Senate Foreign Affairs, Defence and Trade Legislation Committee
Budget Estimates 2011-12

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OPENING REMARKS

MAY–JUNE 2010 BUDGET ESTIMATES

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Introduction

Chair, I would like to address a range of issues, with a particular focus on the 2011-12 Defence Budget.

First, in 2011-12, Defence will receive departmental appropriation funding of $26.4 billion, compared with $24.9 billion in 2010-11. This funding includes new measures and adjustments including:

- supplementation of $1.1 billion for the net additional cost of operations;
- savings measures of $175 million to be returned to Government; and
- a net return to Government of $185 million for 'Other Budget Adjustments' which includes a foreign exchange hand-back of $210 million.

Further, the Committee may also be aware that, for 2010-11, Defence will reduce its call on the Budget by $1.6 billion in 2010-11 and by $2.7 billion over 2011-12 to 2014-15.

Savings Measures 2011-12 to 2014-15

There are four savings measures that deliver $2.7 billion in savings from 2011-12 to 2014-15. These include:

- increased efficiencies of $1.2 billion;
- a temporary increase in the rate of Efficiency Dividend of $139 million;
- cancellation of two additional C130 aircraft which are not required as a result of the purchase of an additional C-17 aircraft, saving $111 million; and
- capital investment reprogramming to future years of $1.3 billion.

Increased Efficiencies ($1.2 billion)

On 6 May 2011, the Minister for Defence and the Minister for Defence Materiel announced additional initiatives as follows:

- The reduction of 1,000 Australian Public Service positions across the next 3 years through reforms to shared services and other efficiency measures.
- A reduction in the cost of the investments needed to implement the Strategic Reform Program by $60 million, or 2½%.
- Reductions in $250 million Net Personnel and Operating Cost expenditure as a result of capital project slippage.
- Reductions in general supplier expenses in light of the 2010-11 underspend and the success of the SRP in reducing general expenditure.

The externally-led review of shared services will be completed by July 2011 and implemented from August 2011. This review, to be conducted by McKinsey and Company, will examine ways of improving the delivery of services across Defence and eliminating overlap and duplication. McKinseys commenced work today.

The Underspend in 2010-11

In 2010-11, Defence underspent by an estimated $1.6 billion, of which $1.1 billion related to slippage in the Approved Major Capital Investment (AMCIP) and Major Capital Facilities Programs and has been reprogrammed into future years.

Some $399 million of the projected AMCIP underspend of $815 million reflects project milestones slipping by a month or two in relation to key projects. That is always difficult to forecast. However, Defence had also anticipated, on the basis of recent industry performance, that we would be able to spend an increased capital allocation in 2010-11 and in late 2009 brought forward $2.5 billion for the AMCIP program over the period 2009-10 to 2015-16, including $969 million into 2010-11. This turned out to be only partly correct as industry has struggled to live up to its commitments and Defence's forecasts.

It is disappointing that Defence did not adequately forecast its expenditure for 2010-11 and that we underspent our allocation.

We have therefore directed the Defence CFO, in consultation with relevant areas, to rigorously review Defence's budget estimation practices and processes including capital programs and running costs. First, there will be a bottom up, project based assessment of the major capital spending programs, including the Defence Capability Plan, the Approved Major Capital Investment program, the Major Capital Facilities program and the ICT program. The review will consider the cash flow risks of projects, both individually and in aggregate. It will also consider how we can better incorporate into our budget estimates the forecasting risks of delays and uncertainties that come from internal processes and industry capacity.

In relation to our operating expenditure, the CFO will also review key expenditure areas such as employee costs, supplier payments and Net Personnel and Operating Costs for new platforms. The review will baseline the underlying assumptions of each budget area to assess robustness.

In addition to these reviews, we have instituted a formal quarterly, centralised budget review process. This will be based on year to date expenditure and forward commitments and will inform ongoing adjustments to Group and Service operating budgets. This will provide an earlier indication of possible expenditure variations and help us reallocate funds to other priorities.

In undertaking this review, we will also be mindful of the ability of industry to support us delivering our plans.

Impact on the White Paper

The Committee will be aware that, in his recent ASPI Defence Budget Brief, Mark Thomson suggested that, while Force 2030 might still be achievable, Defence's plans over the next few years in moving toward Force 2030 are unrealistic.

In considering this concern, we need to be clear that the adjustments to Defence in this budget are $2.7 billion, or 2.6% of the $105.1 billion Defence has been allocated over the Forward Estimates – which excludes future supplementation for operations beyond 2011-12 – and 0.85% of the $317 billion allocated over the decade.

Further, in 2009-10, 28 major Defence capability projects were approved and we are tracking toward 26 major capability projects to be approved in 2010-11. This is about the historic average and, while less than planned at the time of the Defence White Paper, the 2010-11 estimate needs to be seen in the context of the election, the extended caretaker period and complete change of Defence's Ministers following the election.

Nonetheless, as we have said before, the 2009 White Paper is an ambitious plan for Defence out to 2030.

As I have previously said, we have not been able to fully meet the expectations of the White Paper framers in terms of initially progressing some capability projects. That does not, however, mean it is either unachievable or should be 'torn up'.

It is wrong to look at the 2009 Defence White Paper, or any other White Paper, as simply a shopping list, and one whose policy and programmatic objectives can only be achieved if a rigid timeline is met absolutely and in every respect. We have always, and will always, manage our forward capability, readiness, personnel, logistics, enabling and financial plans to match the policy objectives and the financial parameters we are provided by Government.

Our acquisitions since the White Paper show we are continuing to build toward Force 2030 and that we can take action to meet emergent capability gaps.

I agree with Dr Thomson that Defence needs to look carefully at its implementation plans for Force 2030 for the Forward Estimates period and the next few years beyond and we are doing that.

- As part of the SRP, a review and re-engineering of our major capability development and acquisition processes will be undertaken. This covers the process from idea to delivery.
- An internal review of processes and timelines is nearing completion, aiming to install greater discipline to the project approval process.
- In addition, as outlined, we are reviewing our current and future budget estimating processes and forecasts.

Finally, actions are already underway to start the next Force Structure Review in 2013, as required by the 2009 White Paper, in order to inform the next Defence White Paper.

Improving Major Capability Development and Acquisition

As I noted earlier, we have struggled to match our capability aspirations with our capacity to deliver. There are numerous reasons, but broadly, they fall into three categories:

- First, we need to identify problems in development and acquisition earlier. As the Minister recently announced, we are instigating a series of tiered measures focused on improving project management and minimising risk at project start, and identifying problems early. These include the Early Indicators and Warnings, the expansion of the existing Gate Review processes, and the introduction of the Quarterly Accountability Reports to Ministers, the Secretary and the CDF.
- Second, Defence has experienced difficulty in attracting and retaining an appropriate number of skilled staff to progress our projects. Partly for this reason, we have taken recent efforts to

increase resources and improve skilling in Capability Development Group, which is also exempt from the additional reductions to the forecast APS workforce.

- Third, major Defence projects are technically complex and some have taken more time than was originally anticipated in order to mitigate technical risks ahead of Government consideration. This is a plus as well as a minus, because a rushed project often becomes a failing project.

Notwithstanding these challenges, Defence can seize opportunities and deliver rapid outcomes. Our acquisition of *Largs Bay* shows we can develop a compelling business case for Government and put an internationally competitive bid together in the space of three months – including an extensive range of due diligence inspections of the vessel. We remain on track to have the *Largs Bay* arrive in Australia by the end of 2011. We also achieved the rapid acquisition of an additional C-17 – bringing forward an enhanced capability and saving $111 million dollars by removing the need for a project in later years.

Gifts, Hospitality and Sponsorship Policy

We recently initiated a review of Defence's gifts and hospitality policy, in order to address any potential conflicts of interest and reputational issues that Defence might face. A revised policy was implemented on 1 May 2011 and has been circulated for your information.

This policy is more prescriptive than the previous one, increases transparency, and raises the necessary level for approvals and decisions for such activity.

The policy applies to all Defence officials including APS employees and members of the ADF of all ranks. Contractors/consultants acting in an official capacity on behalf of Defence must also comply.

Strategic Reform Program Progress

As I advised at the February Additional Estimates and as reported to Government, Defence is on track to achieve the more than one billion dollars in cost reductions programmed for 2010-11.

Contrary to some public discussion, including in the ASPI Defence Budget Brief, SRP cost reductions are real. They represent a material reduction to Defence's cost of doing business. SRP cost reductions are based on the extensive work done by George Pappas and McKinseys during the Defence Budget Audit in 2008. They are subject to sign off by the Defence Audit Committees, and to close scrutiny by the Central Agencies and the DSRAB. Finally, they are agreed by Government.

It is true that Defence's budget has increased since commencement of the SRP. This is due to the injection of funds required to accommodate increased activity resulting in delivery of Force 2030, Howard government decisions, the funding of additional SRP investments and the operations in the MEAO. Without SRP cost reductions of $20.6 billion over a decade, the Defence budget would have grown faster. SRP means that Defence is producing expanded outcomes with a smaller budget than it otherwise would have required.

The Government is counting on Defence's reinvestment in Force 2030 through SRP. If Defence fails to meet its commitment, there will be fewer funds available for investment in new capability. In the current fiscal environment, it is highly unlikely that the Government could or would meet any shortfall. Contrary to claims made in the ASPI Budget Briefing, reinvestment in of SRP cost reduction in Force 2030 is not a "rhetorical claim". It is a necessity. Further, we are seeing the SRP really start to drive change in Defence. To date, we have delivered on our commitments but, as I have said previously, we are facing a substantial ramp up in cost reductions and reinvestment over the next two years. We need our reform activity to meet that trajectory.

APS Workforce Reductions

As indicated, there will be a reduction to planned growth of Defence's APS workforce, and a second phase of shared services reform and other efficiencies will help allow us to achieve Force 2030 despite a smaller than planned APS workforce. This second phase of reform will be done in a careful and considered manner, and the design and implementation of this reform will help Defence achieve measured workforce reductions in corporate overhead functions.

There is still a projected growth in the average number of APS staff from 2010-11 to 2013-14. This growth primarily allows the continuation of key Strategic Reform Program initiatives, particularly saving money through the civilianisation of military positions, and the conversion of contractor positions to APS positions.

Allegations of Inappropriate Vetting Practices

The Minister commented publicly last week on the allegations of inappropriate vetting practices in the Defence Security Authority vetting centre in Brisbane, and I don't propose to repeat what the Minister has said.

On advice from Defence, the matter is being referred to the Inspector General of Intelligence and Security (IGIS). The IGIS is a statutory office and the legislation that the IGIS works under provides for the protection of witnesses – which addresses one of the concerns of the former contractors who appeared on Lateline. We hope that now that protection is fully available, the individuals will engage constructively with the IGIS inquiry.

As part of the investigation, an audit of relevant security clearances from the period will be done. That has already started and it should indicate whether the integrity of the process has been compromised.

I would, however, caution against jumping to worst case conclusions here. There are many parts in the security vetting process and it's important to understand that the allegations relate to the initial data entry phase only. That is simply the start of a lengthy assessment process that includes a series of checks and rechecks. These need to be completed before a decision to grant or withhold a clearance is made. The IGIS inquiry will allow these to be properly tested.

Separate to the investigation, there are a number of management actions that Defence is currently implementing. These include: reviewing the instructions that are provided to staff that are completing soft copies of the clearance packs and bringing forward the latest set of upgrades and improvements to the E-vetting pack that is currently in use.

The Defence/ASC Relationship

Submarine availability was poor during 2009 to 2010, particularly between July 2009 and December 2009. Defence is concerned about this and a reform program was initiated to help address the causes. This included the establishment of the Australian Submarine Program Office in Adelaide, by the then Minister for Defence Personnel, Material and Science in February 2010.

Further, a new Government-ASC Steering Committee has been effective in progressing whole of government issues to resolution, resulting in a clear pathway to In-Service Support Contract signature by fourth quarter 2011.

DMO and ASC have been working together to review maintenance practices and achieve greater efficiencies, aligned to the Navy's continuous improvement efforts.

Additionally, Defence, Finance and the ASC have agreed to conduct a benchmarking review to help establish best practice for the business of submarine sustainment, including:

- the best commercial framework for submarine sustainment;
- performance targets based on best practice efficiency and effectiveness metrics; and
- the subsequent priorities for ASC and Defence reform.

The review will commence mid-2011 and take approximately six months. Once the benchmarking recommendations are received, the Steering Committee will make further recommendations to the Ministers of Finance and Deregulation, Defence and Defence Materiel for joint acknowledgment and decisions.

Thank you, Chair.