Defence Submission to the FADTC Inquiry into *Defence Amendment (Sovereign Naval Shipbuilding) Bill 2018*

The *Defence Amendment (Sovereign Naval Shipbuilding) Bill 2018* (the Bill) proposes an amendment to the Defence Act 1903 that would require new vessels for use by the Royal Australian Navy be built in Australia by a "well-established, high performance Australian owned and controlled shipbuilder", except in times of defence emergency or in time of war.

As outlined in the Explanatory Memorandum, this would apply to all vessels over 30 metres in length, covering most classes in service with the Royal Australian Navy but excludes smaller support craft such as launches, rigid-hulled inflatable boats, lifeboats and barges.

Mandating the construction of naval vessels in Australia by Australian-owned shipbuilders would severely restrict Government's ability to consider the multiple factors in balancing the cost, schedule and capability implications of future naval construction programs. It would also impair future decision making particularly for large vessels built infrequently and in low numbers, such as the Landing Helicopter Dock and Auxiliary Oiler and Replenishment vessels, where the feasibility of using an Australian-owned shipbuilder would depend on the kind of capability required, the level of expertise within Australia and industry capacity at the time.

The overall effect of these legislative amendments would undermine planning assumptions that have underpinned the development of the Government's Naval Shipbuilding Plan, which was based upon the extensive analysis undertaken by the RAND Corporation on behalf of the Commonwealth, through its April 2015 report, "Australia's Naval Shipbuilding Enterprise – Preparing for the 21st Century".

The RAND Corporation identified that Australia had become one of the most expensive places to build complex naval vessels and that the Australian defence budget could not afford to pay such a premium and still deliver the naval capabilities needed for the future. RAND also identified that Australia possesses limited domestic capability to design warships larger than patrol vessels.

If enacted, the Bill would have profound implications for the affordability of executing the Naval Shipbuilding Plan. Further analysis would be necessary to clarify the full financial implications, but they would likely include significant cost increases in amending and renegotiating current agreements. The provisions of the Bill would also reduce the forecast productivity gains from a reformed, motivated and cost-competitive naval shipbuilding industrial base, whereas mandating construction would drive industry behaviour in unpredictable ways.

Sovereign Capability

The Explanatory Memorandum states the purpose of the Bill is to ensure that Australia continues to develop and sustain a sovereign naval shipbuilding capability; Defence has already commenced this process within the naval shipbuilding enterprise.

Sovereignty can be delivered through a range of mechanisms including Australian ownership of sovereign assets (e.g. the shipyards and systems used to design and build ships), suitable rights over intellectual property, and the transfer of knowledge to Australians within the subsidiaries of Prime Contractors operating in Australia. This must also ensure Australian involvement in the operation of subsidiaries to balance foreign control.

This approach to the development of a sovereign industrial base provides flexibility for Australia to deliver and acquire cost-effective, fit for purpose capabilities which enable a potent and agile Australian Defence Force. The Future Frigate program is emulating this broader approach to sovereignty. ASC Shipbuilding will be transferred to BAE Systems to support the objective of developing a sovereign design and shipbuilding capability in Australia as part of the Government's continuous naval shipbuilding program. ASC Shipbuilding will be the prime contractor with responsibility for delivery of the Future Frigate program – an arrangement that will help maximise the future success of ASC and the Australian naval shipbuilding industry.

While the Bill does not preclude foreign shipbuilders from tendering to be the prime contractor in any shipbuilding program, it does mandate that the entire build be sub-contracted to an Australian-controlled shipbuilder that is incorporated in Australia, not controlled by one or more foreign persons and not a subsidiary of a foreign entity.

The establishment of subsidiary business operations in Australia with an appropriately skilled and competitive workforce is key to the Australian Industry Capability (AIC) Program objectives. The AIC Program is the major lever for Australian industry to support Defence capability and the long-term development of our defence industry. This will provide the appropriate assurance to Defence capability and represents a pathway to export opportunity.

Seven of the top ten defence contractors by revenue in 2017 were subsidiaries of foreign-owned companies. Foreign investment represents confidence in Australian industry to deliver world-class products and services, signals growth prospects for the economy and provides Australian industry with access to greater resources and technical expertise.

Some countries, such as the United States, do have legislative requirements such as the *Merchant Marine Act 1920* (commonly referred to as 'the Jones Act') and *Buy America Act 1993* mandating that vessels for United States Navy must be built in the United States. However, these legislative restrictions do not restrict foreign ship designers and builders establishing subsidiary operations in the United States, such as Austal USA's operations in Mobile, Alabama.

Effects on Current Shipbuilding Contracts

The provisions of the Bill would jeopardise business models being established by Naval Group Australia, Luerssen Australia and other large multinational companies investing in Australia. Instead, foreign designers would be mandated to subcontract the build to a very restricted number of Australian shipbuilders, who may lack the experience, workforce, infrastructure and capacity to successfully execute complex warship build programs. Until the workforce base has the capacity, Defence will incur a further premium competing for the limited resources available.

Mandating the build to the restricted number of current Australian shipbuilders could reduce the incentive for the shipbuilder to drive efficiencies and innovation and blur accountabilities for cost and schedule performance. It would also increase the risk to performance by Prime Contractors, which would either lessen the accountability they would accept under contract to the Commonwealth, or increase the costs they would seek to cover the risk of underperformance by the mandated Australian shipbuilder.

Mandating the use of Australian-owned and controlled shipbuilders would also limit the intervention options available to Government when programs encounter difficulties. For example, the Government decided in 2015 to appoint Navantia (a foreign owned company with deep expertise) as the Shipyard Management Services contractor to oversee the completion of construction of the Air Warfare Destroyers after the program encountered schedule slippage and significant increase to cost. If the proposed mandate were in place, the Government would not have been in a position to take this action.

As outlined in paragraph 14 of the Explanatory Memorandum, the proposed legislation would apply to any commercial agreement entered into by the Commonwealth on or after the day the Bill was introduced to the Parliament (9 May 2018). The Bill specifies this provision is to ensure it applies all future naval construction programs and those currently under consideration by the Government.

The retrospective aspects would have profound implications for ongoing contract negotiations with Naval Group on the Future Submarine Program. This would necessarily delay the schedule of this program and extend the timeframe substantially for the delivery of the Future Submarine.

Further, and notwithstanding the undertakings in the context of and since the Competitive Evaluation Processes for the Future Submarine and Future Frigate, the retrospective enactment of the Bill would also undermine market confidence in doing future Defence business in Australia, which would be detrimental to the delivery of the Defence capability and the development of Australian industry in the future. The loss of trust would increase risk to future contracts and have premiums applied to mitigate those risks further increasing costs.

Effect on Australian Industry

Australia cannot afford a naval shipbuilding industry at any price. Such reshaping and reform of the industry is crucial to deliver the future naval capability Australia needs, at price the nation can afford. The nation needs to move progressively and on affordable terms to a sovereign ship building capability in an evolutionary approach. The provisions of this Bill would restrict the Government's ability to deliver these reforms, and would introduce significant commercial, schedule and performance risk to the national shipbuilding endeavour.

The Bill further mandates the provision of intellectual property rights to the Commonwealth relating to vessels constructed for the purposes of maintaining, repairing and modification. As outlined in the Government's Naval Shipbuilding Plan, a key enabler to the national shipbuilding enterprise is a motivated, innovative, cost-competitive and sustainable Australian industrial base. In selecting experienced international ship designers and builders to deliver the naval construction programs, the Government is identifying and mandating the technology, intellectual property, business processes and workplace cultures that must be transferred to Australian industry in order for a sovereign Australian naval shipbuilding enterprise to be delivered.

The Government's vision to maximise Australian industry involvement in the national shipbuilding enterprise will, over time, see Australian industry actively involved to the greatest extent possible across the spectrum of the enterprise – from capability design to complex program management, construction and sustainment activities.

Shipbuilding infrastructure is also being upgraded to support the enterprise, and these activities. The upgrades underway at Osborne Naval Shipyard are based on the design requirement for the continuous build of multiple types of major surface combatant designs up to 10,000 tonnes (destroyer-sized). At Henderson, the Common User Facility's current floating dock is capable of accommodating vessels up to 12,000 tonnes in support of the minor war vessel construction program. There is a potential option to add a second floating dock to increase the Precinct's capacity to handle larger vessels up to 28,000 tonnes. However, note that floating dock capacity to transfer ships to and from the Henderson Common User Facility is significantly lower than the capacity to simply lift a vessel out of the water in the floating dock. This factor, coupled with the weight bearing capacity of the Common User Facility, will constrain the size of vessels that can be constructed at the Henderson Maritime Precinct without substantial infrastructure investment.

The Shipbuilding Bill mandates the construction of all naval vessels by Australian owned Shipbuilders. This requirement would infer the sale of the Osborne Naval Shipyard, currently under ownership of the Government Business Enterprise (GBE), Australian Naval Infrastructure Pty Ltd (ANI) to privately owned Australian shipbuilders. In the case of the Future Frigate and the Future Submarine programs, the retrospective aspects of this Bill would necessitate the sale of ANI to the preferred program suppliers. As previously stated, mandating the use of Australia owned and controlled shipbuilders would limit the ability of

Government to intervene when programs encounter difficulties such as the Government decision to intercede in the construction of the Air Warfare Destroyers after the program encountered significant schedule slippage and cost increase.

Procurement and contracting arrangements for the design and build components of the major shipbuilding projects are a key component of the Naval Shipbuilding Plan. As noted by RAND Corporation, increased productivity in the naval shipbuilding industry requires as close a relationship as possible between ship designer and shipbuilder – where both the designer and builder are incentivised to make the other succeed.

Lastly, the Bill is also ambiguous on the overseas procurement of vessels already constructed. Prohibiting such options may limit the operational effectiveness of the RAN when the rapid acquisition of a vessel is required to meet urgent capability requirements. For example, Australia conducted a rapid acquisition of HMAS *Choules* in 2011 following the early retirement of former amphibious transports HMA Ships *Manoora* and *Kanimbla*, where a construction process would have left a significant capability gap. The Explanatory Memorandum allows for the overseas procurement of vessels in a time of defence emergency or war, but focuses specifically on construction and build programs and does not contemplate the acquisition of vessels already constructed to meet emerging capability requirements.