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Foreign Affairs, Defence and Trade Committee
Department of the Senate
PO Box 6100
Parliament House
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INQUIRY INTO THE PERFORMANCE OF THE DEPARTMENT OF DEFENCE IN SUPPORTING THE CAPABILITY AND CAPACITY OF AUSTRALIA'S DEFENCE INDUSTRY

Dear Committee Secretariat

On behalf of the Australian Industry and Defence Network (AIDN) thank you for invitation to provide a written submission to the inquiry into the performance of the Department of Defence in supporting the capability and capacity of Australia's defence industry. We sincerely appreciate the opportunity to participate in this important inquiry.

ABOUT AIDN

AIDN is the peak industry association for small-to-medium enterprises (SMEs) who support the Australian Defence Force (ADF) and the Department of Defence (DoD). AIDN **represents almost 1000 Australian SMEs**, who employ approximately **61,000 of Australian workers** across the country.

At a time of national economic and geopolitical uncertainty, our hardworking middle Australians **contributed \$10.6 billion to the Australian economy** in the 2021-22 financial year, through our sovereign supply chains; modern manufacturing practices; research and innovation; skills development; and regional and veteran employment.

AIDN's nationwide membership is agile and can pivot to support the Australian Government to deliver its urgent needs requirements, but we need clarity on specific capability priorities.

In light of the Defence Strategic Review's (DSR) assessment of Australia's current and required defence capability, posture and preparedness in the current strategic environment; AIDN commends the Committee and Senate's decision to inquire into these matters.

As reinforced by the DSR, establishing a sovereign Australian defence industrial base is fundamental to Australia's national defence, and modern warfighting capabilities.

AIDN'S EXECUTIVE SUMMARY

The Australian Industry Capability (AIC) policy framework established by the Australian Government is good start and AIDN and our members welcome the initiative. However, compared to more developed and mature policies such as the USA's [Jones Act](#) or the Canadian [Defense Production Act](#), which are proven to be 'best in class', the existing AIC policy framework lacks the authority and rigour AIDN's members require to continue providing a sustainable sovereign defence industrial base.

The current AIC policy framework does not translate into meaningful or tangible outcomes for AIDN's members. Additionally, supply chain events over recent years due to Covid-19, have demonstrated the reality, that when national or Global events occur, a country's ability to be self-sufficient is fundamental. COVID-19 demonstrated Australia's general and defence industrial base was at the mercy of major supply chain disruptions.

AIDN appreciates the role of foreign primes and Original Equipment Manufacturers (OEMs) in delivering speed to capability for the Australian war fighter. However, to ensure Australia can continue to grow and sustain a truly sovereign defence industrial manufacturing base, the AIC policy framework must ensure that foreign primes and OEMs must be held to account in implementing AIC as part of the Commonwealth procurement rules.

The reality is that foreign primes and OEMs consistently default to their indigenous local supply chains, which are most oftent offshore in the USA, UK or Europe, and they assert that the time and investment to qualify for alternative Australian domestic options are a capability delivery risk. This is simply untrue. Pre-qualified and credible Australian supply chain companies with proven capability offerings will always be well positioned to integrate into foreign prime and OEM supply chains. Designing ADF procurement contracts with greater AIC percentages (or dollar values) will motivate foreign-owned primes and original equipment manufacturers (OEM) to develop and sustain Australian supply chains.

Non-resident majority-owned foreign companies must be contractually obliged to engage Australian industry to engineer the platforms to enable integration of Australian industry, from the outset (for the first-of-class). Disproportionately lengthy procurement processes often result in a hastily acquired commercial-off-the-shelf (COTS) capability solution. This in turn, may not address the unique requirements of the war fighter and more often than not, results in the procurement of an overseas capability solution. Adequate time must be allocated for Australian industry consultation to ensure capability requirements are defined and designed in conjunction with the war fighter, prior to the capability acquisition.

If Australian companies are not included in foreign prime or OEM supply chains for the first-of-class item, then, inevitably they never will be. The contracting structure should consider the level of risk associated with projects and share that risk between the Commonwealth and the contractor. Australian companies must be included in early engagement in the design and supply chains for the development program, to ensure they will be engaged on full rate production, through life support and sovereign capability.

RECOMMENDATION: AIDN believes that more the AIC policy framework must be recalibrated, and preferably legislated, to enable more Australian SMEs to benefit from foreign-owned supply chains and enable Australian primes and major service providers

(MSP) to be developed. AIDN's members recommend that Defence, foreign primes and OEMs engage Australian industry early to ensure mutually beneficial outcomes.

EXISTING STRUCTURE

Much of Defence procurement is dominated by foreign owned and/or controlled prime contractors and occurs via Foreign Military Sales (FMS), as it is perceived to be the simplest and most efficient pathway to capability acquisition. This leaves minimal opportunity for Independent Australian Owned Businesses (IAOB), such as AIDN's SME members, to participate in the procurement process.

In the United States, defence contractors are incentivised to use US-owned SMEs, as well as rural (HUBZone), minority-owned, veteran-owned and female-owned suppliers. By contrast, in Australia offshore foreign-owned prime contractors have been allowed to dictate a largely foreign supply chain based on a proven design. This has resulted in the decline of the Australian defence industrial manufacturing base.

Overall, the ADF continues to promote an acquisition process that is transactional rather than collaborative. The best way to break down this paradigm is to engage industry earlier in the process and allow industry to develop solutions to problems, in conjunction with the end user – the war fighter. The continual reliance on foreign-owned military COTS capability acquisition, which is then significantly modified to address specific Australian operational requirements, has led to numerous examples of dramatic cost and schedule blow-outs during the contract execution.

RECOMMENDATION: Contracting models need to be tailored for particular capability acquisition requirements, with fixed price contracting for MOTS solutions, as well as risk sharing for developmental solutions, such as cost-plus incentive and fixed-price incentive arrangements. Foreign-owned primes and OEMs should be incentivised to use Australian-owned SMEs and regularly audited to ensure implementation of AIC supply chains. Penalties should apply to those foreign-owned primes and OEMs that do not comply with contractual obligations.

AUSTRALIAN INDUSTRY CONTENT - AS IS

Australian Industry Content (AIC) policy has been a 'best endeavour' policy where foreign-owned primes and OEMs simply must prove they have tried to find Australian suppliers that are competitive – there is no requirement to actually ensure they're included in supply chains. However, there are many problems with the current definition of AIC, including, but not limited, to:

1. 'Australian' being defined as having an ABN (or NZ registration), with no formal Australian ownership/control criteria.
2. Select foreign-owned primes and OEMs can include their own Australian operations as AIC.
3. There is no emphasis on Australian design which would drive the use of IAOB content, and thereby AIDN's SME members.
4. Some foreign-owned primes and OEMs have not complied with AIC requirements and have not demonstrated good faith to their Australian supply chains and the Australian Government has not enforced AIC requirements.
5. IAOB have wasted valuable and limited resources helping foreign-owned primes and OEMs posture themselves to meet AIC intent, at their own cost, with no guarantee of inclusion upon contract award.

Recently, AIC has been 'enhanced', but key weaknesses remain, and the approach set out is still unlikely to provide IAOB certainty that their interests will be protected:

1. Defence must be motivated to pursue the issue where an IAOB listed in AIC plan is sidelined.
2. Defence starts with a 'remediation process' where foreign-owned primes and OEMs can offer alternative ways to meet AIC – including via using their own staff.
3. The IAOB that has been sidelined is not involved in the 'remediation process'.
4. The use of future upgrades to incorporate increased levels of AIC results in the need for significant and costly design change prior to implementation.
5. Many steps involved before a default is declared – in this time IAOB is being progressively sidelined and left behind by alternative supplier.

Several larger Australian firms, such as AUSTAL, NOVA, and DOWNER, have demonstrated what can be achieved by developing local prime contracting capability.

Focusing on AUSTAL as an example, functional designs developed in Australia naval programs have resulted in significant export opportunities for the Australian supply chain. The key issue is that the functional design of these projects occurred in Australia and resulted in the selection of a significant number of Australian suppliers during the design process.

Two specific examples include the following:

1. Hull Design and Optimisation – Austal Australia design teams employed to support ongoing hull design and optimisation for Austal USA; and
2. Lifesaving Appliances – LSA of Tasmania supplied Marine Escape Slides and Life rafts to both the LCS and EPF programs, supporting their growth into the US naval and commercial markets.

SOVEREIGN INDUSTRIAL CAPABILITY PRIORITIES (SICP) - AS IS

The Defence Industrial Capability Plan (DICP) describes priority areas as so important they must be done in Australia for strategic reasons. Yet, Defence has continued to buy [Sovereign Industrial Capability Plan \(SICP\)](#) capabilities from overseas.

RECOMMENDATION: The forthcoming Defence Industry Development Strategy (DIDS) should clearly stipulate and mandate Defence consider acquiring SICP capabilities that incorporate Australian supply chains.

POLICY CONFUSION

Elements of Defence seemed to have grasped the strategic risks of not having sufficient industry located in country, particularly regards certainty of supply during times of war.

Additionally, Defence has declared industry to be a fundamental input to capability ([FIC](#)), and there has been much made about 'sovereign capability'. Yet, procurement source selection is still rooted in value for money (VFM) assessments that ignore the value associated with the war fighter capability.

1. Consideration of VFM in practice is focused on cost, schedule, risk of delivery only – the 'value' attained does not consider the strategic value of work in IAOB providing assurance of supply during war.
2. Employment of ex-ADF officers in BD/GM/Board roles. This influences current decision makers.

Most of all, the policies are just that – policies only, that Defence may ignore. There seems to be no way for the Australian Government to ensure the implementation of well-intended industry-focused policies. Defence project officers can justify overriding AIC policies in the name of speed to capability.

RECOMMENDATION: Like the USA and Canada, AIDN strongly recommends legislation designed to support and mandate AIC for capability acquisition, foreign-owned primes and OEMs.

WINNERS UNDER EXISTING FRAMEWORK

The parties that benefit most under existing framework are the foreign-owned primes. They existing policy framework, while well-meaning, does not guarantee AIDN's members have the opportunity to deliver true sovereign capability or industrial manufacturing. The profitability of foreign-owned primes and OEMs means these organisations can apply resources to marketing. They can:

- sell products from their parent company catalog into ADF,
- claim their own branch office operations as "Australian", and
- claim AIC at tender, do not follow up once in contract or incur consequences as a result.

CURRENT SUPPLY CHAINS

During COVID there were significant disruptions to international supply chains which impacted several contracted programs. The Commonwealth commercial approach should be collaborative in these exceptional circumstances to share risk with the contractor. Too often the contract is used as a weapon to punish contractors rather than collaborating to achieve a mutually beneficial solution.

The more we can increase the Australian Industry Content in all programs, the less we will ultimately be impacted by supply chain disruptions. The most effective way to support the growth of the Australian defence industry's capability and capacity is to foster the growth of Australian prime contractors and major service providers (MSP), who design in Australia. This approach has realised success for nations like Italy, Spain, Germany, the Netherlands, the UK, and more recently Turkiye.

On behalf of AIDN's national membership, thank you again for the opportunity to participate in this important inquiry, we do appreciate it and look forward to the opportunity to meet with the Committee in in due course.

Yours sincerely

BRENT CLARK
CEO, AIDN National