



AUSTRALIAN INDUSTRY & DEFENCE NETWORK

PO Box 5541
Kingston
Canberra ACT 2604

E: administration@aidn.org.au
W: www.aidn.org.au

Dr Andrew Gaczol
Principal Research Officer
Senate Standing Committees on Economics
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Australian Sovereign Naval Shipbuilding Inquiry – Questions on Notice

Dear Dr Gaczol,

AIDN is pleased to provide the following answers to the Australian Sovereign Naval Shipbuilding Inquiry.

Questions

General to both AIDN and Ai Group

1. What value do AIDN and the Ai Group place on early engagement of Australian firms with respect to the naval shipbuilding program?

AIDN is of the firm belief that early engagement is vital for Australian companies to be included into these ship building programs. AIDN's position is that Australian companies need to be designed into the program from the outset of the program. If this activity is not undertaken, then it becomes increasingly more difficult for Australian companies to break into the supply chain.

- a. Do you think that Defence has been adequately engaging Australian firms to date?

Defence has spent a great deal of time working with the foreign owned multi-national Prime contractors in their capacity as tier one suppliers, the interaction with the second and below tiers of contractors falls away very quickly. The main interaction with the lower tier of suppliers primarily is through the Prime contractors who manage these relationships given the nature of the commercial arrangements. This in effect separates Defence from the supply chain.

2. Do you think that Australian firms/suppliers are unfairly disadvantaged in defence procurement?

There is no doubt that Australian firms can struggle to become part of the supply chain. Often, they require to undergo a qualification process to be able to enter the supply chain. Australian firms also are rarely afforded the opportunity to quote for opportunities outside of the Australian environment, which can make them appear to be less competitively priced, as an example having an Australian firm quote a price for 9 shipsets of equipment (the Australian fleet) whilst the overseas supplier quotes for the Australian program, the home program and multiple international programs, is not a fair reflection of the value for money of an Australian supplier. Australian firms in many cases do not have established relationships with many of the overseas Prime contractors and the Australian subsidiaries rarely are the holders of the IP and technology that is required to be made available for Australian firms to firstly qualify and then provide pricing on. Finally given the cost/schedule constraints that are applied to Defence programs it becomes a relatively simple exercise to apply increased levels of risk provisions onto the Australian supplier which also impacts on their ability to be meaningfully considered for supply chain opportunities.

a. How can local industry be given a better opportunity to participate in the naval shipbuilding program?

The only way for Australian firms to be given better opportunities in the Naval Shipbuilding programs is for direct Government intervention. The Government has reasonable policy on the inclusion of Australian Industry into these programs, however it does not appear that Defence is following these policies effectively. In many cases defence is undertaking a very rudimentary value for money analysis as opposed to the requirement to undertake a full economics benefits study. Equally as defence is so heavily reliant on the advice from foreign owned multinational Prime Contractors it is difficult to see how established foreign supply chains will be penetrated. This is an obvious danger for Australia companies – Prime Contractors that have multiple international obligations and domestic pressures, awarding contracts in Australia seeking to award subcontracts to businesses in those countries where there are firm expenditure quotas to fulfil, rather than to Australian businesses for which there is no equivalent quota obligation nor Government legislation preventing this type of behaviour or requiring Australian Industry inclusion.

Until the Australian Government enforces a credible Australian industry inclusion methodology, that Defence is obligated to follow, Australian firms will simply receive token contracts.

b. Do you think Defence's approach to assessing technical risk of tendered offers is in the best interests of Australian Industry?

Proposals involving technical risk appear to be actively marked down by defence. This acts to advantage overseas suppliers (or the local subsidiary of a foreign owned prime) which may have an offering that is already in service with their own defence force, as a result of development contracts funded by that country's defence force. The risk has already been taken by another nation.

This immediately puts the Australian technology supplier behind the eight ball.

Yet the assumption that any need to undertake technical development poses a risk to project delivery is overly simplistic. After all, the technical risk to project delivery is not simply a matter of **how much** technical development is proposed but is also a question of **how good** the proposing company is at undertaking the relevant type of development.

For example, a local supplier might have an exemplary track record of delivering development intensive projects; yet even with such a record, a tendered proposal from this Australian company would still be ranked behind a proposal from an overseas supplier requiring a lesser degree of development.

The results of this approach are predictable. Local technology suppliers attain at best an intermittent stream of development projects from Defence in their area of expertise. Unsurprisingly, this causes the technologies and products from the overseas suppliers, with continuous (rather than intermittent) support from their own defence forces, to further improve their competitive position.

The result is a self-reinforcing system. Australian suppliers are competitively disadvantaged, which reduces their ability to win projects with Defence, which then further reduces their competitive position.

3. What steps would you like to see taken by the Government to ensure that a significant proportion of defence spending is occurring locally and with Australian companies?

See response to Q2A.

4. The Defence Industry Minister said in July that: *"We're talking about a generation of Australian jobs, and a substantial level of Australian industry involvement in these major acquisitions"*. How and to what extent has the Government sought your organisation's involvement to ensure that Australian industry involvement is optimised and integrated in both the acquisition and sustainment phases of the naval shipbuilding plan?

The Department of Defence has to its credit engaged industry and the Defence Associations during this process and it has held a series of workshops, one on one discussions and accepted submissions from numerous sources.

- a. What work has been undertaken to design Australian firms into the supply chain?

At this point it is difficult to quantify this – on face value there have been numerous supplier advice discussions and seminars, however in terms of the real effort required to bring Australian companies into the supply chain, which requires pre-qualification, qualification, transfer of technology including the transfer of IP and the ability to understand the know-how, know-why and know-what and finally the inclusion of these companies into the supply chain and to ensure that these suppliers are being actively designed into the supply chain during the actual design process for the Submarines and the Frigates it appears to be very little has and is being done.

This lack of effort will ensure that as the programs enter their build phases it will be extremely difficult to include Australian firms into the supply chain do to the risk to the programs schedule and cost and the cost to now qualify these companies as mentioned above.

- b. Can you provide examples of Australian companies that are in the process of qualifying to supply tier 1 and tier 2 level supplies at either of the Primes?

No.

5. The Government's rhetoric suggests support for home-grown growth, but accountability is crucial if this is to occur. How do you think this could be achieved?

For an individual to be held accountable there must be some form of Government policy in place to be held accountable to.

Therefore, there is a requirement to have a legislated requirement in place and a policy drawn from this legislation otherwise all that is available is rhetoric. All Government Departments, not just Defence, will continue to follow the policy that they currently have in place.

Questions to AIDN

6. AIDN submitted in November 2019 that “around 7,400 full time equivalent (FTE) jobs across Australia can be attributed to the production of naval vessels by the five largest prime contractors in the industry”. Can you please advise if you have an update on that figure and could you provide a detailed breakdown on notice of the numbers of direct employees, contractors and flow-on jobs across each of the five primes?

This information was taken from a variety of public statements, both from Government Ministers and the Defence Prime contractors as such the only accurate source would be to go back to the Defence Prime Contractors and seek an update on these numbers.

7. You have indicated that “Historically, the level of Australian industry involvement in naval shipbuilding has been high; approximately 70 per cent of the total contract value of the ANZAC, Minehunter and Collins-class submarine programs was met by Australian industry”. What are the factors behind that outcome and is it possible to replicate or exceed that level of Australian industry involvement in future builds?

In a complex major shipbuilding contract, typically, the split of contract value is about 30:70 between shipyard fabrication/assembly/integration/trialling (i.e., 30%) and the supply chain (i.e., 70%). Similar ratios apply for other major military platforms.

The Australian Government set minimum levels of Australian Industry Participation (AIP) or local content, for the Collins (~60%) and ANZAC (~72%) programmes. Both targets were exceeded.

It is understood that the contracts for the Future Submarines (SEA 1000) and the Offshore Patrol Vessels (SEA 1180) do not include any mandatory requirement for local content in the supply chains. It is understood that contractually ASC Shipbuilding has in the order of 54% local content contracted.

The Australian Government can determine and set the required outcomes because the Future Submarines and Frigates programs are essentially cost-reimbursable contracts with no firm/fixed commitments to construction prices at this stage.

Failure to enforce AIP content now will see a majority of the overseas supply chains locked- in.

8. You have noted that in recent local Australian ship builds such as the Hobart-class Guided Missile Destroyers and Canberra-class Landing Helicopter Docks, the level of Australian industry involvement was not as high due to contractual issues around using overseas suppliers. What were those contractual issues and what recommendations would you make in relation to future contractual negotiations to ensure that Australian industry involvement is not detrimentally affected?

The specific nature of the acquisition drove the commercial outcomes, for example the Canberra-Class LHDs were primarily constructed overseas in Ferrol Spain by Navantia and the superstructure and combat system integration undertaken in Williamstown Victoria by BAE Systems, this did not allow for the inclusion into the Spanish supply chain.

Equally the overseas supply chain was primarily retained for the Hobart-Class Destroyers in order to reduce cost and schedule risk, something that in hindsight was not achieved given the slippage in schedule for those platforms.

The AIDN position remains that Australian industry must be designed into these programs from their commencement and that Government legislation is required to ensure that this occurs.

9. You say that *"Australian SMEs continue to struggle to be involved in shipbuilding projects in Australia because more often than not the Defence Department's Value for Money (VfM) criteria focusses on the short-term acquisition costs and this drives subsystem and component procurement often to an overseas supplier"*. What can the Federal Government do to address this issue and introduce a 'whole of life' approach – do administrative processes just need to be streamlined or do the procurement rules need to be amended? Is legislation required?

The VfM criteria needs to have a requirement for an economics benefits study to be undertaken when awarding contracts to overseas suppliers, clearly there would need to be some form of dollar limit applied otherwise the unintended consequence would be to tie Defence in bureaucratic knots. VfM is not simply an exercise in pricing rather it needs to look at the entire benefit to the Australian economy, indeed given the long-term effects of the COVID 19 pandemic to the Australian economy now more than ever this type of analysis is required.

Most of our trading partners have a local industry inclusion policy, the UK, the EU, Canada, USA, India and Japan to name but a few, this is placing Australian companies in unenviable positions when compared to their overseas competitors. Given that our Free Trade Agreements specifically exempt Defence from these agreements it is clear that our partners have recognised the fundamental importance of Defence self-reliance and a sovereign industrial base therefore the Australian Government should also recognise the importance of Australian Industry to the defence of the nation.

In order for this to occur it will require a legislative review, in short order as time is fundamentally of the essence. From this review there may well be a requirement for legislative change, and this will then drive the required policy outcomes.

10. You say that *"AIDN members across Australia are reporting significant frustration in getting Australian industry involved to the extent envisioned across major new defence programs"*. You call for the *"creation of an AIC Program assurance regime to transparently monitor and review AIC quantum and quality contained within actual Purchase Orders placed, against contractual commitments and any pre-contract assurances made by prime contractors and be subject to external audit"*. Could you please elaborate on how this regime would work and the schedule or plan that you referred to at the Hearing on 14 August 2020 that needs to be in place *"for the establishment of the Australian Industry Capability."*?

There is a complexity in attempting to answer this question as this regime would be of fundamental importance in shaping the way forward for the inclusion of Australian Industry into these supply chains. Fundamentally a body, for example a Statutory Authority, should be established with legislative powers to review and approve Australian Industry Involvement in Government acquisition, this does not have to be limited to defence, rather it should cover all Commonwealth Government departments. Departments would be required to seek the authority's approval for Industry plans and have the authority to audit programs and have the ability to enforce outcomes. Further to this the Authority should have the authority to ensure that pre-contractual commitments are contractualised by

Defence, there is a need to ensure that the contractors attempting to win programs in Australia are held to account for the offers they make pre-contract.

11. In February, Minister Price announced that she had *“directed the Secretary and CDF to establish an independent AIC audit program”* and that it would *“be independently administered and be required to investigate and report on whether major contractors are meeting their AIC contractual obligations”*. What has been the industry’s reaction to this announcement?

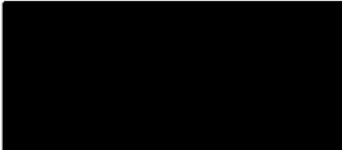
There has been some confusion in some quarters as to what the Minister announced and what in effect was being audited. Whilst the Minister and the Department have gone to some length to clarify this it is not certain that this AIC Audit will actually achieve. The Minister has laid out a timeframe and this includes industries involvement in the process. Our members have expressed a strong desire to be part of this and there is an expectation in our membership base that this audit will provide clear recommendations.

12. You say that it is unfortunate that ‘maximising opportunities for Australian industry’ is not a specific sovereign industry capability priority (SICP). If it was, would tenderers be obliged to identify corresponding Local Industry Activities (LIA) to meet that requirement? Does the requirement need to be more specific?

The simple answer to this question is yes. The flow on effect from a specific sovereign capability priority would be for tenders to advise how they intend to meet this requirement, and this would therefore place a greater requirement and therefore expectation on these tenderers. This requirement needs to be specific and mandatory for selection.

13. In what way do the efforts of the Centre for Defence Industry Capability (CDIC) need to be strengthened in order that it may overcome some of the concerns you have expressed and deliver an “Australian Industry Capability facilitation function”.

The Minister has undertaken a large review of the CDIC and has made the results of this review public. This review null and voids AIDNs original issues. A proper review of the published CDIC review is required prior to AIDN making further statements.



Brent Clark

Chief Executive Officer

AIDN



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