

# Defence Industry Policy and Defence Accountability

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In May 2006 Australia's Minister for Defence Brendan Nelson announced his intention to revisit Australia's defence industry policy<sup>1</sup>. In explaining why such a review was timely, the Minister mentioned changes in our strategic circumstances, changes in the structure of defence industry and the operational experience accumulated by the Australian Defence Forces (ADF).

These are good reasons to revisit our defence industry policy in 2006. But similar reasons led to the release of a succession of defence industry policies in 1983, 1987, 1993, 1997, 1998, and 2000<sup>2</sup>. For much the same reasons Defence went on to publish plans for the naval shipbuilding, defence aerospace and defence electronic systems sectors in 2002, 2003 and 2004 respectively. In response, the Defence Council of the Australian Industry Group joined with State Government agencies and other stakeholders in commissioning a Profile of the Australian Defence Industry, published in November 2004<sup>3</sup>.

But the outcome of all this activity seems to have been unsatisfactory. In 2006, for example, Dr Nelson observed that "Defence Industry Policy is something that we've let drift in recent years."<sup>4</sup> Progress in defence industry policy seems likely to require a more effective alignment of the objectives of defence industry policy (ends) with arrangements to implement the policy (ways) and with the resources required to do so (means). The 2006 review might do best to focus on the 'ways' of defence industry policy with particular reference to the links between what Government demands of Defence and what Defence demands of industry.

The evolution of Defence governance since 1999-2000 now permits more effective linkage between defence industry policy and ADF capability than

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<sup>1</sup> Minister for Defence media release 084/2006 "Defence Industry Roundtable" Thursday 17 May 2006, at <[www.defence.gov.au/media](http://www.defence.gov.au/media)>. (Accessed Thursday 18 May 2006).

<sup>2</sup> Minister for Defence, opening remarks, Defence Industry Policy Roundtable, Sydney 17 May 2006, at <[www.minister.defence.gov.au/speeches/transcripts](http://www.minister.defence.gov.au/speeches/transcripts)>. (Accessed 6 June 2006).

<sup>3</sup> Bob Wylie "A Profile of the Australian Defence Industry: Helping align defence industry, defence industry policy and defence strategic planning", ACIL Tasman, Canberra, November 2004.

<sup>4</sup> Minister for Defence, opening remarks.

hitherto. Hence Dr Nelson's review team might investigate opportunities for reinvigoration of defence industry policy flowing from improvements in Defence governance.

## **External and Internal Accountability Arrangements in Defence**

Changes in Defence governance flow from wider reforms of the legal and regulatory framework for Commonwealth agencies initiated by the Australian Government in 1997 to improve performance, conformance and accountability.<sup>5</sup> 'Performance' is about Defence and other government agencies using their governance arrangements to improve the delivery of the goods, services or programs for which they are responsible. 'Conformance' means that government agencies should use their governance arrangements to ensure they meet the requirements of the law, regulations, published standards and community expectations of probity, accountability and openness. 'Accountability' is the obligation of public sector organisations, and the individuals within them, to answer for a responsibility conferred<sup>6</sup>.

The Australian Parliament is the focus of arrangements for external conformance and accountability. A key aspect of such arrangements was the move by all Commonwealth Departments, including Defence, to an accrual-based outcomes/outputs framework for managing resources appropriated by Parliament. This framework was introduced to encourage Commonwealth Departments to manage their resources with an emphasis on measuring performance in terms of what is being produced, what is being achieved and what individual goods and services cost.

In this context, planned *outcomes* are the results for or impacts on the community, economy or national interest that the Government intends to achieve, and are often long term or on-going in nature.<sup>7</sup> *Outputs*, on the other hand, are the actual deliverables – goods and services – agencies produce to generate the desired outcomes specified by government. An agency's intended outputs are detailed in the annual Portfolio Budget Statements. They expand on the outputs for which Parliament appropriated funds, specify performance measures and explain associated risks. Such outputs are therefore scrutinised closely by Parliament and ministers.<sup>8</sup>

A year later the minister responsible for each department reports what that department actually did with the resources appropriated by Parliament in the

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<sup>5</sup> As for example summarised in Australian National Audit Office "Public Sector Governance" Volume 1 *Better Practice Guide*, Canberra 2003, pp. 14-15.

<sup>6</sup> *Ibid.*, pp. 6-8.

<sup>7</sup> <[www.finance.gov.au/budgetgroup/Outcomes and Outputs/The Outcomes and Outputs Framework/Specifying Outputs](http://www.finance.gov.au/budgetgroup/Outcomes%20and%20Outputs/The%20Outcomes%20and%20Outputs%20Framework/Specifying%20Outputs)>. (Accessed 7 June 2006).

<sup>8</sup> *Ibid.*

last financial year by tabling the department's annual report in Parliament.<sup>9</sup> Departmental annual reports are the second element of external accountability arrangements.

### **DEFENCE GOVERNANCE REFORMS: EXTERNAL ACCOUNTABILITY ARRANGEMENTS**

The 1999-2000 Commonwealth Budget was the first to use this outcomes/outputs framework which was then refined over several budget cycles. The defence outcomes/outputs framework in the 2006-07 Defence Portfolio Budget Statement (PBS) is relatively mature.

The 2006-07 Defence PBS comprises seven outcomes for Defence, of which six outcomes focus on the delivery of military capabilities. Of these outcomes, the most directly relevant to the demand side of defence industry policy are Outcome One (*Command of Operations*), Outcome Two (*Navy Capability*), Outcome Three (*Army Capability*) and Outcome Four (*Air Force Capability*). Each military capability *outcome* is in turn divided into a series of military *outputs* – for example, Output 2.1 is Capability for Major Surface Combatant Operations<sup>10</sup>.

Within Defence, the supply side of the defence industry policy equation is dominated by the Defence Materiel Organisation (DMO). In the 2006-07 Defence PBS, the DMO generates the single outcome of supporting defence capabilities through efficient and effective acquisition and through-life support of materiel. To this end, DMO generates three outputs:

- DMO Output 1.1: Management of Capability Acquisition (which is about the delivery of specialist and associated military equipment to Defence);
- DMO Output 1.2: Capability Sustainment (which is about sustaining Defence equipment through maintenance and the provision of, for example, explosive stores, fuel, stores and spare parts);
- DMO Output 1.3: Policy advice and management services.<sup>11</sup>

The 2006-07 Defence PBS explains planned performance and key risks to, and limitations on, achievement of that performance at *outcome* level. These explanations are qualitative. It also specifies performance targets for the assets responsible for generating each military *output*. These output targets are more asset-specific and quantitative: For example, Military Output 4.3 (Capability for surveillance and response operations) is

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<sup>9</sup> For details, see Department of Prime Minister and Cabinet "Requirements for Annual Reports", June 2005, on <[www.dpmc.gov.au/guidelines/index](http://www.dpmc.gov.au/guidelines/index)>. (Accessed 7 June 2006).

<sup>10</sup> Defence Budget 2006-07, pp. 101-102.

<sup>11</sup> Ibid, p. 245.

generated by, among other assets, nineteen P-3 Orion aircraft operated by Air Force. The performance target for these aircraft is 8,200 flying hours in 2006-07.<sup>12</sup>

The efficacy of the dual PBS/Annual Report arrangements for accountability depends on the two documents presenting budget and performance on a compatible basis. What PM&C terms a 'clear read' between the PBS and Annual Report documents is an essential part of the accountability system that compares targets and figures set out in a department's annual PBS to those the department actually achieved. Since 1999-2000, this emphasis has resulted in the focus of annual reports moving away from simply reporting administrative detail to the provision of more information about actual program performance.<sup>13</sup>

Defence annual reports have also evolved along these lines since 1999-2000. At the defence outcome level, for example, the 2004-05 Defence annual report (the latest available) refers back to the two key risks (personnel and logistic support) Army identified in the 2004-05 PBS.<sup>14</sup> At the military capability output level, the report explains why, for example, the RAAF's 24 C-130 aircraft achieved only 84% of their planned flying hours<sup>15</sup>.

The 2004-05 Defence annual report also devotes a chapter to activities by the Defence Materiel Organisation for the year under review. That chapter provides an overview of the DMO's performance, noting that, for example, schedule slippage has reduced from 20 per cent to 12 per cent compared to the previous year – a performance approaching the 10 percent slippage typical of private sector best practice.<sup>16</sup>

The DMO chapter in the 2004-05 Defence annual report also reports key management initiatives and provides a useful summary of activity in the top 30 approved major capital equipment project by actual 2004-05 expenditure.<sup>17</sup> On the other hand, the description of Australian Industry Involvement (All) activity in the 2004-05 Defence annual report is much less satisfactory, with no explanation of how this activity has contributed to ADF performance.<sup>18</sup> Because industry supply and support is so critical to the achievement of military outputs, such unsatisfactory reporting of All not only undermines the Defence outcomes/outputs framework. It also reduces incentives to improve industry performance.

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<sup>12</sup> Ibid, p. 160.

<sup>13</sup> For background, see Australian National Audit Office "Better Practice Guide: Performance Information in Portfolio Budget Statements", Canberra, May 2002, p. 35.

<sup>14</sup> *Defence Annual Report 2004-05*, Chapter Four – Outcome Performance: Outcome Three Army Capabilities, p. 2 on <[www.defence.gov.au/budget/04-05/dar/04-05 outcome3](http://www.defence.gov.au/budget/04-05/dar/04-05%20outcome3)>. (Accessed 6 June 2006).

<sup>15</sup> Ibid, p. 202.

<sup>16</sup> Ibid, p. 256.

<sup>17</sup> Ibid, pp. 267-283.

<sup>18</sup> Ibid, p. 266.

This important deficiency in the external reporting of Defence performance is reinforced by a comparable deficiency in Defence's internal performance reporting arrangements.

### **DEFENCE GOVERNANCE REFORMS: INTERNAL ACCOUNTABILITY ARRANGEMENTS**

Defence arrangements for *internal* conformance and accountability start with the Ministerial Directive to the Secretary and Chief of the Defence Force (CDF). The Ministerial Directive renders them accountable for specified results which are cascaded down the Defence organisational chains via subordinate performance charters between the Secretary, CDF, Defence Group Heads and the Service Chiefs.

Institutional structures and processes are a key feature of the Defence governance arrangements. The most important for defence industry policy purposes is the DMO's shift to prescribed agency status on 1 July 2005.<sup>19</sup> Prescription of the DMO is intended to foster improved DMO performance through clearer alignment of the accountabilities, responsibilities and authority of the DMO and its Defence 'customers.' To this end, 'prescription' enables the DMO to adjust financial resources and personnel to meet workload within the Government's regulatory framework.

The new relationship between the DMO and Defence is underpinned by a series of purchaser-provide agreements. Of these agreements, the following are of most relevance to Defence Industry Policy:

- Materiel Acquisition Agreements which cover the services DMO provides Defence for acquisition of both major and minor capital equipment (DMO Output One).
- Materiel Sustainment Agreements which cover the sustainment of current capability (DMO Output Two).

The DMO's Chief Executive Officer (CEO) concludes Materiel Acquisition Agreements with the Chief of the Capability Development Group to cover the acquisition of major capital equipment and with the Chiefs of Army, Navy and Air Force to cover the acquisition of minor capital equipment. In 2006-07 the DMO plans to spend \$4,957.0 million on the acquisition of capital equipment under a suite of Materiel Acquisition Agreements (one for each project). Although Defence does not publish Materiel Acquisition Agreements, the 2006-07 Defence PBS describes them in general terms.

Each Materiel Acquisition Agreement specifies the scope of the project to be delivered, the schedule for delivery, and the budget approved by Government. Embedded in each Materiel Acquisition Agreement are key

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<sup>19</sup> Ibid pp 261-262.

performance indicators: The project scope covers underlying customer specifications and key measures of capability effectiveness as selected by the Capability Manager. The project schedule sets out such key milestones as project start up, contract negotiations and acceptance into service. The project budget information includes, for example, estimates of percentage spent at each schedule milestone, the current expenditure program, and assessments of the adequacy of provision for contingencies.<sup>20</sup>

The problem here is that, at this stage of their development, the Materiel Acquisition Agreements make no provision for the performance of industry in the supply of the platforms and systems concerned. This deficiency matters because the performance of the Chief of the Capability Development Group depends on the effectiveness of the Materiel Acquisition Agreements with the CEO DMO and, by extension, on the performance of industry in supplying the equipment involved.

The CEO DMO concludes Materiel Sustainment Agreements with the Service Chiefs in their capacity as defence capability managers. Under these agreements, and in 2006-07, the DMO plans to spend \$3,503.9 million on sustainment of military equipment operated by the ADF. Although Defence does not publish the Materiel Sustainment Agreements, they are also described in the 2006-07 Defence PBS.

The level of services DMO provides to Capability Managers under Materiel Sustainment Agreements is linked to the level of capability preparedness those managers are directed to maintain by the Chief of the Defence Force (CDF). The CDF's Preparedness Directive is in turn linked to the level of defence capability the Government is prepared to fund having regard to other national priorities. The Materiel Sustainment Agreements between the CEO DMO and the respective Service Chiefs are structured around key platforms (for example, Collins Class submarines), fleets (for example field vehicles and trailers) or systems (for example surveillance and control systems) supported by the DMO.

Again, the performance of the Service Chiefs in meeting the CDF's standards of preparedness hinges on the efficacy of the Materiel Sustainment Agreements they have concluded with the CEO DMO. The latter's ability to meet preparedness objectives set in the Sustainment Agreements is similarly dependent on industry performance. Because Defence does not publish Materiel Sustainment Agreements, there is no direct visibility of how well the agreements address industry performance.

Defence and the DMO are, however, required to report in the Defence Annual Report on the performance of Materiel Acquisition and Sustainment

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<sup>20</sup> Ibid, p. 259.

Agreements against targets set in the annual Defence PBS.<sup>21</sup> (There is no such coverage in the 2004-05 Defence Annual Report - presumably because the Agreements were then still in their infancy). The Defence PBS 2006-07 summarises the DMO's materiel sustainment activity in terms of maritime materiel, land systems, aerospace systems and electronic and weapon systems. This reporting structure and the specification of related sustainment performance targets in the Defence PBS 2006-07 is much less mature than that of other Defence outcomes and outputs. Specific deficiencies include:

- The lack of linkage to the preparedness of military capability outputs defined elsewhere in the PBS;
- The listing of activity rather than interpreting that activity in terms of preparedness objectives for which capability managers are responsible;
- The documenting of administrative arrangements rather than explaining how those arrangements will help capability managers achieve their preparedness objectives;
- The lack of consideration given in the 2006-07 Defence PBS to the value added by Australian industry in terms of the preparedness of military capability outputs.

These deficiencies are likely to flow through to individual materiel sustainment agreements between the CEO DMO and the Service Chiefs, with adverse implications for the adequacy of Defence's internal accountability arrangements and, in turn, incentives to improve industry performance.

### **THE MISSING LINK: THE VALUE ADDED BY DEFENCE INDUSTRY**

So how should Defence describe industry performance in remedying the above deficiencies in its arrangements for internal and external conformance and accountability? A useful way of thinking about how to do so is the defence value chain concept proposed by Markowski and Hall.<sup>22</sup> They envisage the value of the national security produced at the end of the defence value chain determining the value of the goods and services produced at various stages along the chain. In this sense, the main measure of the value of defence industry is its contribution to military capability outputs downstream.

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<sup>21</sup> PM&C, "Requirements for Annual Report", p. 6.

<sup>22</sup> S. Markowski and P. Hall, "The Economic Benefits of Defence Industries: A Framework for Cold Blooded Assessment", in I. Marsh (ed), *Growth 57: The Business of Defence*, Committee for Economic Development of Australia, Melbourne, forthcoming.

## **Defence Industry and the Provision of Military Capability**

“Military capability” is the power to achieve a desired operational effect in a nominated operational environment (land, sea or air) within a specified period and to sustain that effect for a designated period. Military capability results from developing a force structure appropriately prepared for operations.<sup>23</sup>

“Force structure” is one of the two basic components of military capability. It comprises the personnel, equipment, facilities and military doctrine required to conduct military operations effectively. Force structure is relatively stable in the short term but evolves more or less continuously in the longer term. Defence industry policy is partly about the choices Defence and the Australian Government make in supplying the equipment element of Australia’s defence force structure.

“Preparedness”, the second component of military capability, is more flexible and dynamic in the shorter term. Defence industry policy is also about the choices Defence makes in supporting the preparedness of the Australian Defence Force (ADF). The preparedness of the Australian Defence Force is a combination of its readiness and sustainability.

“Readiness” is the ability of the Australian Defence Force to undertake specified military operations within a designated time. Australian industry supports ADF readiness by, for example, upgrading platforms and systems in order to retain their military competitiveness.

“Sustainability” is the ability of the ADF to continue operations for a specified period. Sustainability depends on, among other things, the level of maintenance of equipment and the availability of consumables like ammunition or spare parts. Australian industry supports ADF sustainability by, for example, repairing and maintaining platforms and systems and by manufacturing, storing and distributing consumables like ammunition.

### **DEFENCE INDUSTRY: ADDING VALUE BY SUPPLYING AUSTRALIAN DEFENCE FORCE STRUCTURE AND SUPPORTING DEFENCE PREPAREDNESS**

In terms of Defence’s external accountability arrangements, therefore, each annual Defence PBS needs to include targets for the value added by Australian industry. Those targets for industry value-added need to be framed in force structure and preparedness terms. To this end the PBS project summaries need to explain how Defence plans to support the equipment in service and how it is managing the acquisition so as to ensure that industry establishes the requisite capacity. In accordance with wider

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<sup>23</sup> Department of Defence, *Defence Capability Development Manual*. Commonwealth of Australia, Canberra, 2005, page 2 para 1.4.

guidance in the input/output framework, such explanations should include industry-related risks and limitations perceived by each capability manager. This information is required for the Government's second pass approval of the project and is therefore already available for inclusion in the PBS. Defence can then report on industry's performance in meeting those targets in subsequent annual reports.

In terms of Defence's internal accountability arrangements, Materiel Acquisition Agreements for each project need to include provision for industry performance. According to the 2006-07 Defence PBS, the DMO will manage some 210 approved major capital equipment projects in 2006-07. Of these, the top 30 (ranked in terms of forecast expenditure in 2006-07) are summarised in the 2006-07 PBS. Because each PBS project summary already includes the prime contractor involved, it would seem a short step to include a summary of the objectives of Australian industry involvement and of progress made toward achieving those objectives.<sup>24</sup>

Similarly, Materiel Sustainment Agreements between the DMO and each capability manager need to include analysis of the value industry adds in terms of readiness and sustainability of the platforms and systems covered in each agreement. As already indicated, the 2006-07 PBS discusses DMO's sustainment activity in terms of maritime systems, land systems, aerospace systems and electronic and weapon systems. This presentation sheds some light on Defence activity in the relevant industry sectors and on the challenges it anticipates. But the presentation does not illuminate the value industry adds to military capability outputs for which each capability manager is responsible.

Until the annual PBS establishes performance targets for DMO materiel sustainment activity and, by extension, for the industry upon which the DMO depends, this crucial aspect of defence industry policy will continue to drift. In addition, in the absence of explicit linkage between Australian industry support, DMO materiel sustainment agreements and the preparedness of military capability outputs, neither the Government nor Parliament will be able to make an informed assessment of the contribution Australian industry makes to the defence value chain.

## **Conclusion**

Changes in Defence governance not only permit, but now also require, a sharper definition of the ends of defence industry policy, a more purposeful management of the ways of defence industry policy and a clearer measurement of the means of defence industry policy. Integrating defence industry policy into Defence's overall framework for managing performance on an outputs/outcomes basis would enable stakeholders to gauge the value

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<sup>24</sup> Ibid, pp 259-276.

added by Australian defence industry more accurately. The resulting scrutiny would create a compelling incentive for Defence and industry to reinvigorate defence industry policy across the full spectrum of ends, ways and means.

The Australian Government, the Parliament, and the Australian community have all benefited from the substantial progress Defence has made in reforming its internal and external accountability arrangements over the last seven years. Extending defence governance reforms to include defence industry policy is a logical next step. The terms of reference of Dr Nelson's defence industry policy review team should therefore include defence governance reforms as well as changes in our strategic circumstances, the evolution of defence industry and ADF operational experience.

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