



Premier of Victoria

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Senator Helen Kroger
Chair
Senate Foreign Affairs, Defence and Trade References Committee
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Parliament House
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Dear Senator

Thank you for your letter about the Inquiry into Defence Procurement, and for the extension granted by the Committee Secretariat.

The Victorian Government acknowledges of the role that Victorian defence companies play in supporting the Australian Defence Force. As such we appreciate the opportunity to make a written submission to the Committee's Inquiry into Procurement Procedures for Defence Capital Projects.

The Committee's Inquiry is timely, as the Victorian Government is aware of a number of significant issues facing the local defence industry. The attached submission presents these issues for the Committee's consideration.

Regards

 **Ted Baillieu MLA**
Premier



DEPARTMENT OF BUSINESS AND INNOVATION

Victorian Government submission

**Senate Inquiry into 'Procurement Procedures for Defence
Capital Projects'**

May 2011

Summary

The 2009 Defence White Paper and the 2010 – 2020 Defence Capability Plan (DCP) outline the Commonwealth Government's plans for a major defence equipment investment program that offers many opportunities for Australia's defence industry.

The Victorian defence industry is a strategically important sector and delivers high return economic opportunities for Victoria and Australia. The Victorian Government is committed to ensuring that Victoria's defence industry remains highly skilled, productive and competitive.

There are a number of issues currently impacting on the sector which, if unresolved, could lead to the loss of some core industry capabilities and impact on the ability of local industries to service the future needs and requirements of the Australian Defence Force (ADF).

The key issues concerning the Victorian Government are as follows:

- ***The slow down in Defence procurement:*** The slippage in the timing of domestic Defence procurement opportunities and delays in decision making is having a detrimental effect on the ability of defence industry companies to make the necessary business and investment decisions to ensure the ongoing viability of the sector.
- ***Military off the shelf and Commercial off the shelf purchasing:*** The Victorian Government accepts that the purchase of military off the shelf (MOTS) and commercial off the shelf (COTS) products and equipment is a necessary and important part of supporting and modernising Defence's equipment inventory. It should not, however, allow the erosion of the nation's capability to design, develop and produce equipment where it is in the national interest to retain these capabilities.
- ***International opportunities for the domestic defence industry:*** The introduction of the Australian Industry Capability and Global Supply Chain initiatives have generated benefits for the domestic defence industry but both programs require continuing positive support and enhancement if they are going to provide lasting outcomes.
- ***Continuity of work for naval shipbuilding:*** The cyclical nature of the demand for shipbuilding is well understood by industry. What is of concern is the potential length of the demand 'gap' following the completion of the Air Warfare Destroyer and Landing Ship Helicopter Dock programs. Without the opportunity to bid for new work, shipbuilders will have to reduce or shut down operations and infrastructure, risking their ability to win new projects.
- ***The lack of support for proven local industries:*** Where it is in the wider national interest to do so, there is a need for Defence to find the best way to

support local industry with domestic defence work even if that industry sector does not pass the Priority Industry Capability or Strategic Industry Capability test.

- ***The Defence Capability Plan (DCP)***: Further improvements to the DCP and provision of similar information across all defence procurement programs will aid industry.

Overview of Victoria's Defence Industry

Victoria's defence industry provides the State and Australia with high-value employment and export revenues. The industry acts as a catalyst for growth and provides substantial flow-on benefits, such as innovation, to other industry sectors.

Victoria's defence industry consists of over 300 companies, generating around \$2 billion in turnover and over \$200 million in exports per annum. Almost 35 per cent of all defence industry activities occur in regional centres¹. The Victorian Government recognises the significant benefits which result from a strong local manufacturing industry, and is committed to maximising opportunities for the sector in both the near and long term.

Victoria has well established capabilities across the full defence industry spectrum and is recognised as:

- Australia's centre for military aerospace component manufacture;
- Australia's pre-eminent military vehicle designer and manufacturer;
- a major location for Australia's munitions manufacturing industry;
- a national leader in naval shipbuilding and design;
- a national leader for defence science, development and innovation;
- the national leader in autonomous systems design and development;
- a national leader for the design and manufacture of military uniforms and personal protective equipment; and
- a major centre for military and trade training.

Major global defence companies BAE Systems, Thales, Lockheed Martin, Boeing and QinetiQ have significant operations in Victoria. These companies are serviced by well-established and proven supply chains.

¹ AADI report on Victoria's Defence Industry 2009/10, Page ii.
(Available from:
http://www.business.vic.gov.au/busvicwr/_assets/main/lib60185/2010%20report%20on%20victoria's%20defence%20industry%20activity.pdf)

Response to the Committee's Terms of Reference

The Committee's Terms of Reference draw attention to some particular aspects of procurement procedures for items identified in the Defence White Paper, *Defending Australia in the Asia Pacific Century: Force 2030*. These are:

- A. assess the procurement procedures utilised for major defence capital projects currently underway or foreshadowed in the Defence White Paper, including the operations of the Capability Development Group and its relevant sub committees;
- B. assess the timeline proposed for defence modernisation and procurement outlined in the Defence White Paper;
- C. assess proposals arising from the Defence accountability reviews, including, the Mortimer Review, the Pappas Review and the McKinsey Report (2010), in regards to enhancing accountability and disclosure for defence procurement; and
- D. make recommendations for enhancing the availability of public information and parliamentary oversight and scrutiny of defence procurement in the context of guaranteed 3 per cent real growth in the Defence budget until 2017-18.

This submission provides discussion and recommendations relevant to the first, second and fourth subject areas in the Terms of Reference.

Terms of Reference

A. Assess the procurement procedures utilised for major defence capital projects currently underway or foreshadowed in the Defence White Paper, including the operations of the Capability Development Group and its relevant subcommittees.

A1 - The slowdown in Defence procurement

The slippage in the timing of domestic Defence procurement opportunities and delays in decision making are having a detrimental effect on the ability of defence industry companies to make the necessary business and investment decisions to ensure the ongoing viability of the sector.

At the Australian Defence Magazine (ADM) Conference held in February 2011, a number of senior officers from the Defence Materiel Organisation (DMO) publicly acknowledged a reduction in the number of Defence acquisition projects being put to tender. This reduction is significant and evident against the timing of Defence projects reported in the publicly available Defence Capability Plan 2009 and impacts

on the ability of companies to make informed and sensible decisions regarding current and future operations.

In fact \$8.5 billion in Defence spending has been deferred since the release of the 2009 Defence White Paper.² Further evidence of this slippage is that in the three years to 2007-08, the value of defence projects approved by Government was \$26.5 billion, while in the three years from 2008-09 (to June 2011) the value of projects approved is likely to fall below \$10 billion.³ To further amplify this point, the initial schedule to meet the timetable of the 2009 Defence Capability Plan required a total of 60 project approvals (first and second pass), while the actual number approved was 25.⁴

A related issue is the delays, against published timeframes, in announcing outcomes of projects that have been approved. The cost of bidding for Defence projects is already significant, delaying procurement decisions forces industry to assume outcomes or to take significant and other unreasonable business risks.

An example of the above situation is Project LAND 121 'Overlander – Field Vehicles & Trailers' Phase 3. The process for this project started eight years ago with the release of an invitation to register interest in August 2003. Since that time there has been continual and incremental slippage in decision making that has placed enormous pressure on bidding companies. The Commonwealth Government has acknowledged the delays in this project which has been added to the Government's 'Projects of Concern' list.

A consequence of the decline in Defence expenditure and delays in decision making is that defence primes are beginning to shed their workforce.

This is despite the Defence White Paper in May 2009 creating expectations that there was a real intent by the Commonwealth Government to modernise up to 80 per cent of Defence equipment in accordance with published timeframes.

While the defence primes have greater access to resources to manage this predicament, the small to medium enterprises (SMEs) that operate in this space find it more difficult.

About 70 per cent of the value of defence materiel produced in Australia for the DMO is sourced from eight defence prime contractors and around 30 per cent of this work is subcontracted to SMEs in Australia and overseas.⁵ There are around 300 SMEs in Victoria that primarily rely on defence work.

The relationship between the primes and the SMEs is crucial and despite the defence primes' prominence in the local industry landscape, they would not be able

² ADM conference presentation by the CEO of the Defence Materiel Organisation 15 February 2011

³ ADM conference presentation by Dr Mark Thomson (from the Australian Strategic Policy Institute) 15 February 2011, reported in the Australian Financial Review, Wednesday 16 February 2011; page 60.

⁴ ADM conference presentation by Dr Mark Thomson 15 February 2011.

⁵ Australian Government Policy Statement: 'Building Defence Capability: A policy for a smarter and more agile defence industry base'; page 26.

to meet the needs of customers without the support of SMEs. The Department of Defence has previously acknowledged that strong relationships between the primes and SMEs are important to ensure that the capability needs of the Australian Defence Force (ADF) are developed on time and on budget.⁶

The slippage in Defence expenditure has had a detrimental effect on a number of companies including efficient SMEs who had geared up to meet the schedule of activity defined in the 2009 Defence White Paper. While a number of SMEs in Victoria have left the sector in the past 12 months, it is concerning that there are a significant number of companies that have expressed a desire to enter the sector but feel it is not prudent to do so in the current environment. Thus it can be surmised that the current slow down is acting as a barrier to new entrants into the sector.

The Victorian Government recommends that the Committee notes the impact that delays in decision making and the slowdown in defence procurement is having on the sector and the potential that it has to erode the ability of local industry to service the current and future needs of the ADF.

A2 – Military off the shelf and Commercial off the shelf purchasing

The Victorian Government accepts that the purchase of military off the shelf (MOTS) and commercial off the shelf (COTS) products and equipment is a necessary and important part of supporting and modernising Defence's equipment inventory. This activity should not, however, allow the erosion of the nation's capability to design, develop and produce equipment where it is in the national interest to retain these capabilities.

The current focus on the procurement of military off the shelf (MOTS) and commercial off the shelf (COTS) equipment will eventually erode the ingenuity and capability of Australia's defence industry and force the sector down to the low value-add end of the engineering spectrum.

A quarter of a century ago Australia had a defence industry of substantial intrinsic capability and a world class engineering capability. This capability enabled Australia to design and build its own unrivalled over-the-horizon radar system, the Collins Class submarine - widely acclaimed as the world's best non-nuclear powered submarine, the ANZAC frigate - a highly capable warship class that uniquely met the specific requirements of the Australian and New Zealand navies; and a protected mobility vehicle – the Bushmaster, widely acknowledged as the best of type in the world and directly responsible for saving the lives of some 40 Australian and allied service personnel on active duty in Iraq and Afghanistan.⁷

⁶ Australian Government Policy Statement: 'Building Defence Capability: A policy for a smarter and more agile defence industry base; page 27.

⁷ Warren King, Deputy Chief Executive Officer of the Defence Material Organisation presentation to the ADM Conference, February 2011

Since then, however, these engineering capabilities have been allowed to move to other sectors of the economy or to decline and on current trends the Australian defence industry could, within a decade, be reduced to a sector merely focused on the repair and support of military equipment designed and manufactured off shore.

A continued preference for MOTS and COTS will hamper Australian defence industry growth, undermine defence self-reliance and in time, the ability of the domestic industry to support the ADF operational capability.

The Victorian Government recommends that the Committee further examines the impact of MOTS and COTS purchases on the future capabilities and capacity of the defence industry sector.

A3 - International opportunities for the domestic defence industry

The introduction of the Australian Industry Capability and Global Supply Chain initiatives have generated benefits for the domestic defence industry but both programs require continuing positive support and enhancement if they are going to provide lasting outcomes.

Today the defence market is truly global and it is unrealistic and counterproductive to isolate the Australian market from the international one. To this end the Victorian Government supports efforts by the Commonwealth to provide effective pathways for local companies to compete for international supply chain opportunities.

The Victorian Government recognises the significant benefits which result from a strong local manufacturing industry. Victoria's manufacturers are quality-driven and committed to their industries, and are outstanding contributors to the State's economy. The Victorian Government is committed to working with them to maximise opportunities, both within Australia and internationally.

While the Australian Industry Capability (AIC) initiative has a sound policy base, there is a risk that it will not be able to deliver the desired benefit. AIC provides sensible rules to allow opportunities for Australian industry but in times of high exchange rates it will be difficult for industry to provide value for money against international competition. Given that many Defence contracts are long term (10 years and more), there is a risk that a short term competitive disadvantage (based on current exchange rates) may determine the awarding of long term contract and so the future location of industry capability.

The Global Supply Chain (GSC) initiative has been very successful, with Victorian companies gaining a number of significant export orders. The success of the GSC is dependent on the goodwill of participating primes and a commitment from Defence to meet the financial obligations of the program. As such there is a risk to the ongoing viability of the program. This could be mitigated if:

- when negotiating future contracts for off-shore procurement, Defence places contractual obligations on defence primes to participate in, and meet the requirements of the program;
- Defence establishes stronger arrangements to meet the financial obligations of the program; and
- The Commonwealth introduces robust audit processes to ensure that local companies are actually gaining the access to opportunities that are being claimed.

Such initiatives would work to ensure that AIC and GSC objectives are being met.

The Victorian Government recommends that the Committee seek to strengthen the AIC and GSC programs to ensure that they continue to deliver measurable benefits to the Australian Defence industry.

Terms of Reference

B. Assess the timeline proposed for defence modernisation and procurement outlined in the Defence White Paper.

B1 - Continuity of work for naval shipbuilding

The cyclical nature of the demand for shipbuilding is well understood by industry. What is of concern is the potential length of the demand 'gap' following the completion of the Air Warfare Destroyer and Landing Ship Helicopter Dock programs. Not having the opportunity to bid for new work will have a negative effect on local manufacturing, such as shipbuilding.

The 2009 Defence White Paper outlined a significant expansion of Australia's maritime capability. The White Paper describes a future Royal Australian Navy that will operate a higher number of larger vessels than is currently the case and a doubling of the size of the submarine fleet. Including the Air Warfare Destroyer (AWD) and Landing ship Helicopter Dock (LHD) programs already underway, the total tonnage to be delivered in the next 25 years is over 265,000 tonnes. The corresponding figure in the previous quarter century is less than 150,000 tonnes.

As a result of the Commonwealth's commitment to a competitive model for naval shipbuilding, the LHD and the AWD programs are drawing upon both domestic and international capabilities to meet delivery timeframes for these vessels. These programs currently provide continuity of work out to 2015, however after that time the

opportunity for domestic shipyards is much less clear, and indeed there is very real likelihood of a significant gap before the next tranche of shipbuilding commences.

Failure to provide continuity of work erodes skills and delays capital investment decisions, which in turn leads to project delays and drives up costs.

The Senate Standing Committee on Foreign Affairs, Defence and Trade has previously acknowledged the need for better management of scheduling for naval shipbuilding projects. In 2006, the Committee examined the scope and opportunity for naval shipbuilding in Australia and recommended that:

“Recommendation One. The Committee recommends that the Government make a public commitment to maintain Australia’s naval shipbuilding and repair industry. This commitment to be supported by improved long-term planning of naval shipbuilding needs in order to maximise economies of scale and provide continuity for the broad but specialised design and construction skills required for a healthy industry over the long term.”⁸

The current Defence Capability Plan contains a number of shipbuilding projects that could be rescheduled to provide the continuity of work required for industry to enable it to be current and competitive. This is particularly relevant should the Commonwealth elect to continue its stated policy of supporting local competition in the naval shipbuilding sector.

The Victorian Government recommends expedient action is taken by the Federal Government and the Department of Defence to close the impending gap in naval shipbuilding opportunities by bringing forward projects that provide the opportunity to bid for work.

⁸ Blue Water Ships: consolidating past achievements (released December 2006), page xxvi

B2 - The lack of support for proven local industries

Where it is in the wider national interest to do so, there is a need for Defence to find the best way to support local industry with domestic defence work even if that industry sector does not pass the Priority Industry Capability or Strategic Industry Capability test.

The Defence White Paper 2009 outlines the Commonwealth Government's commitment to ensure that certain strategically important industry capabilities continue to be available from within Australia. Under this policy, the Government has identified 12 Priority Industry Capabilities (PIC) along with a number of Strategic Industry Capabilities (SIC). The Victorian Government acknowledges the robust process used by Defence to determine its PICs and SICs, and recognises that the list will change over time as the requirements and priorities of the ADF change.

What appears to be missing for those industry sectors that do not pass the PIC or SIC test is the capacity or will for Defence to overtly support local industry where that industry has demonstrated capabilities which might be in the wider national interest to sustain into the future.

This situation occurs in the protected mobility sector where Australian industry has demonstrated the ability to produce a vehicle (the Bushmaster) that is internationally recognised for its quality and capability. That sector supports manufacturing in regional Australia, creates export opportunities and helps to sustain an SME supply chain that also supports the wider automotive sector. These outcomes are important for the national economy and a balancing of economic opportunities, yet there is no obligation on Defence to sustain this sector.

<p>The Victorian Government recommends that the Committee note that where there is a wider national benefit from sustaining particular defence industry sectors, and that there is a need to find the best way for them to be supported through domestic defence work, regardless of whether the sector is classified by Defence as a PIC or SIC.</p>

Terms of Reference

D. Make recommendations for enhancing the availability of public information and parliamentary oversight and scrutiny of defence procurement in the context of guaranteed 3 per cent real growth in the Defence budget until 2017-18.

D1 - The Defence Capability Plan is an important resource for the defence industry

There are a number of enhancements that, if applied, would serve to make the DCP a more usable and informative information resource. These fall into the three broad areas: 'improving understanding', 'enhancing utility' and 'other Defence procurements'.

The Defence Capability Plan (DCP) is an effective means for the provision of public information on Defence's capital equipment acquisition program. The Victorian Government welcomes the return of the 10 year DCP as this provides industry with a greater degree of planning certainty and allows for more balanced and informed decision making by industry.

Improving Understanding

As it currently stands, the DCP is difficult for industry to understand and fully comprehend. For example, project descriptions make little allowance for a reader who does not have a strong defence background. This is a particular issue for many SMEs who are unlikely to have staff with the necessary background to make full use of the information in the DCP.

Similarly, the DCP fails to identify where the real opportunities lie for industry. The background information and project scopes do not identify whether a project is truly 'footloose' or part of a multi-phase project that has been the domain of one particular supplier or provider.

Enhancing Utility

There appears to be a significant disparity between the data provided on the different projects in the plan. This disparity can be explained to a degree by the sheer number of projects in the current DCP, however the use of a standard template, augmented by a proof-reading service would ensure that there is a consistent level, tone and style applied.

Other Defence Procurements

While regular updates of the 10 year DCP provide a good level of information on Defence's capital acquisition plans, finding information on Defence's other programs is more difficult. The Chief Information Officer's Group, Defence Estate and

Corporate Support Group all have significant procurement programs but do not publish an equivalent document to the DCP. Similarly, none of the three services provide easy to find information on their various Minor Capital Acquisition Programs. A similar document to DCP in its current format would be a good starting point for other groups within Defence to follow.

The Victorian Government recommends that the Committee note that:

- The DCP provides a good model for the delivery of public information on opportunities for industry in the defence sector,
- that improvements can be made to further enhance and improve the types of information made available; and
- other procurement programs in defence would benefit from a document similar the DCP.