planned. And it's set to get worse.



Slide 2: First-pass approvals; historical and planned

Take a look at Slide 2 – which plots the number of planned and achieved first-pass approvals from 2004-05 onwards including the figures taken from the latest version of the DCP as amended in the May budget. Apart from the small number of classified projects which are not listed in the DCP, this is a complete picture of current plans.

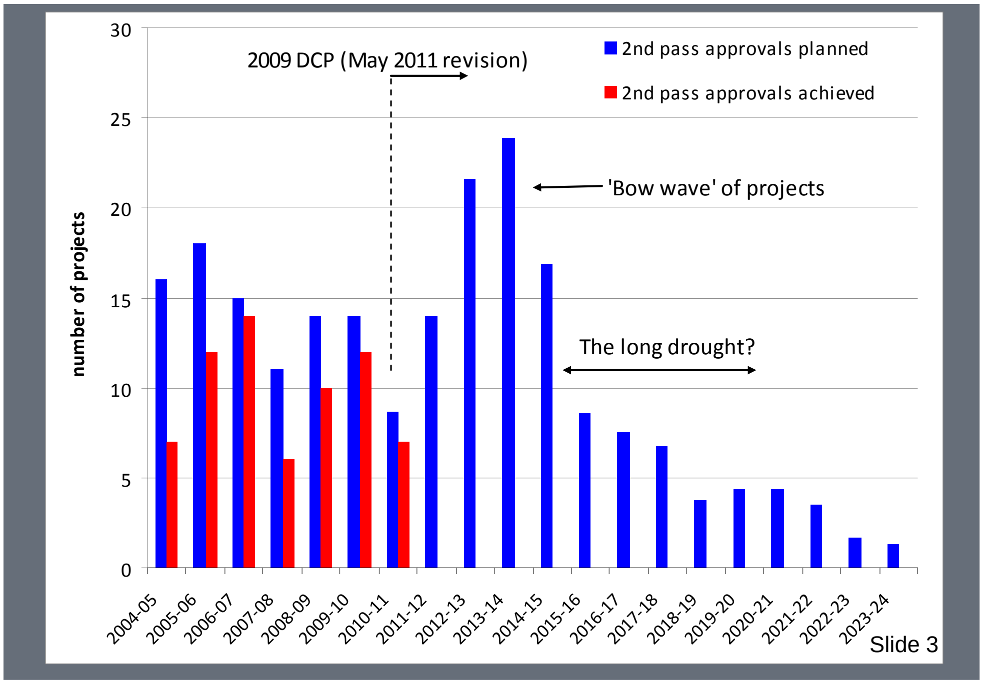
And in case you are wondering, you won't find this information in a table at the back of the DCP—Defence stopped disclosing this sort of detail several years ago—it took me a long while to extract it by statistical means.

Two things are apparent:

First, there is an enormous bow wave of approvals over the next two years. Around 58 first-pass approvals are going to be required over the next 25 months to meet the current schedule—compared with the 10 achieved over the past 24 months.

Second, despite being a 10-year rolling program (based on an undisclosed 20-year program); there is a long drought of approvals beginning in the middle of the decade. This raises serious questions about the sustainability and completeness of the DCP.

While the situation with second-pass approvals is not quite as bad, it is hardly more encouraging. Consider Slide 3:



Slide 3: Second-pass approvals; historical and planned

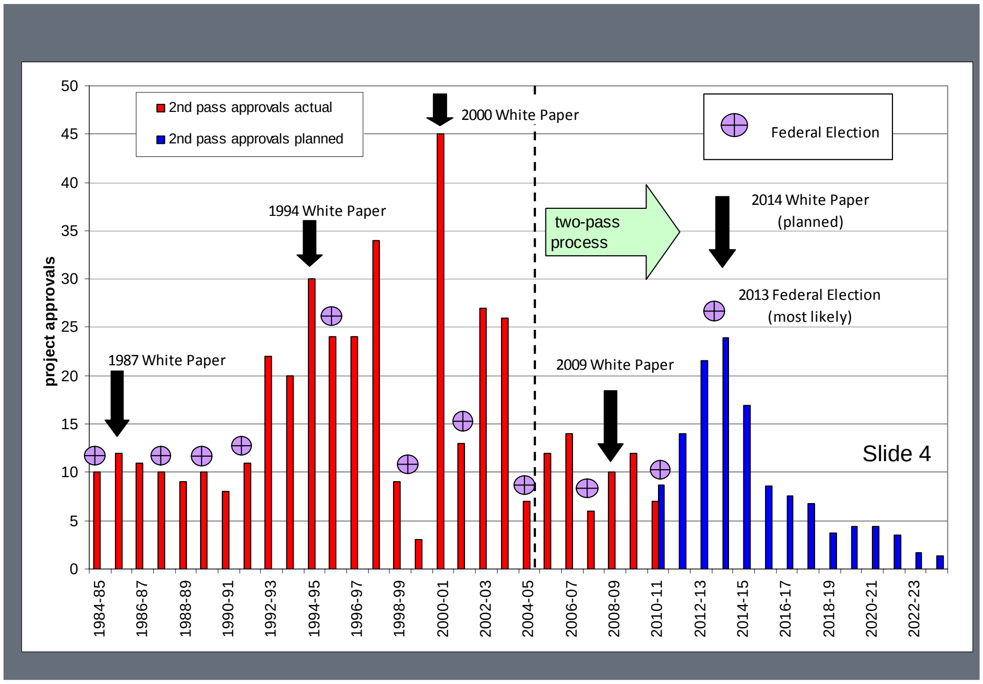
Of the seven non-classified second-pass approvals[iii] that have been achieved this year, only four were listed in the DCP, and two of these resulted from splitting a single phase of a project into two parts.

Of the remainder, two were unplanned opportunity buys driven in part by this year's investment underspend (C-17 *Globemaster* and *Largs Bay* acquisitions), and the final is the additional purchase of Bushmasters—effectively a change of scope to an existing project. The net result is that only three projects have been removed from the DCP over the past twelve months.

In any case, because a great many future second-pass approvals are contingent on the mounting back-log of first-pass approvals, caution is needed in extrapolating even the recent modest rate of second-pass approvals into the future.

Given what was planned, and even taking the disruption due to the election into account (which should not have come unexpected), the rate of approvals over the past 24 months has been disappointing. Yet, it is not surprising.

Consider Slide 4:

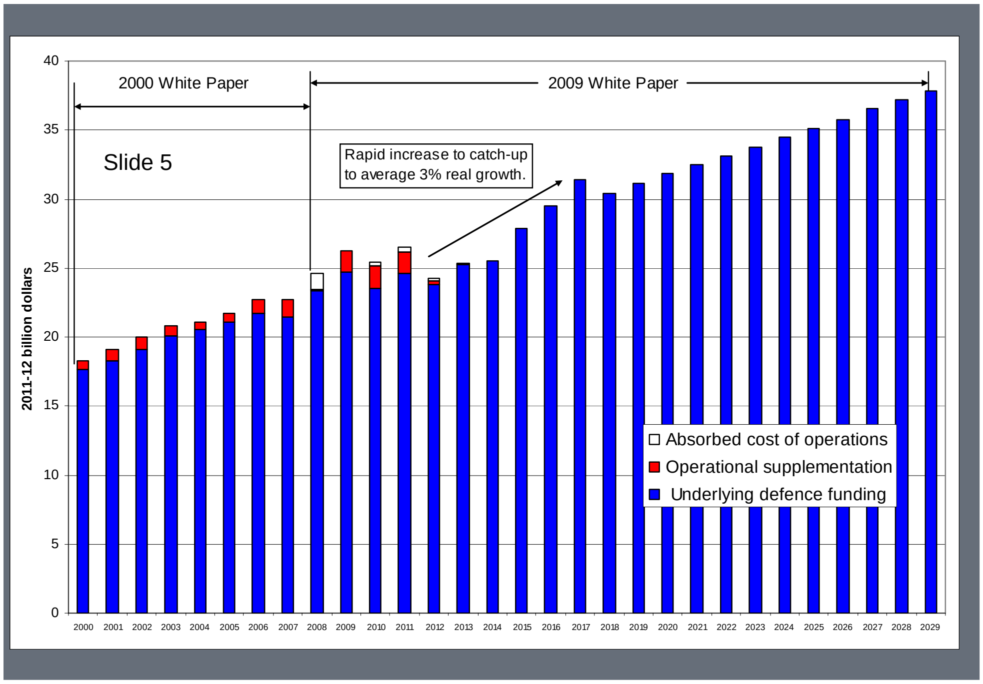


Slide 4: Second-pass approvals – the impact of white papers and elections

Since the adoption of the two-pass process in 2004, approvals have taken significantly longer to achieve than they used to. Defence is responding by expanding, diversifying and up-skilling its capability development workforce. While this is to be commended, such programs take time and cannot deliver a rapid turn-around.

In any case, to complicate matters further, there's a White Paper planned for 2014 (not to mention an election the year before), which will be highly disruptive of progress if past experience is anything to go by.

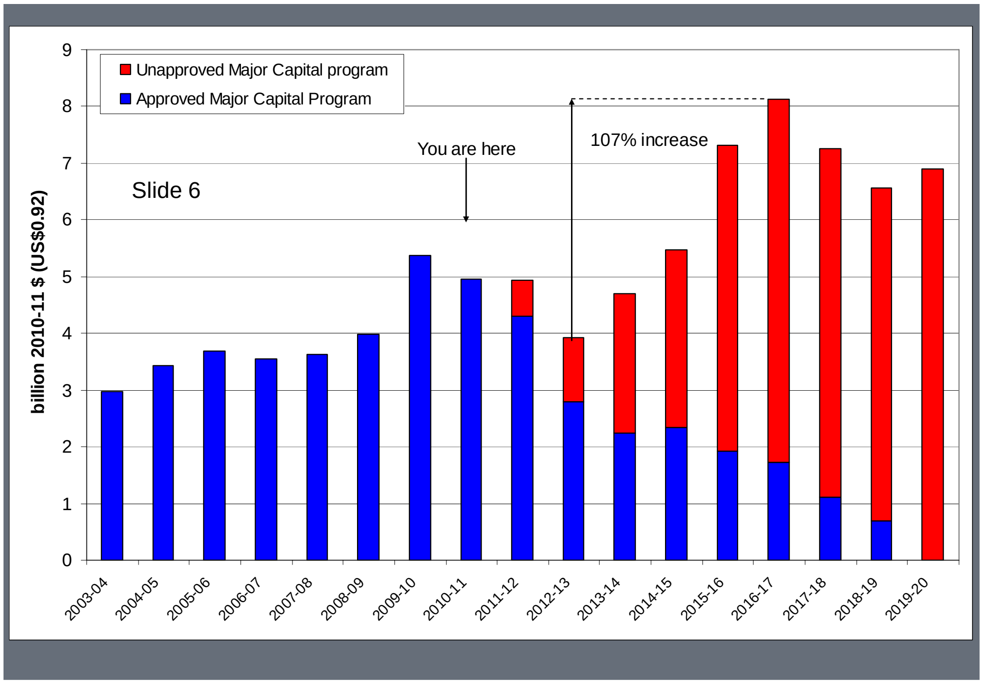
Defence's already ambitious plans are about to be hit by a perfect storm.



Slide 5: The Defence budget; historical and planned

If the reality gap between past and planned approvals was all we had to worry about, things would be bad enough. But it gets worse. Because of the deferral of defence funding back in 2009 to accommodate the fiscal impact of the Global Financial Crisis, (Slide 5), baseline defence spending (exclusive of operational supplementation) will decline towards 2012-13—the year when the government plans to return to surplus. After that, it rises quickly to regain the promised '3% real growth' over the decade.

The trouble is that most of the contraction and subsequent growth is concentrated in the major capital investment program. See Slide 6:



Slide 6: Major Capital Program – past and future

As best I can estimate, this means that spending on new equipment is set to rise by in excess of 100% in a period of only four years. This seems optimistic in the extreme given that most of the delays experienced this year reflect the non-delivery of approved projects by industry.

Unless the plan is to buy a massive quantity of new equipment off-the-shelf from overseas, this rapid expansion will sorely test the capacity of industry at the same time as they compete for skilled workers in what's shaping up to be the largest mining boom in Australia's history.

Thus, as things stand, Defence's acquisition plans over the next several years are simply unrealistic. And the deferrals in this year's budget only made things worse by amplifying the bow wave of approvals and spending ahead. What was probably already an untenable plan in 2009 has been made more so.

There is no point clinging to existing plans. The development of the ADF needs to be put on a realistic and sustainable footing. Existing resources need to be directed towards approving a manageable program of new projects over the next several years that can feasibly be delivered by industry.

This will mean focusing efforts on those capabilities most urgently needed by the defence force and deferring others into the future. Doing so will demand much more than tweaking the existing program at the margin. A comprehensive audit of Defence's present capability plan is required to get *Force 2030* on a track.

At the same time, the government needs to close the gap between the capacity of Defence to prepare projects for approval and the demands of the two-pass approval process. Efforts underway to boost the capacity of Capability Development Groups should be given a high priority.

At the same time, however, the government needs to also ensure that the increasingly labyrinthine two-pass process is not wasting time in a futile effort to avoid the intrinsic risk that accompanies many defence acquisitions. Risk should be managed not avoided.

The *Defence Funding Model* and the *Strategic Reform Program*

A centrepiece of the 2009 White Paper was a 21-year funding commitment built around 3% real growth to 2018, accompanied by $20.6 billion worth of savings from the SRP over the first decade.

Although it's claimed the SRP savings are being redirected to fund *Force 2030*, nothing of the sort is occurring. The budget is what the budget is. Instead, the savings are notional quantities relative to a counterfactual 'business as usual' baseline of what it *would* have cost to deliver capability absent the reforms.

While this does not mean that the savings are somehow less real, it does make them contingent on the credibility of the what-would-have-been baseline.

For two budgets now, I've examined the SRP savings program and compared it with what limited concrete data can be found in the public domain. My conclusion is twofold:

Point one: the SRP is leading to substantial and worthwhile changes to the way Defence does business. Moreover, there are real and significant savings being made. These are most apparent in the area of capability sustainment where Defence and industry have been working together to find innovative ways to maintain equipment more cheaply than in the past.

The recent renegotiation of the Jindalee Operational Radar Network (JORN) maintenance contract is a good example. Savings of $100 million over the next decade have been achieved – representing a 16% saving on existing arrangements.

And progress is not limited to materiel sustainment; for example good progress is being made in rationalising and modernising Defence's information and communications infrastructure.

Point two: notwithstanding the efficiency gains that have been made, the overall scale of savings claimed is not credible.

Let me explain.

To start with, many of the claimed savings (around $5 billion worth) come from the shifting expenditure from one category to another without any reform. My favourite example was picked up by the Audit Office recently; Over the first four years of the SRP, $150 million in previously planned capital facilities investment has been cancelled and designated as 'savings'.

Yet, at the same time, the SRP touts a $190 million capital facilities reinvestment program to 'help address the deterioration in Defence facilities' over the same period. With savings like this, the scale of possible savings is limited only by the size of the Defence budget.

Table 4.5: Reported net non-equipment procurement savings 2009-10 and comparators

SRP costs ($55 m) - SRP gross savings ($343m)	- $288 m
Year-on-year real change to Estate upkeep ($541m - $468m)	+ $73 m
Year-on-year real change to Professional and technical advice ($542m - $468m)	+ $47 m
Year-on-year real change to Research and development ($157m - $157m)	0
Year-on-year real change to Utilities ($143m - $142m)	- $1 m
Year-on-year real change to Training ($293m - 296 m)	- $ 4 m
Year-on-year real change to Travel ($199m - $212m)	- $12 m
Year-on-year real change to garrison support ($568m - $581m)	- $13 m
Year-on-year real change to freight, storage & removal ($391m - $409m)	- $18 m
Total year-on-year real change to identified items ($2,834m - $2,761m)	**+ $73 m**
Gap	**$361 m**

Source: 2009-10 DAR p. 218

Slide 7

Slide 7: Reported savings and actual expenditure

More importantly, many of the savings appear to be relative to implausibly high baselines. For example (Slide 7), last year Defence reported savings of $343 million in non-equipment procurement. To achieve this saving they spent $55 million on reform, yielding a net saving of $288 million.

But going through the line items in the Defence Annual Report for the areas ascribed to non-equipment procurement, we find that around $73 million more was spent in 2009-10 than in the previous year. To summarise: they spent an extra $73 million in 2009-10 yet claimed a saving of $288 million, meaning that savings are being calculated against a baseline $361 million higher than spending in the previous year.

Of course, Defence would argue that their baseline for savings is robust and verified. But that proposition is steadily becoming harder to sustain as Defence continues to surrender savings and absorb additional costs year after year.

Consider what happened with this year’s budget: with so much extra money left over after savings have been delivered, it follows that the savings were calculated relative to an unrealistically high baseline. Indeed, on the basis of what we’ve learnt in this year’s budget, it appears as though the baseline was around $4.3 billion too high.

Absorbed Costs, Savings, Efficiencies and Hand backs (excluding SRP)

Year	Initiative	Cost $m
2009-10	Absorbed costs (including extra Navy personnel)	1,680
2009-10	Accumulation of cash in DMO Special Account	278
2009-10	Hand back in 2009-10	
2010-11	Absorbed cost of force protection ($912 m - $402 m)	510
2010-11	Hand back of $400 m	400
2010-11	Cost of Largs Bay ($277 m) and additional C-17 ($333 m)	610
2010-11	Accumulation of cash in DMO Special Account	159
2011-12	Savings measures and efficiencies	3,900
	Total	7,537

Slide 8

Slide 8: The Magic Pudding – billions and billions

But that might be an underestimate. Consider Slide 8. Over the past twenty-four months, Defence has absorbed additional costs, surrendered new savings, accumulated unspent funds and handed back more than $7.5 billion. At this rate, the Defence budget really is becoming the proverbial *magic pudding*.

As a specific demonstration, consider civilian personnel. Around $300 million of the new savings come from reducing planned civilian numbers by 1,000 over the next three years. But all signs are that Defence never needed the 1,000 positions in question.

Last financial year they got by with 645 fewer people than planned and this financial year they got by with 1,205 fewer than they said they needed. The 1,000 positions that were cut were never filled. Yet, the average strength of the civilian workforce next year is still planned to grow year-on-year by 992 positions.

So while some of $3.9 billion in additional savings (and the $400 million returned this year) reflect delays in introducing new capability into service, it's increasingly clear that Defence's simply got more money than they needed in the 2009 White Paper.

And let's be realistic; if Defence couldn't predict what it needed for this year's budget, how can claims of multi-billion savings years ahead based on an understanding of business-as-usual costs a decade hence be taken seriously.

The time has come to stop pretending that Defence is a bottomless rabbit hole of savings and efficiencies. It undermines the credibility of the very good work that is being done by the Strategic Reform Program to deliver better value-for-money to the taxpayer.

More importantly, it obscures the fact that Defence's financial management is in need of urgent attention.

There are no quick solutions to this problem. It will take several years to develop the management information systems that Defence needs, and even then the effort will fail without a sensible business model that aligns accountability and control of resources. Hopefully, the soon to be released response from the government to last year's review of accountability will get things rolling.

But that can only be the first step. Improved financial management has been promised repeatedly over the past twelve years, and yet it remains elusive. The budget has been remediated, rebaselined, zero-based and audited. Yet defence spending remains more an emergent than managed phenomenon.

The government needs to put a plan in place to fix Defence's budgeting and financial management. And given the importance, the plan should be made public so that that we can track the milestones.

Until financial planning and control is put on a solid basis, the Defence budget will have to be managed from year to year as more is learnt about what it will cost to operate the raft of new capabilities entering service. It is entirely possible that the situation could revert from feast to famine in a relatively short time—such are the uncertainties in Defence's understanding of its costs.

Conclusion

This year's budget showed that there are serious problems with Defence's capability planning and financial management. Firm action is urgently required on both fronts.

A capability audit is needed to put the DCP onto a sustainable basis.

The gap between the demands of the two-pass process and the capacity to prepare projects for approval needs to be closed.

A comprehensive plan to fix Defence's budgeting and financial management is needed.

And in the meantime, defence funding will have to be adjusted year-by-year as a better understanding of costs emerges.

Whatever happens, no progress will be possible by clinging to unfeasible plans and funding models that clearly exceed Defence's capacity to spend.

This means an end to the iconic promise of 3% real growth in defence spending that has hung like a lodestone around the necks of successive governments.

Fixing defence spending to an arbitrary growth figure is as poor a policy as it is lazy. Defence should only be given as much money as it can realistically and sensibly spend.

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[i] Professor Ross Babbage, 'Defence cuts cripple the nation's options', *The Australian*, May 18, 2011.

[ii] Major General (Retd) Jim Molan; 'We should be very polite to the Americans', *The Interpreter Blog*, Lowy Institute, May 24, 2011.

[iii] Classified projects are not included because these are neither listed in the DCP nor routinely announced.