Chapter 14

The role of Defence in Australia's naval shipbuilding and repair industry—informing industry

Background

14.1 Information is the lifeblood of any industry. One way of improving the efficiency and overall performance of an industry is to ensure that it has the necessary information to learn from previous experiences and to plan ahead. This chapter focuses on how well the Australian industry is informed about the performance of past projects, including local premiums, and about Defence's policy on Australian involvement in major projects. It also considers the value of the Defence Capability Plan as a means of keeping the industry informed about Defence's future plans and intentions regarding its acquisition program.

Australian industry—an informed provider

14.2 As noted in chapters 9 and 10, the committee was unable to obtain any meaningful data on the productivity of Australia's naval shipbuilding and repair industry. Furthermore, recent studies conducted on Australia's naval shipbuilding projects by ACIL Tasman, commissioned by the Australian Industry Group Defence Council with support from other organisations and the Department of Defence, had difficulty extracting information from the department.

14.3 In a general discussion about the availability of information on major naval products, Mr John O'Callaghan, Head of the Australian Industry Group Defence Council, told the committee that, for example, he had never seen any public analysis of the problems that occurred with the Collins class submarine. He said:

> I know for a fact that one of the great errors we made, and I was partly responsible for it, was that we paid too much upfront at the time we signed the contract. That meant that when we got downstream we did not have enough financial leverage on the contractors—because that was more than one—to force them to perform better. That was an important lesson. That is the sort of lesson I am talking about.[1]

14.4 Mr O'Callaghan acknowledged that problems are a natural part of project activity but 'it is how those problems are managed which is the key thing'. He thought that Defence needed to be 'a bit more mature about putting on the table' some of the lessons from experiences such as the problems with the modernisation of the FFGs and the Collins class submarine. In his view, such an approach may help industry avoid the sorts of problems that have arisen. He said that he had never seen any public analysis of these problems and called for a 'sensible debate' about failures:

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1 *Committee Hansard*, 28 June 2006, p. 31.

> …exposing some of these analyses so that industry can get the benefit of it, and the media, would avoid some of the tabloid sensationalism that we see from time to time.[2]

He added that one of the challenges for the DMO over the coming five years 'is to fess up when errors are made because we learn from the errors'.[3]

14.5 A number of commentators pointed to the problems that can result from the lack of information about Navy acquisitions including the speculation that can swirl about a project when information is vague or general.[4] Mr Derek Woolner noted:

> Had people understood that the Collins submarine project was a developmental project and that there had been a change from the earlier stated project objective, which was to buy a proven submarine in service or about to enter service with an overseas navy, there would have been a greater understanding of how the project would work out, perhaps some expectation that there would be problems that would need to be fixed and a clearer basis on which to draw the contract.[5]

14.6 The lack of data on the public record means that industry experts and companies involved in the industry cannot obtain a complete picture of how the industry operates. On the one hand, insufficient information stifles public debate and undermines accountability and on the other encourages speculation about projects. Such a situation is unhelpful for the industry and for Defence.

14.7 Commercial-in-confidence concerns may well prevent some information from being available. Even so, regular and frank analysis of the successes and failures of projects and the extent of assistance given to a project (local premium) could assist industry. This knowledge would help to keep industry better informed about the performance of particular projects and also make Defence more accountable for its decisions and the way it manages major projects. Indeed, as noted earlier, Mr John O'Callaghan, Head of the Australian Industry Group Defence Council, was of the

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2 *Committee Hansard*, 28 June 2006, p. 30.

3 *Committee Hansard*, 28 June 2006, p. 31.

4 See for example the discussion about the reported $6b final cost estimate for the AWDs. The committee notes that the 2006–2016 Defence Capability Plan stated that 'Estimated Phase Expenditure' for the AWDs (Project SEA4000) was between $4.5 billion and $6 billion. In evidence given to the committee, Mr Greg Tunny, Managing Director of ASC Pty Ltd, hesitated in confirming the $6 billion price tag for the AWD project. Defence acknowledged that the 2001–2002 estimated expenditure of $3500m to $4500m was updated in the 2004–2014 DCP to $4500m to $6000m. It explained that the revision in cost estimates 'allowed for the cost of additional capabilities, contingency and price movement'. It was also aware that some commentators were suggesting that the cost of the AWDs may be as high as $8 billion. It concluded that two design options were under consideration that would vary in capability, cost, schedule and risk. The final cost of the AWDs would be dependent upon these decisions. Questions 20, 21, 23, answers to written questions on notice from 18 October 2006.

5 *Committee Hansard*, 4 September 2006, p. 21.

view, that a more open approach may help industry avoid the sorts of problems that have arisen.

14.8 The committee sees a need for Defence to make available information that would enable the analysis of major projects and to release the results of their own studies on the performance of projects. In noting that the studies that have been undertaken on major naval acquisitions tend to be conducted at the end of the construction of the vessels, the committee suggests that data should be gathered and analysed as a project moves through its various construction stages. This continuous monitoring would increase transparency and improve accountability of how a project is being managed. Clearly, Defence, must develop and adhere to high standards of probity and accountability in its procurement practices. The committee accepts that commercial-in-confidence requirements will prevent the disclosure of some information but this should not be used as an excuse for withholding data that could be placed on the public record.

Recommendation 2

14.9 The Committee recommends that the government establish a thorough detailed model, subject to audit by a body such as the ANAO, for the establishment of through life design, construction and maintenance costs of each naval ship building project in the future by class and by individual ship. The model to contain sufficient detail to enable benchmarking to be done on an international basis, providing total budget accountability, assessment of domestic industry competitiveness, including all administrative overheads, with industry compliance to be mandated in all contracts.

14.10 The committee recommends further that Defence commission an independent assessment of the progress of major projects against the model as it attains set milestones providing explanations for any departures from the costings and other projections contained in the model. The reports to be provided to the Minister for Defence to be tabled within 3 months of being submitted to the Minister.

14.11 The committee now examines local build premiums as an indication of the information made available on naval acquisitions.

Premiums for local builds

14.12 As mentioned in chapters 3 and 4, Defence has awarded local industry a cost premium for past RAN warship projects. It is very difficult, however, to obtain reliable evidence on the premiums. Even for well-publicised projects such as the ANZAC Ship Project, the committee cannot confirm the veracity of the 3.5 per cent figure.

14.13 This confusion also surrounds the upcoming LHD bid. Mr O'Callaghan drew the committee's attention to an article in the *Australian Financial Review* on 29 July 2005 which stated estimates that an in-country build of the LHDs 'could be 30 per cent

higher than the cost of acquiring them overseas'. Mr O'Callaghan rejected this estimate stating:

> It is a number which to the best of my knowledge, no-one in Defence has ever exposed with any analysis. It is a number which has no bearing in terms of our own track record in the Australian defence naval construction industry in successfully building the number of platforms I mentioned previously.[6]

14.14 Again, the lack of clear statements by Defence has encouraged public speculation. Mr O'Callaghan stated that Australian industry has never had 'the benefit of the sort of modelling or analysis that is being done within Defence and which leads to that outrageous '30 per cent' statement being made…' He added 'It is bunkum, basically. I would love to see the analysis, so let us encourage them.'[7]

14.15 Engineers Australia suggested that Defence should provide clear guidance on the level of any premium attributable to construction in Australia, versus construction overseas, and particularly for the costs of any new infrastructure and training of personnel.[8]

14.16 It should be noted that, according to Defence, it 'does not directly apply a premium to undertake naval shipbuilding projects in Australia'.[9] It explained:

> In accordance with Commonwealth Procurement Guidelines, the source selection for the acquisition and sustainment of military platforms and systems is based on best value for money. The strategic value of generating and sustaining indigenous industry capabilities, as required in support of ADF operational capability and military self-reliance, is one of many factors taken into consideration in Defence's overall value-for-money considerations.[10]

14.17 The committee believes that this is another way of saying that some naval shipbuilding projects in Australia do attract a local build premium.

14.18 In its tender documents, Defence defines the indigenous industry capability outcomes it requires. It explained that:

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6 Mr John O'Callaghan, *Committee Hansard*, 28 June 2006, p. 19.

7 *Committee Hansard*, 28 June 2006, pp. 32–33.

8 Engineers Australia, *Submission 24*, p. 11.

9 Department of Defence, answer to question on notice, 18 August 2006, (received 29 October 2006), Question 3.

10 Department of Defence, answer to question on notice, 18 August 2006 (received 31 October 2006), Question 3.

> The associated cost of developing program-specific indigenous industry capability is reflected in the overall value-for-money consideration of achieving program objectives. [11]

14.19 Defence was 'unaware of any naval shipbuilding decision in the past 20 years that was not based on value-for-money considerations'.[12] Whether the additional cost to construct a ship in Australia is termed an in-country build premium or value for money, there is no reliable information available on the extra costs involved in major naval ship construction undertaken in Australia. Defence informed the committee:

> Defence is unaware of any formal internal reviews to determine whether undertaking naval shipbuilding projects in Australia has returned value-for-money over time. The tender evaluation process and subsequent source selection decision for naval shipbuilding projects and naval sustainment contracts are based on value-for-money criteria, and this has partially obviated the need to undertake such reviews.[13]

14.20 At the moment, Defence's method for determining cost premiums or 'value for money' for local construction lacks transparency and has given rise to unhelpful speculation. This lack of transparency may have implications for industry which has no clear guidance on the policy and application of local build premiums and for Defence's accountability. This matter of local build premium is closely related to another area of vital importance to the industry—the policy governing Australian industry involvement in major naval acquisitions.

Industry involvement

14.21 Accurate, reliable and clear information on Defence's policy regarding local Australian involvement in its major acquisition projects is fundamental for those in the industry to plan and manage their business effectively.

14.22 According to the January 2001 Australian Industry Involvement (AII) Manual, indigenous industry capability is 'crucial' to meeting the ADF's capability requirements.[14] The Manual identifies the AII Program as 'the key tool for maximising

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11 Department of Defence, answer to question on notice, 18 August 2006, (received 31 October 2006), Question 3.

12 Department of Defence, answer to question on notice, 18 August 2006, (received 31 October 2006), Question 3.

13 Department of Defence, answer to question on notice, 18 August 2006, (received 31 October 2006), Question 4.

14 Department of Defence, Industry Operations Branch, Industry Division, *Australian Industry Involvement Manual*, p. 1–1. http://www.defence.gov.au/dmo/id/aii/manual_inclannexes_5Feb00_contactsremoved.pdf

the involvement of Australian industry development in Defence acquisition projects…where this is cost effective'.[15]

14.23 A June 2006 *Defence Industry Policy Review* Discussion Paper noted that the AII program is less transparent than what it once was. The Paper mentions that Defence's previous method of listing specified percentage targets for Australian industry content was ineffective in achieving particular industry capabilities. However, it added that specifying targets was transparent, 'and allowed industry to seek the most cost-effective solution to the requirement'.[16]

14.24 The committee was particularly interested to obtain an understanding of the policy on Australian involvement in major naval acquisitions.

14.25 In evidence to the committee, Defence made plain that the primary objective of its industry policy was to ensure that there is sufficient indigenous capability and capacity to support the operational capability of Australia's naval vessels, once acquired. It explained that it:

> uses its acquisition leverage to generate the required level of in-country skills, technologies and capabilities to meet this objective. The nature and level of skills, technologies and capabilities required for support is assessed on a project by project basis.[17]

14.26 Defence advised the committee that in some projects, industry issues may attract a higher priority in the overall process of tender evaluation.[18] It explained that local industry involvement in its projects is approached through a series of steps which involves Defence:

- identifying the industry capabilities it considers important for strategic, logistical and other reasons;
- specifying industry capability outcomes for new projects, i.e., the outcomes it wants in terms of support services, in the Request for Tender (RFT);[19] and
- assessing each bid and ranking potential suppliers in terms of the quality of their response to Australian industry and other tender requirements.

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15 Department of Defence, Industry Operations Branch, Industry Division, *Australian Industry Involvement Manual*, p. 2–1. http://www.defence.gov.au/dmo/id/aii/manual_inclannexes_5Feb00_contactsremoved.pdf

16 *Defence Industry Policy Review* Discussion Paper, June 2006, p. 17.

17 Department of Defence, answer to question on notice, 18 August 2006 (received 31 October 2006), Question 15.

18 There is no uniform level of Australian industry involvement specified for each project. That is, fixed percentages specifying targeted values of Australian industry participation are no longer part of the tender process.

19 These industry capability outcomes may cover specific requirements, such as the ability to modify command and control system software, or they may be more general, such as the ability to undertake deeper maintenance of systems in Australia.

14.27 Having defined the level of in-country activity required to meet its strategic industrial capability needs and confident that demand is sufficient to sustain the required level of activity; Defence takes the approach that the remaining work should be subject to open competition on the global market.[20]

14.28 According to Defence, the principal criterion against which the proposals are evaluated is how well tenderers' Australian Industry Capability proposals meet the industry capability outcomes required for the project and specified in the RFT'.[21] It informed the committee that 'a bidder's failure to satisfy all of the Australian industry involvement outcomes set out in a RFT may disadvantage that bidder relative to its competitors and potentially disqualify the bidder from contention'.[22] Defence stated, however, that it 'retains the right to select a bidder whose approach may not satisfy all Australian industry involvement outcomes set out in the RFT if other aspects of its approach provide offsetting benefits.[23] Thus, while Australian industry involvement outcomes are considered important by Defence, there may be instances where a preferred bidder is selected without these being satisfied fully'.[24]

14.29 Defence also stated that proposals for local industry involvement are evaluated on the basis of value for money and tenderers are required to show how cost-effective involvement in the project by Australian industry has been maximised.[25] According to Defence, 'This does not always mean that goods and services sourced from local industry must be cheaper than those available from overseas. There may be instances where paying more for a local source of supply yields offsetting strategic or other benefits which mean that value for money has been achieved'. Defence explained:

> The percentage or dollar value of Australian content is but one factor. Direct benefits such as capabilities for support and savings resulting from shorter repair times are taken into consideration in evaluation against these criteria. Some of the less tangible benefits, such as technology transfer and

20 Department of Defence, answer to question on notice, 18 August 2006 (received 31 October 2006), Question 16.

21 Department of Defence, answer to question on notice, 28 March 2006 (received 29 May 2006), p. 48.

22 Department of Defence, answer to question on notice, 28 March 2006 (received 29 May 2006), p. 7.

23 Department of Defence, answer to question on notice, 28 March 2006 (received 29 May 2006), pp. 47–48.

24 Department of Defence, answer to question on notice, 28 March 2006 (received 29 May 2006), p. 7.

25 Department of Defence, answer to question on notice, 28 March 2006 (received 29 May 2006), pp. 47–48.

> access to intellectual property, are achieved through the activities proposed for Australian industry and form part of the evaluation of these activities.[26]

14.30 Engineers Australia called on the Australian government to:

> Clarify the strategic direction of the Australian naval shipbuilding and repair sector so as to determine the weighting that Australian industry development should have in the value for money calculation in the source selection of the Amphibious Ships' preferred tenderer and potential prime contractor.[27]

14.31 Having questioned Defence at length about how it goes about determining and informing industry about its requirements for Australian involvement in its acquisition projects, the committee still does not have a clear understanding of the department's policy on this issue and how it applies this policy. The matter becomes even more difficult to understand when taking account of the broader economic advantages that accrue to an in-country build.

14.32 The committee notes Defence's own statement that matters such as technology transfer and access to IP form part of the evaluation of tenders. Other benefits, however, 'such as potential spin-offs to industry at large and wider benefits to the economy, such as increased employment, may be recognised but play little or no part in the numerical evaluation. Such benefits will be noted in advice to Government'.

14.33 Given the difficulties estimating the value of broader economic benefits, the committee asked Defence how these wider benefits would be 'noted in advice to Government'. It explained:

> Knock-on effects such as industry skilling, regional development, engagement of local businesses, enhanced employment opportunities and a range of other factors will be noted in the business cases. Other Government departments and agencies such as the Department of Industry, Tourism and Resources, will be engaged by the AWD Program in assessing potential benefits.
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> In respect of the LHD Program, the tender incorporates a strategy which seeks as far as practicable to maximise Australian content during the build phase, within budgetary guidance. The tender also stipulates Australian content requirements for through-life support and mandates certain Australian systems as costed options.
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> However, tenderers will also be able to submit an additional proposal—'Tender-Initiated Options'—which will increase the contribution of Australian industry, but at increased cost which may exceed the guidance in the Defence Capability Plan. The Tender-Initiated Options proposals will need to demonstrate specifically that they offer value for money by

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26 Department of Defence, answer to question on notice, 28 March 2006 (received 29 May 2006), pp. 47–48.

27 *Submission 24*, p. 2.

> showing the marginal benefit of the extra expenditure that will accrue to the Commonwealth and to Australian industry.
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> Tender evaluation will also consider the projected benefit of effects on the wider economy. This element will be conducted by contracted, independent third-party experts. The analysis will examine the tenderer's economic benefit assessment including the validity of assumptions, their economic viability and the likely effects of the proposal on other major defence projects.[28]

14.34 This explanation demonstrates clearly, why industry may be confused about Defence's intentions and plans for the domestic industry, let alone its commitment, to involve Australian companies.

14.35 The committee now turns to address directly the lack of information on Defence's policy on Australian industry involvement in its major naval acquisitions and how it applies this policy.

14.36 As noted earlier, the construction of a modern naval vessel is a major and expensive undertaking with substantial follow-on effects that benefit the broader economy. From Defence's perspective, an off-the-shelf purchase from overseas may offer the capability it wants at an apparently lower cost. This situation may well create tension between the government's desire to foster local industry and Defence's approach based on a narrow definition of value for money which takes account only of Defence's capability requirements and not the economy as a whole.

14.37 Although Defence asserts that it does not consider naval procurement decisions in terms of broader economic considerations or market influence, the government cannot divorce itself from such considerations. It has a broader responsibility that encompasses the whole economy. It follows that Defence's acquisition decisions should be consistent with the government's policy on Australia's broader industrial base.

14.38 The confusion arising from Defence's response to the committee's questions on Australian involvement and Defence's procurement policy and practice may well be due to a disjunction between the broader political interest in fostering Australian industry and Defence's primary concern with capability and value for money. There is a clear need for Defence to clarify its position and to articulate its policy against the broader government policy regarding Australian involvement in government funded acquisitions.

14.39 The committee is aware that Defence is currently undertaking a review of its Defence industry policy. This will be discussed in the following chapter. Whatever the outcome of this review, the committee sees a definite need for Defence to articulate

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28 Department of Defence, answer to question on notice, 18 August 2006 (received 31 October 2006), Question 12.

far more clearly its policy on involving Australian industry in its major projects and how this policy sits within the broader government policy on Australian involvement.

Recommendation 3

14.40 The committee recommends that Defence clearly articulate its policy on Australian industry involvement in naval shipbuilding and repair.

Recommendation 4

14.41 The committee recommends that Defence at the earliest phase of a major naval acquisition issue a statement on the measures it intends to take to maximise Australian industry involvement in that project and how they fit within Defence's broader acquisition program and the whole of government approach to support local industry.

Recommendation 5

14.42 The committee recommends that in tender documentation, Defence provide detailed information on the value placed on, and the weight given to, Australian industry involvement.

Recommendation 6

14.43 The committee recommends that as a benchmarking exercise, Defence on completion of a project, report on the measures it had undertaken to involve Australian industry in the project and the results of those measures. The report is to be provided to the minister for tabling in the parliament.

Conclusion

14.44 The committee notes the absence of meaningful data that would help to inform industry about the factors that shape or influence major acquisition decisions. The most notable areas where little information was available included analysis on the performance of past projects especially where there have been scheduling or budget problems, milestone assessments as a project moves through its various stages, the policies underpinning local industry involvement including the application of those policies and on government subsidies for a local build. Such information would generate debate and promote critical analysis by those interested in the industry. They would gain a better appreciation of the factors that shape or influence major acquisition decisions. It would also assist the industry better appreciate how the industry is performing and enhance the accountability and transparency of naval acquisitions. Indeed, the information made available on local build premiums exemplified the problems associated with the way in which the government and Defence convey information about the industry.

14.45 The following chapter examines one of the areas of concern to many of those who participated in the inquiry—the planning process for naval Defence's acquisition program.