

**HOW TO RADICALLY REFORM THE DEFENCE**  
**MATERIEL ORGANISATION: SUBMISSION BY PAUL**  
**DIBB TO THE NATIONAL COMMISSION OF AUDIT**

**Key Points:**

- The DMO needs to be radically changed. It has become a hugely complex and ponderous bureaucracy employing over 7000 people and costing more than \$800 million a year to run.
- At the very least, it needs to be cut in half to less than 3500 people – thereby saving \$400 million a year. Ideally, however, it should be reduced to a workforce closer to 2000 and so save almost \$600 million annually.
- DMO needs to become predominantly a contract management organisation and relinquish its preoccupation with micro-managing projects, second-guessing industry, and running engineering and systems integration services.
- The DMO imposes onerous transaction costs on defence industry through its endless demands for tender and contract documentation and the mirror imaging through its regional Project Offices of industry's maintenance activities.
- Today's DMO unnecessarily wastes taxpayers' money and it needs a complete redesign. It should become more independent of Defence, including in terms of hiring and firing. But it must still be responsive to the CDF and the Service Chiefs. The government-owned contractor-operated model is an attractive option to consider.
- A key determinant of DMO's performance is the nature of the projects delivered to it by the CDG. But CDG needs to become more independent in its recommendations to Government and more informed about capability risk and estimating more realistically through-life support costs.
- The DMO needs to develop a national defence industry policy, which spells out the technological competencies and investments required from industry over the next decade or more when the Government plans to spend \$150 billion on replacing or upgrading the ADF's military equipment.

## **This is the Problem with the DMO**

- The Defence Materiel Organisation (DMO) is an unwieldy bureaucratic organisation that is very large in relation to its modest output. It employs more than 7000 people and costs more than \$800 million a year to run (\$900 million if the costs of giving advice to Defence are included). That is about the same as the running costs of the Department of Foreign Affairs before it absorbed AusAid.
- The DMO demands unnecessarily complex tendering procedures that add substantially to industry costs, and it imposes time-consuming processes and oversight of projects. It effectively duplicates much of defence industry by having project managers, engineers, and systems integrators to monitor and scrutinise industry performance.
- But defence industry in Australia is different today from what it was 25 years ago when much of it was Commonwealth-owned. It is now part of a highly competitive international industry with access to the highest military technologies and capable of undertaking sophisticated modifications to suit Australia's unique physical operating environment.
- The Australian Defence Force (ADF) now depends heavily on industry not only for the supply but also the through-life maintenance of its military equipment.
- As Australia's strategic circumstances become more uncertain, so will it become more important for Australia's defence capabilities to be at the leading edge and to be subject to regular updates to keep them there. This means there should be a review of current assumptions about the best balance between procurement risk and operational risk.

- Acquiring military-off-the-shelf solutions might bring fewer problems in the acquisition phase but it will increase the risk of defeat on the battlefield. We need to manage procurement risk, rather than automatically be averse to it--which is the present predisposition of the DMO.
- The DMO also appears to have little understanding of the role of Australian industry as an expansion base to support sovereign ADF operations in conflict. The last serious discussion of this matter was in the 1987 Defence White Paper, and since that time there have been radical changes in technology, the structure of defence industry (both here and overseas), and in the increased use of industry to give direct support to the ADF, including on operations.
- Australia now needs a DMO that takes a long-term and sustainable approach to the future of Australian defence industry. But the DMO's heavy imposition of regulatory measures on industry imposes heavy imposts in the form of enforcement, transaction and monitoring costs.
- As the ██████████ submission of November 2013 to the Commission of Audit notes, correcting costly regulations such as this will deliver double benefits to the economy, through savings made to Government as well as to industry.
- What drives the DMO is that it is essentially pre-occupied with competition for competition's sake. It sees the competitive process as the single most important outcome, rather than delivering long-term value for money.
- The DMO has become a centre for industry reporting with increasing micro-demands for huge amounts of data from industry. This leads to

DMO mirroring of industry, particularly with sustainment projects where the DMO project offices are sometimes the same size as the industry maintenance line.

- Essentially, what we have is a defence acquisition organisation that is process driven rather than a decision-making management team. It has become less decision oriented, but also less accountable for measurable outcomes.
- The ever-increasing demands for process, data and hugely costly tender bids generate transaction costs that ultimately have to be recovered by industry. In the end, this is all paid for by the taxpayer when industry has to recover unnecessarily high costs.

### **But it all starts with the Capability Development Group**

- The problems of the DMO cannot be separated from those of the Capability Development Group (CDG). The latter is the body that defines the requirements for future military capability, which is then handed to the DMO for acquisition.
- In practice, the decision-making process is not as straightforward as this. The Single Service chiefs have their own strong lobbies, including military staff posted within CDG, for interpreting the Government's endorsed strategic guidance.
- One of the most substantial Defence acquisition reforms was the introduction of the so-called two-pass process for Government approval of major capability development projects. The Kinnaird Review in 2003 recommended strengthening the two-pass process and this led to the creation of the CDG to give focus to and improve capability definition.

- In October 2013, the Australian National Audit Office (ANAO) released an independent performance audit of Defence's *Capability Development Reform*. Defence acknowledges this as representing “the most extensive external review to date of capability and procurement reforms.” The ANAO report is critical of CDG and its performance in providing rigorous and independent capability definition.
- The ANAO report quotes the 2011 Black Review as observing that the capability development is a process which "has a profound effect on Defence as a whole, and is where much policy and organisational risk concentrates."
- It is generally during the acquisition phase of a capability development project that these issues are manifest, particularly any shortcomings in the execution of the requirements phase by the CDG. The underlying causes of schedule delay in the acquisition phase very often relate to weaknesses or deficiencies in the requirements phase of the CDG's capability development process.
- The key problems in CDG identified by the ANAO are:
  - High turnover of capability development staff (particularly military staff) prevents the development of skills and experience necessary in such a complex and specialist area.
  - CDG personnel have low average cost-estimating experience. High levels of skill in this area are critical to delivering capability. The CDG frequently under estimates the cost of new equipment specified in the Defence Capability Plan and of associated through-life operating costs.
  - There is an absence of scrutiny of capital investment proposals to assess affordability and schedule risk by military staff that

are organisationally independent of the proposal Single Service sponsor.

- Capability requirements are inadequately specified, and the procedures to verify and validate compliance with them are not adequately defined and agreed.
  - Significant risks are not adequately identified and technical risk is a major factor causing both post-approval project slippage and cost escalation.
  - CDG is poor at estimating capability whole-of-life costs even though understanding such costs is a vital component of managing capability.
  - There are still instances of CDG and DMO not reporting to Government on significant difficulties affecting individual major projects until long after those difficulties have been apparent within Defence.
- The ANAO report concludes that “Defence can demonstrate incremental improvements in some areas of capability development but finds it harder to demonstrate lasting change”.

## **Proposals for Radical Reform**

### **1. A Much Smaller DMO**

- We need to seriously rethink how the DMO goes about its business. The scale and complexity of the DMO bureaucracy has become an impediment to efficient decision-making. It needs to be cut in size by at least 50% and thereby save some \$400 million a year.

- Further opportunities for efficiency exist through reductions in size of the DMO sustainment workforce – principally through the use of performance-based contracts. This would allow DMO to operate with fewer in-house personnel.
- But even that may not be going far enough: why should the DMO be much larger than 2000 people? The annual savings then would be closer to \$600 million.
- The key aim should be to stop the DMO from trying to second-guess everything that defence industry does and imposing hugely expensive transaction costs on the private sector for no particular purpose.
- We need to stop the DMO trying to micro-manage everything by it having a veritable army of project managers, engineers and systems integrators. DMO's core workforce needs to be reduced effectively to the role of highly competent contract managers. The DMO will never be able to attract the best project managers from the private sector. Instead, a much reduced DMO would focus on contract acceptance, milestones and outcomes and only be high-level managers of major projects, if at all.
- There should also be greater consideration of long-term contractual relationships with industry lasting 8 to 10 years, as distinct from the current practice of annual renewal of competition. Of course, there would need to be strict requirements for meeting long-term contractual outcomes. Failure to meet them would result in the contract being reopened to the competitive process.
- The Service Chiefs want to see effective maintenance and sustainment support without the DMO inserting itself between them and industry.

- Clearly defined long-term performance-based contracts should be able to deliver to the Service Chiefs the guaranteed support they require.
- The DMO's industry division should be abolished. It has never understood the relationship between strategic guidance, force structure priorities and the need for a sustainable defence industry.
  - The Government expects to upgrade or replace up to 85% of the ADF's equipment at a cost of up to \$150 billion over the next decade alone. A National Defence Industry Plan is required to spell out the future technological competencies and investments needed from industry.
  - What I have in mind here is a drastically reduced DMO in size with a lean top management team. It will select the best contract managers from industry: they will need to be highly paid but strictly accountable to perform. This renewed DMO will require sufficient autonomy to hire and fire its personnel along private sector standards.
  - The Minister for Defence has said that he is open to a range of options for reforming the DMO, including "establishing it as a more independent agency driven by cost-benefit procurement assessments and commercial imperatives"<sup>1</sup>.
  - One such option is the government-owned contractor-operated (GOCO) model which the UK government is currently considering. Other options include making the DMO an executive agency independent of Defence.
  - While the full privatisation of the DMO separate from Defence is an attractive option, it is unlikely that the CDF and the Service Chiefs would accept that the supplier of the military equipment they use and

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<sup>1</sup> Speech by the Minister for Defence to the Australian Strategic Policy Institute, 3 December 2013.

operate in combat could be separated from the Defence Organisation as the monopsony purchaser. Therefore, I am inclined to recommend the alternative of the government-owned contractor-operated model, but with a hard boundary from the rest of the Defence Organisation.

## 2. A More Independent CDG

- The key determinant of DMO's performance is the nature of the projects delivered to it by CDG, which has a poor record of measuring risk and assessing the complexity of major projects. CDG needs to be reorganised and made more independent in its analysis of what strategically are priority military projects. To accomplish this will require the top manager of the CDG no longer being a three-star military officer who lacks the authority to challenge Single Service wish lists.
- The new CDG should be headed by a very senior policy officer experienced in hard-headed and independent analysis of contending military equipment purchases. His/her staff should be recruited from a new professional capability development career stream. The promotions of military staff in the CDG should not be determined by the Service Chiefs.
- What the Government needs is a CDG with independent accountability for making capability recommendations, clearly assessed against the Government's endorsed strategic guidance. This is essential if the new DMO is to operate effectively and produce well-considered and strategically relevant military capabilities.