

Executive summary and recommendations

This report is the committee's third on the future of Australia's naval shipbuilding industry. Although the committee's first and second reports dealt with the tender process for the navy's new supply ships and the pre-tender process for the future submarines respectively, the committee also made findings applicable to the broader topic of Australia's future shipbuilding industry. In this report, the committee builds on its earlier findings and recommendations.

New supply ships

The committee accepts that in many cases a limited tender may be the most sensible, strategically prudent and cost-effective means of acquiring capabilities for the Australian Defence Force. It is firmly of the view, however, that, wherever possible, options under consideration should include Australian defence industry participation as well as thorough assessments of the economic and strategic benefits of domestic involvement.

In this regard, the committee believes that the limited tender process for the new supply ships failed to adequately account for the potential for Australian industry involvement. Indeed, the committee remains concerned that the process neither adequately nor holistically assessed the economic and strategic imperatives of such an acquisition. The committee is also concerned that Australian industry was given no formal opportunity to engage with the process. This limited the depth of understanding in relation to contributions that the Australian defence industry could make to such a project.

In the committee's view, the process the government adopted has damaged industry confidence and harmed the Australian Defence Organisation's (Defence) relationship with Australia's defence industry.

Recommendation 1

paragraph 2.34

The committee reaffirms recommendation 1 from its initial report that the tender process for the two replacement replenishment ships:

- **be opened up to allow all companies, including Australian companies, to compete in the process; and**
- **make clear that a high value will be placed on Australian content in the project.**

Future submarines

Despite the announcement that Defence would conduct a competitive evaluation process, the committee remains deeply concerned that this process falls short of a truly rigorous procurement process for the largest and most complex defence program in Australia's history—the future submarines.

Evidence given during Budget Estimates in June confirmed that the competitive evaluation process was not designed to deliver three competitive contract options; would not produce accurate costs and build schedules; nor would the resulting designs be of a 'mature' nature.

Evidence was also presented during Budget Estimates that Japan's involvement in the process to acquire the future submarines is based on political imperatives rather than merit. This is concerning given that the government has restricted the potential involvement of Australian industry, and other international bidders, on the basis that the competitive evaluation process was a merit-based process. Evidence clearly indicates that this is simply not the case.

While the committee agrees that timeliness is an important consideration, it remains strongly of the view that the government's decision not to undertake a competitive tender is poorly-considered and highly risky. Noting the strategic importance of the future submarines, the complexity of the undertaking and the costs involved, the committee believes that further caution in conducting the tender is warranted.

The committee is also concerned by recent reports that the government is considering the acquisition of eight submarines instead of 12. The 2009 and 2013 Defence White Papers outlined the strategic rationale for the quantum of vessels. Navy confirmed recently at Budget Estimates that the threats underpinning this strategic assessment had not diminished.

In a speech to the Australian Submarine Institute in March this year, the Minister for Defence said that '[b]y 2030, half of the world's submarines will be in Australia's broader strategic region'. Evidence given to this inquiry by submarine experts reaffirmed the need for 12 submarines to provide an effective submarine force. The committee is particularly concerned that a potential reduction in the number of future submarines from 12 to eight does not reflect the strategic realities that the Defence Minister has recently acknowledged, nor would it result in an effective force to meet both current and future challenges.

It is also the view of the committee that eight submarines will not provide the certainty that industry requires to ensure that the economic value of this project is optimised.

Based on evidence given by expert submariners and industry, the committee is of the view that an acquisition process that is competitive, allows for maximum participation from prominent submarine builders and is complete by the end of 2016 would ensure that the first of 12 future submarines would be in the water by the middle of the next decade.

Noting this, the committee makes the following recommendations:

Recommendation 2 **paragraphs 3.83–3.87**

The committee recommends that the government adopt the following procurement process to acquire 12 future submarines:

- a twelve to eighteen month procurement process, involving a Request for Proposal, followed by a Request for Tender;
- invite the most prominent and relevant submarine designers to participate in the process, encompassing Germany, France, Japan and Sweden;
- conduct a Funded Project Definition Study; and
- down-select two submarine builders to provide full design definition and fixed priced contract bids.

The committee also reaffirms recommendation three from its report on future submarines that:

Given the weight of evidence about strategic, military, national security and economic benefits, the committee recommends that the government require tenderers for the future submarine project to build, maintain and sustain Australia's future submarines in Australia.

Also, given the national significance and complexity of the project to acquire the future submarine, the committee recommends that the government establish a Naval/Submarine Construction Authority as a 'non corporate Commonwealth entity with appropriate industry and defence expertise and authoritative leadership to deliver the future submarine'.

The committee recommends further that Defence heed and apply the lessons learnt from the AWD regarding the transfer of knowledge and those of the Collins Class submarine about the consequences of being a parent navy to the future submarines.

Air Warfare Destroyers (AWDs)

It is clear from the evidence presented to the committee that the source of the AWD project's problems can be attributed to a poor understanding and inadequate analysis of cost and schedule, and poor or inadequate management at the Alliance and Commonwealth level. From the beginning, decision-makers failed to appreciate the difficulties in transferring the design work to Australia, where industry was trying to meet demands created by fitting out the Landing Helicopter Dock ship (LHD) and starting on a 'first of class' vessel. There are clear lessons to be learned from the AWD project. It is important to note that a number of factors that affected productivity were outside the control of the people working on the ships. Two systemic issues identified by experts such as Dr John White are that the project was starting from scratch, and the lack of long-term strategic planning.

The committee is deeply concerned that the government has not released either the Winter Report, or the more recently conducted comprehensive cost audit of the AWD, even in an abridged form. The committee calls on the government to release these documents as a matter of urgency to assist industry and subject matter experts to understand and learn from their findings.

Recommendation 3

paragraph 4.68

The committee recommends that the Australian Government provide the committee with a copy of the 'forensic audit' of the AWD program.

The committee also repeats its recommendation contained in its first report that the government release the report of the independent review of the AWD program (also known as the Winter Report).

The committee understands that it may be appropriate for a public version of both documents to be released with classified material removed.

Continuous build

One of the most important observations presented to the committee is that industry can only produce when the government purchases—that the industry 'cannot be competitive if it has no work'. The committee understands that Australia's defence industry cannot survive a 'stop-start' order book: that it needs a consistent and reasonably predictable local workload to be sustainable and competitive. In the committee's view, it is unacceptable for the government, as sole customer, to criticise the industry for poor performance when many of the problems originate from a lack of government foresight, and the 'feast and famine' cycles inflicted on industry.

While the predicted gap in shipbuilding activity, sometimes referred to as the 'Valley of Death', is now closer than it was at the time the committee tabled its first report, the committee remains of the view that the government could and should be doing more to maintain a viable naval shipbuilding industry in Australia. Witnesses have suggested maximising Australian content in the construction of the new replenishment ships, as well as bringing forward the construction of the Pacific patrol boats and the future frigates.

The committee understands that the 2015 Defence White Paper will state the government's priorities for major naval acquisitions. The committee, however, believes that important decisions have already been delayed for too long and the government should give clear and certain indications of its intentions to acquire the future frigates, and to maximise Australian content in the new supply ships.

Recommendation 4

paragraph 5.59

The committee recommends that the Australian Government take measures immediately to reverse the perilous downturn in Australia's naval shipbuilding industry, reduce the impact of the 'Valley of Death' and enable a program of continuous build by:

- **mandating a hybrid build for the first Auxiliary Oil Replenishment Ship and an onshore build for the second;**
- **mandating that all 12 of the future submarines be built in Australia;**

- **fast tracking the build of the Pacific Patrol Boats and the replacement of the Armidale Class Patrol Boats; and**
- **bringing forward the construction of the Future Frigates.**

Strategic naval shipbuilding plan

The committee underscores the importance of the government keeping the Australian defence industry informed of its future naval requirements so it can align its planning, investment and research and development to meet Defence's long-term needs. Without doubt, there is a need for Defence to take a more coherent and strategic approach to planning its major naval acquisition programs and to consult with industry when planning. The committee strongly supports the call for a long-term strategic plan, which should be developed within the context of Australia's broad national strategic framework and take account of how best to:

- optimise the use of Australian small and medium enterprises (SMEs) and overseas subsidiaries established in Australia;
- build on existing infrastructure and encourage future investment in people, facilities and research and development to ensure that Australian shipyards and their complementary supply chains are prepared to participate in and support Australia's naval shipbuilding industry;
- provide the Australian defence industry with a clearer sense of Defence's future plans, priorities and intentions, providing industry with the confidence to invest in Australia's naval ship building industry for the long term and to make informed and better targeted investment decisions;
- smooth the 'peaks and troughs' that have characterised Australian naval shipbuilding; and
- maintain a constant base load of work that would sustain a viable naval shipbuilding industry in Australia.

The proposed enterprise-level Naval Shipbuilding Plan should complement the Defence Investment Plan and provide a certain and reliable indication of Defence's future acquisition program, with sufficient information to enable the Australian defence industry to deploy resources with confidence. Based on previous reports and the evidence before this inquiry, the committee makes the following recommendation.

Recommendation 5

paragraph 6.35

The committee recommends that the 2015 White Paper is prepared in such a way that all procurement proposals are costed and scheduled realistically, and informed by the need to have a continuous build program for naval ships.

The committee understands that, following the release of its 2015 Defence White Paper, the government will also publish a Defence Investment Plan and an enterprise-level Naval Shipbuilding Plan.

The committee recommends that both documents take note of the evidence provided in this report about the importance of having a continuous build program that will sustain a viable naval shipbuilding and repair industry. Further that both documents, provide:

- **a schedule of anticipated timelines for the construction and delivery of all Defence Capability Plan (DCP) projects, with continuity of production the paramount feature;**
- **a discussion about the nation's future strategic capability requirements that identifies the industrial capabilities deemed to be strategically important and Defence's expectations for Australia's naval shipbuilding industry;**
- **an assessment of the nation's existing shipbuilding and repair facilities, including the shipbuilding supply chain, and predicted investment needs;**
- **a comprehensive statement providing accurate and reliable information on Defence's future plans for its naval acquisition program that goes beyond ten-year projections;**
- **a detailed explanation on the acquisition schedule indicating the reasoning behind it and the major factors influencing demand flows; and**
- **reliable cost estimates.**

The committee recommends the establishment of an ongoing naval shipbuilding industry advocate to work with the Australian Government and the shipbuilding industry, including supply chain and SMEs. The shipbuilding industry advocate should advise Defence and industry during the development of the Defence Investment Plan and Naval Shipbuilding Plan.

Industry investment

Significant capital investment has already been made in the Australian shipbuilding industry to develop requisite infrastructure and skills—this is consistent with the establishment of any industry on such a scale. Evidence presented to the committee suggests that this capital expenditure has been considered and efficient. With the infrastructure and skills now available, the industry is ready to transition from an investment phase to a production phase.

The committee is concerned that efforts to denigrate Australia's shipbuilding capabilities have focused upon the conflation of fixed capital expenditure investments and marginal production costs. This has artificially inflated the reported costs of ship unit production, rather than capitalizing the fixed investments separately. These inflated figures have subsequently been circulated, forming the basis for arguments against the efficiency of Australia's domestic shipbuilding industry.

Having reached the threshold of capital investment required to establish the industry, the committee is firmly of the view that the returns on investment from future shipbuilding projects will continue to grow. The committee also notes, however, that

the Commonwealth Government is the industry's only effective client and, consequently, it has total control over demand factors. The government's failure to ensure sustainable demand through steady and predictable ship orders significantly undermines the industry's competitive position and the loss of the substantial capital investments.

Evidence to the committee demonstrates that the current processes for assessing the economic value of domestic shipbuilding projects are unsophisticated and flawed. Basic cost-based analysis does not fully capture the economic value of domestic shipbuilding, as shipbuilding expenditure has an economic multiplier effect: every dollar spent generates a level of economic expansion beyond the nominal value of the expenditure. This is in stark contrast to the loss of economic value when the government purchases overseas.

The committee also notes that the risk factors associated with currency fluctuations (including systematic currency depreciation) are significantly intensified when making overseas ship purchases. This issue is particularly pertinent given the Reserve Bank's publicly stated objective to depreciate the Australian dollar. A strong, sovereign, domestic shipbuilding industry hedges the government against market instability—particularly when shipbuilding contracts generally extend across multiple years and economic cycles.

Recommendation 6

paragraphs 7.21–7.22

The committee recommends that, given requisite capital investments have already occurred, and as the industry's only effective client, the Australian Government adopt an approach to domestic shipbuilding that ensures sustainable demand in order to realise returns on these investments.

The committee also recommends that, during the development of the forthcoming Strategic Naval Shipbuilding Plan, the Australian Government ensure that the Plan recognises the holistic economic value of any domestic shipbuilding project. It is the strong view of the committee that the Plan must also acknowledge the economic multiplier effect of domestic shipbuilding, including that expenditure generates a level of economic expansion beyond its initial value.

