

## CHAPTER 5

### STRUCTURE OF THE AUSTRALIAN DEFENCE INDUSTRY

#### Introduction

5.1 One of the threads that ran through the inquiry was the future structure of the Australian defence industry, including rationalisation of prime contractors and the role of government in shaping the evolving structure. It was a matter that arose out of the inquiry rather than one that was specifically referred to in the terms of reference<sup>1</sup>. As a result, comments on this matter were restricted to companies and individuals who had some association with the sale of ADI and who took part in the inquiry. However, the Defence Council of the Australian Industry Group, the relevant industry association, took advantage of the inquiry to speak on this matter for the wider industry.

5.2 The Committee was not in a position to undertake a detailed inquiry into this area. This would have required specific terms of reference and an opportunity given to many more players within the Australian defence industry to participate in the inquiry. Nevertheless, the Committee believes that it should draw to the attention of the Government comments made on this matter during the inquiry. It is in the national interest for the Government to take all appropriate measures to ensure that, through the ongoing rationalisation of the defence industry, Australia continues to have a defence industry that meets our national needs.

5.3 The Australian defence industry now comprises a small number of privately owned prime contractors<sup>2</sup>, small to medium-sized enterprises and small companies providing boutique or specialised services. Much of their defence work is supplied to the ADF or the Department of Defence. According to Mr Sharp (GEC-Marconi), not much is exported given the difficulties of breaking into overseas defence markets in competition with large foreign prime contractors.<sup>3</sup>

#### Industry comments

5.4 The Defence Council submitted that:

If the Government and/or the Defence Organisation have a vision for the future structure of the industry it is not being clearly articulated. This causes the industry significant uncertainty in positioning itself for the future. Such a vision could be expected to include:

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1 These matters were considered under term of reference 2(b).

2 Although most witnesses said there were about five prime contractors, the Defence Council said there were 27 companies that had submitted bids for prime contracts.

3 *Committee Hansard*, 25 October 1999, p. 1.

- An appraisal of the current trends in industry restructuring around the globe, particularly among major defence powers;
- An assessment on how these trends will affect the Defence portfolio, including a forecast on how major capability decisions and the acquisition process will be affected, and the consequent ramifications for the domestic industry across all major tiers; and
- A broad action plan for detailing the Government's position on how the domestic industry can prosper in the new environment.<sup>4</sup>

5.5 In his evidence to the Committee, Defence Council Policy Adviser, Mr Christopher Rodwell, explained that the Department of Defence has strong links with the defence industry through the publication of the Pink Book (Defence New Major Capital Equipment Proposals 1998-2003) and the Yellow Book (Defence Forward Procurement Plans for Minor Capital Equipment 1999-2004) and 'through various forums, such as the Capability Development Advisory Forum'. However, he went on to say that:

I suppose this is a broader issue than any one forum. The 1998 defence industry strategic policy statement was, in a sense, an outlook for the defence and industry relationship. For the Industry Group Defence Council, the logical step then is to put together a vision for the future structure of the industry. We have looked at the defence-industry relationship; now it is time to move forward and look at what the future industry will look like, because it does affect Defence. The fact is that, if the industry does not rationalise, there is little doubt that we will be seeing more defence spending flowing overseas. Really, it is Defence's interests – and, more broadly, in the government's interests - to see that this vision is put forward to help industry set itself up for the future.<sup>5</sup>

5.6 In June 1998, the Government released its Defence and Industry Strategic Policy Statement. The foreword to the Statement reads:

This strategic defence industry policy will put into place the appropriate framework, in partnership with industry, to ensure the ADF acquires the capabilities we identify as vital, in a nationally efficient way.

5.7 As to whether the Department of Defence took into account the future shape of Australia's defence industry and national security when assessing the bids for ADI, the Head of Industry Procurement Infrastructure, Mr Graham Kearns, told the Committee:

Given that ADI is one of the largest players in the Australian defence industry, clearly what happens in the sales process is going to have some

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4 Defence Council of the Australian Industry Group, submission.

5 *Committee Hansard*, 26 October 1999, pp. 74-75.

effect one way or the other on the shape of that industry and on whether that shape would better serve our interests or not. That was one issue that we certainly focused on, and that meant that we looked at the two bids in terms of what that shape of industry would be and to what extent we would prefer either bid from that point of view.<sup>6</sup>

5.8 Mr Ian Sharp, Managing Director of GEC-Marconi Systems Pty Ltd, expressed sentiments similar to those of Mr Rodwell in his evidence to the Committee:

First, Defence needs to sit down and understand what are its long-term strategic demands of industry, then within maybe an industry portfolio understand the benefits that a strong defence industry sector does bring to the Australian economy. Once those are understood, they should work with industry to achieve the outcomes they are looking for. Having worked in the defence industry now for 20 or 25 years, I say that to date such discussions and such a model have not been developed.<sup>7</sup>

5.9 Asked whether he thought there was not enough collaboration between the defence industry and the Department of Defence, Mr Sharp replied:

That is correct. Before you have that collaboration, and maybe it happens in parallel as well, a government of any persuasion needs to understand those benefits which we have just been talking about, develop an industry model and then work with industry for that outcome. Definitely from both the government and the opposition at the moment I have seen a change through the privatisation process, where these things have been thought about maybe for the first time, and I think that needs to continue.<sup>8</sup>

5.10 Mr Bathgate (Tenix) said that the initiatives being taken as a result of the 1998 policy statement will assist planning within the defence industry. He went on to say that Defence is talking to industry about the capabilities they have in mind in the future and seeking input from industry about achieving those capabilities, rather than about talking about particular contracts. He added that 'it is early days as yet; that might be the best and simplest way of putting it'.<sup>9</sup>

5.11 In his opening statement to the Committee, Mr Tony Shepherd, Chief Executive Officer, Project Development, Transfield Thomson-CSF Pacific Holdings, drew attention to the rationalisation already taking place within the Australian defence industry – the BAe acquisition of Siemens Plessey and the upcoming merger with GEC-Marconi, and the Lockheed Martin Tenix joint venture, apart from the Transfield Thomson CSF purchase of ADI. He went on to say that:

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6 *Committee Hansard*, 26 October 1999, p. 103.

7 *Committee Hansard*, 25 October 1999, p. 15.

8 *Committee Hansard*, 25 October 1999, p. 15.

9 *Committee Hansard*, 25 October 1999, p. 64.

In examining the Australian defence industry, it is important not to get too carried away by the number of competitors; rather, one should focus on which companies are capable of being prime contractor on major procurements and have access to the appropriate technology. An examination of the industry on this basis shows that we have two, and at best three, competitors in each of the major defence segments of naval, aerospace, land and sea for ISR. A reinvigorated and independent ADI is vital to the retention of a strong local capability and competition, particularly given the small number of companies that are truly prime contractor capable.<sup>10</sup>

5.12 The rationalisation that is taking place within the Australian defence industry reflects global rationalisation trends but its evolving structure also reflects Australian Government acquisition policies and practices.

5.13 Mr Favaloro told the Committee:

The government is in an extremely powerful position to influence the shape and the structure of the Australian defence industry by the way that it implements its purchasing decisions. At the present moment, we find it difficult to understand how the procurement policy is being applied. It leaves us with the impression that the policy is being implemented as if there was a policy of competition at any cost. If that is the case, the Williamstown dockyard, which we own and control and use to build naval ships, in the scenario you have described would be ill-placed to cope, because in a \$5 billion program you can build another shipyard - perhaps it would cost you \$100 million or \$150 million - and you would add it to your price. It might not make a big difference in a \$5 billion program.<sup>11</sup>

Having said that, there are ways that have been developed in other countries of having a defence procurement policy which would enable you to have a prime contractor with a single facility, such as our yard, contract that for a specific project in a specific fashion and have the suppliers and subcontractors and the technical solutions that would be wanted by the government run on a competitive basis underneath that yard. In other words, the yard is the prime contractor that is engaged for a specific project on specific terms, but the sourcing of and access to supplies, be they from the US or elsewhere, and the implementation and integration of those supplies into whatever the vessel is can also be done in a competitive spirit, because you are now running these things in a collaborative sense with your prime contractor sourcing best of breed from overseas. In addition, you can use the process to develop a local R&D which may not otherwise be there.<sup>12</sup>

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10 *Committee Hansard*, 25 October 1999, p. 28.

11 *Committee Hansard*, 25 October 1999, pp. 56-57.

12 *Committee Hansard*, 25 October 1999, p. 57.

5.14 Mr Sharp also drew attention to Tenix's dockyard dilemma and then discussed a similar problem facing his company:

We suffer exactly same problem in electronics systems and software projects. We run a major project today which is coming to a conclusion. What do I do with 200 software engineers as I wait for the next contract to come through? We put a lot of investment into the processes, training of our people and the like, and, unless I can have a long-term plan, what do I do? As I go through the cycles of demand in the defence requirement area, I could possibly open and shut businesses of a totally different nature every five years to meet that demand to be competitive, but it does not make sense.<sup>13</sup>

5.15 When taken back to the dockyard example, Mr Sharp elaborated on the views he was putting to the Committee:

I think that in the planning and the concept of running a shipbuilding cycle from frigates to landing craft to whatever it happened to be there is a continuum which can be planned better than it is today. It is challenging, given different demands on the defence requirement, changes in priorities, Timor - it is a dynamic world. If it is communicated well with industry then I think we can live with it. I would suggest that in some areas competition as we have seen it today could change. You commented that you would not necessarily give it to that company. I would suggest that there are models which say you could give it to that company as long as you had an infrastructure in place that showed you are getting value for money.<sup>14</sup>

5.16 Asked whether the Government would still go out to tender, Mr Sharp replied:

Not necessarily. If you look at some of the models in the US and Europe, those governments definitely support certain prime contractors that are major employers where there is not necessarily the level of competition that we suffer today at a prime contract level. They have an open book policy where things are audited and you have got competition at various levels within the food chain. But I think you will find there are very few companies here today that have the deep pockets and the resources to prime contract and manage the risk successfully. That in itself is a challenge.<sup>15</sup>

5.17 Although Mr Favaloro had suggested views similar to those of Mr Sharp, Tenix had obviously taken note of the winds of change in relation to future naval ship building in Australia. He told the Committee:

The Williamstown dockyard was established for the purposes of naval ships. We have been building naval ships there since the middle of the 1980s - well, actually much longer. The Anzac ships were started there in the late

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13 *Committee Hansard*, 25 October 1999, p. 16.

14 *Committee Hansard*, 25 October 1999, p. 16.

15 *Committee Hansard*, 25 October 1999, pp. 16-17..

1980s - 1988 or 1987, I think it was. That program runs out in 2004. Two years ago we realised that the Department of Defence's requirements were shifting and they were not going to be looking for more ships. So we have expanded and changed the shape of our business to be ready to be able to address the department's requirements when they eventually emerge in the future.

That is the reason why, for example, we now have a business that addresses the requirements of army, the land business. We have an aerospace business that is attempting to address the interests and requirements of the Air Force. Also, we have created a systems business, because you cannot run a modern Defence project unless you have the ability to take the various electronic components supplied from wherever, mostly overseas, and integrate them into a whole solution here in Australia. So we have created a business unit that is capable of doing that as well. We recognise that there is a need for us also to evolve and change to keep up with the government's and the department's requirements.<sup>16</sup>

5.18 It is evident to the Committee that there is concern within the Australian defence industry about the extent of consultation and co-operation between Defence and the industry about acquisition policies and practices and their effect on the evolving structure of the industry. The Committee does not wish to be prescriptive on the future of the Australian defence industry in this report because it would need a broader range of evidence under more specific terms of reference. Nevertheless, Committee believes that it is important to flag this concern to ensure that it is placed on the agenda and is discussed in appropriate consultative fora in the national interest. The ability of the defence industry to meet Australia's defence needs in the future is not something that should be taken for granted.

Senator John Hogg  
Chairman