

Northrop Grumman Australia

Inquiry into Government Support for Australian Defence Industry Exports - 11 July 2014

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**Northrop Grumman Australia Submission:
Inquiry into Government Support for Australian Defence Industry Exports**

1. INTRODUCTION

Australian Government support for Australian defence industry exports and how best to achieve these objectives has been an item of policy discussion for a number of years. Several Government initiatives are currently in place including the Defence Export Unit (DEU) and the Global Supply Chain Deed Program (GSC), which are aimed at assisting local industry to secure export sales.

This paper provides a commentary on the current environment for Australian defence industry exports, a perspective on the performance of the existing Government mechanisms in place today to assist defence exports, and recommends for consideration some improvements that could be made, to promote and enhance Australia's defence industry export position.

2. EXECUTIVE SUMMARY - OVERVIEW

The defence export environment is a global market place, one that is very competitive, dominated by large overseas primes, and tightly coupled with national policy priorities. Offset obligations and local content requirements remain part of the landscape in many countries for defence opportunities. This makes for a demanding environment that requires a significant degree of professionalism, experience, and resilience by local firms to navigate the involved and lengthy procurement processes, and be recognised as delivering the best value for money outcomes that also align with extant national imperatives. Notwithstanding, the opportunities and rewards are significant if these outcomes can be achieved.

Government support to defence industry exports needs to be analysed in the context of a coherent Australian defence industry policy, which is intrinsically coupled with the development of Australia's military and national security capabilities. Australia is unlikely to improve its defence industry export position without the development and sustainment of a strong and growing local industrial base developed through participation in domestic defence acquisition and sustainment programs.

Establishing a growing and healthy export business for the Australian defence industry will be dependent upon a number of key underpinning factors.

- a. Establishing an overarching defence industry capability development plan, linked to the Defence Capability Plan (DCP) which provides clarity for local investment and industrial development primarily in support of domestic defence needs;
- b. A local industrial environment that fosters and supports world class innovation, R&D and product development in Australia's core areas of strength;
- c. A track record of supply and success in ADF programs at home;
- d. Industrial productivity and cost competitiveness on a world basis;
- e. Industry scalability and capacity to meet the quantity demands of overseas export requirements;

Northrop Grumman Australia

Inquiry into Government Support for Australian Defence Industry Exports - 11 July 2014

- f. Supplier pre-qualification with international defence Primes and experience in bidding into international RFT's;
- g. Governmental support to access foreign defence markets through Free Trade and Defence Cooperation Agreements, and Australian participation in International co-development and other opportunities on international programs.

Historically Australia has demonstrated the ability to develop innovations within the defence domain, which have been world class in their nature and have gone on to secure substantial export success. The Nulka Rocket Decoy System and the Bushmaster Protected Military Vehicle are probably the most notable to date in this regard. The shipbuilding sector has also had success in projects such as the NZ Protector Project and Pacific Patrol Boat. There have been other successes in electronics and software systems including CEA and NGM5, and a number of companies are now realising export success through the F-35 JSF program.

Australian solutions, if they are to succeed internationally, will need to be of world standard in quality and performance, and cost effective in their implementation and through life support costs. Australia's existing export successes (as above), participation in programs like the F-35 Joint Strike Fighter, Global Supply Chain Deed activities, and local Australian content within domestic defence programs, demonstrates that Australian industry does have the potential to compete in export markets in certain specific areas of expertise.

So what support should Government provide to Defence Industry exports? This paper will present the case that Government should be looking at Australia's defence industry as a capability in itself, one that needs to be developed as an integral part of the national defence of the nation. It is an industry that is now indispensable to Australia's national security, and integral to Australia's ability to develop, project and deploy military power and capability for humanitarian, civil and military needs. It is within this context that defence industry exports should be considered.

Developing defence industry exports not only provides an economic benefit for Australia in terms of growing and strengthening a new high technology export sector, but can also significantly underpin the development of true defence "Priority Industry Capabilities" for the nation, and can also help strengthen regional and bilateral national relations, as evidenced through programs like the C-130H gifting and refurbishment program for Indonesia.

The opportunity exists to increase the level of defence industry exports through a more focussed policy and support approach from Government, greater engagement from the international Primes, and an up-skilling of the local SME's to be in a position to compete internationally. This represents a shared responsibility across the sector.

There are a number of immediate actions which the Government could consider in terms of improving the support to defence exports, these being;

- a. **Defence Industrial Policy.** Defence exports should not be looked at independent of the overall national industrial policy for defence industry. Defence industry policy should be moved upward to a level of consideration integrated with the development of military capability in the Defence Capability Plan (DCP) and Force Structure Review (FSR). A new Industry Capability Plan (ICP) should be developed to articulate the industrial capability development required by the nation in order to support its overall national defence objectives.
- b. **Re-assess Australia's Priority Industry Capabilities (PICs).** As part of the current development of the next DCP, and consideration of the required defence industrial capability development needs (ICP), a review of Australia's defence Priority Industry Capabilities (PICs) should be undertaken, so as to re-align these areas of industrial focus with the coming requirements for national security capability.
- c. **Governmental support to access foreign defence markets through Free Trade and Defence Cooperation Agreements.** Australia's bilateral trade and defence agreements provide an opportunity for Government to assist Australian defence industry to a greater

Northrop Grumman Australia

Inquiry into Government Support for Australian Defence Industry Exports - 11 July 2014

level to secure defence exports. Programs like the C-130H gifting and refurbishment program for Indonesia represent a good example of the dual benefit of strengthening bilateral ties, expanding Australian defence exports, and establishing new international industrial relationships. Efforts in this regard with Australia's bilateral partners such as the United States and now Japan should be redoubled, to ensure that there is a focus on securing an appropriate balanced level of defence exports as part of these important trade and defence agreements.

- d. **Develop International co-development opportunities.** Australian participation in International co-development and other opportunities on international programs provides Government with the opportunity to assist Australian companies accessing these major programs. This requires active consideration and should be aligned with the revised PIC's to bring Australian Innovations into these major programs.
- e. **Fostering defence industry innovation.** Securing defence exports is to a large extent underpinned by ensuring that Australia is developing world class innovations within the defence sector which can command exports. Government should be focussed on ensuring that an environment exists such that the defence industry sector is encouraged to conduct world leading innovation in Australia.
- f. **Procure Australia's defence innovations and then support through the DEU.** One of the main attributes required to secure successful defence industry exports is to have the reference and endorsement of the Australian customer through success in domestic defence programs. The Defence Export Unit (DEU) also represents a significant asset and advantage to the local industry in pursuing defence exports overseas, and should be further supported into the future.
- g. **Continue the Global Supply Chain (GSC) Program and prioritise on PICs.** The GSC program has been generating encouraging and growing results. International Primes have been focussed on securing real opportunities for local Australian firms in accessing international programs. However, the program could be further refined and implemented within a policy framework that looks to support industrial capabilities and exports which are aligned to the defence Priority Industry Capability (PIC) areas.

3. CONTEXT - LOCAL AND REGIONAL ENVIRONMENT

Countries in the Indo-Pacific have been steadily raising defence spending, using resilient economic growth to fund militaries able to cope with an increasingly complex regional environment. China is now clearly the second-largest defence spender, and nominal Asian spending (\$287.4 billion in 2012) exceeded total official defence spending not just in NATO Europe but across all of Europe, including spending by non-NATO European states.

Australia is the 8th largest importer of defence systems and armaments in the world, and is currently undergoing an unprecedented replacement of the majority of all defence platforms across the Land, Sea and Air domains. Australia nevertheless remains behind on the scale of defence industry exports compared to comparable nations. Whilst current budget constraints in Australia, NZ and other countries in the Indo-Pacific Region continue to place pressure on defence budgets, with current budgets at a low level, the rate of actual expenditure continues to rise.

In the coming period Australia is facing what could be considered a dynamic and potentially challenging period ahead from an economic perspective. There is significant pressure on Australia's manufacturing sector across the country, with the apparent demise of local Automotive manufacturing activities in Australia's southern states being just one case in point. Indeed, over recent years Australia has witnessed a number of high profile closures of manufacturing businesses across the country, and conditions remain challenging across the manufacturing sector as a whole.

However, the region is experiencing unprecedented growth, with the centre of world GDP moving strongly toward the Indo-Pacific. Defence and Aerospace is growing in Asia faster than anywhere else on the planet. The advent of new technologies in autonomous systems, unmanned vehicles, stealth technologies, and micro satellites is also creating new potential opportunities. These new technologies and systems have immediate and direct application to a country like Australia, with a relatively small population, huge distances, and vast natural resources. These opportunities could be embraced to become one of the central pillars of Australia's new advanced manufacturing base, and position the Australian defence industry for a greater share of defence exports.

4. CURRENT GOVERNMENT INITIATIVES

The existing Governmental support for defence industry development and defence industry exports broadly falls into the following specific policies and programs;

- a. Priority Industry Capabilities Program (PIC)
- b. PIC Innovation Program (PIC IP)
- c. Defence Global Supply Chain Programme (GSC)
- d. Defence Capability Demonstrator Program (CTD)
- e. Defence Export Unit (DEU)

Defence Innovation is also supported through the R&D tax credit framework, and also through other Federal Government support including Commonwealth CRC and ARC grants and programs.

Whilst these initiatives are to be applauded in their intent, it is evident that with respect to the local defence industry they have not been implemented as a fully coherent program, and as a result have potentially not been as successful in their implementation as could have been expected. Essentially these programs have been developed in the absence of a strong and coherent overarching policy on Australia's defence industrial capability, and consequently are not as targeted as might be desired.

Whilst all of these programs above (and others) are essential to supporting and underpinning defence industry exports, commentary will be made here only on those that are specific to defence export programs, the GSC Program and the DEU.

5. GLOBAL SUPPLY CHAIN (GSC) DEED PROGRAM

Australia has established and operates a Global Supply Chain Deed initiative for Defence Industry. The Global Supply Chain (GSC) program was launched in July 2009 to assist Australian defence industry with opportunities made available in international business units of large international companies. The GSC program aims to facilitate access to opportunities for Australian industry to supply directly into international primes, as well as participate in the supply chains of major sub-suppliers. The GSC Program funds the multinationals to establish staff inside their organisations to act as the internal sponsor promoting Australian industry into the business units of the company; to actively seek out opportunities for Australian industry, train Australian industry in the company's purchasing practices and methods, educate Australian industry in the company's requirements, and help make Australian industry globally competitive.

With the cessation of mandatory Australian Industrial Content (AIC) percentage requirements for domestic defence acquisition programs, and the recognition that Australia is largely a buyer of existing Military Off The Shelf (MOTS) solutions for the majority of its defence needs, the GSC Program represents the mechanism for local firms to access international defence export opportunities.

Northrop Grumman Australia

Inquiry into Government Support for Australian Defence Industry Exports - 11 July 2014

Given the dynamics of the global defence market, the stance as articulated by the GSC Program to secure content as part of international global supply chains, represents an approach which has shown success largely for components and fabricated items. However, this should not be the sole mechanism in place to support Australian defence industry exports, particularly when considering complete systems and sub-systems as export opportunities. This is all the more important when considering PIC capabilities.

The GSC program has been running for a number of years now and has generated a number of notable successes through its implementation. Nevertheless, improvements could be made to the structure and implementation of the program which could yield further improved outcomes.

The following observations of the performance of the existing program could be considered as items for improvement;

- a. The GSC program is broadly based across the majority of major Primes in Australia, and participation in the program from Australian SME's has been right across the spectrum of suppliers within defence, many of whom are suppliers of piece parts or components. Whilst the results from the GSC program have been pleasing, and represent a worthwhile investment given the overall business returns for the nation, it has not provided a focus to enhance investment in the technology areas that are of most benefit to the defence of the nation PIC's. Providing an additional incentive for opportunities which are aligned to Australia's defence Priority Industry Capabilities (PICs) would provide additional leverage to further strengthen and support these critical areas of defence industrial capability.
- b. Consideration should be given to introducing into the leadership of the GSC Program personnel who have a broad commercial and/or defence business backgrounds. Staffing the program with individuals who have former military or governmental experience only, without direct industrial backgrounds or experience, will likely not provide the best understanding of suppliers seeking to access overseas industrial opportunities. It is essential that the management personnel in the program are knowledgeable on how major international companies operate from a legal, financial and contractual perspective.
- c. The program needs a robust and detailed searchable data base of the defence suppliers in the country, by state, commodity and/or service.
- d. Management in the program needs cross training in the export process for Australia and import requirements for most of the major countries of import.
- e. The GSC Program should look to partner with the State based Defence Units to operate more as a collaborative team than is the case today. It can be a Canberra led program, but the States are accountable to their local suppliers and need to show how they are assisting in their expansion to international markets.

Participation in the GSC Program over a number of years provides the following lessons learnt from the Prime's perspective:

- a. Develop a structured and organized plan to deal with all aspects of the program
 - i. Technical capabilities of Australian suppliers, et al
 - ii. Comprehensive opportunity development throughout the company
 - iii. Constant engagement with overseas programs, in-county suppliers and customers; in-person as well as by phone
 - iv. Timely customer reporting and assuring data are complete, accurate and understood.
 - v. Communicate success stories and progress in the export country and Australia
- b. Assure a 360 degree look at all Program opportunities; low complexity parts, medium level assemblies for mechanical and electrical parts, cyber and software solutions, sustainment work, and technically complex work

Northrop Grumman Australia

Inquiry into Government Support for Australian Defence Industry Exports - 11 July 2014

- c. Look for opportunities to export/collaborate on technology with Australian suppliers
- d. Let suppliers know that this is a long process and awards take time
- e. Remain knowledgeable of Australian Governmental and Defence procedures

6. DEFENCE EXPORT UNIT (DEU)

A critical attribute in securing successful defence industry exports is to have the reference and endorsement of the Australian customer. The DEU was created to facilitate and promote Australian defence industry exports. The Defence Export Unit aims to assist Australian defence companies to access export markets and global supply chains, and thus broaden their customer base. Overall Australia is respected on the world stage as an intelligent and demanding customer, and the reference of an Australian sales success with the ADF is a significant advantage in the export domain. The Defence Export Unit (DEU) represents a significant asset and advantage to the local industry in chasing defence exports overseas, and should be further supported into the future, noting the above comments with respect to the location of this capability within the Defence Department.

7. REQUIRED INDUSTRY ATTRIBUTES

Australia's local defence industry today is populated by a number of large international primes predominantly from the United States and Europe, connected with a larger number of locally owned SME's which provide entire product/system solutions in either software hardware or both, physical components, services, or a combination thereof.

Australia is unlikely to improve its defence industry export position without the development and sustainment of a strong and growing local industrial base (both from Primes and SME's) achieved largely through participation in domestic defence acquisition and sustainment programs. Establishing a growing and healthy export business for the Australian defence industry is dependent upon a number of key underpinning industrial factors for the suppliers.

- a. A track record of supply into ADF programs at home
- b. Industrial productivity and cost competitiveness on a world basis
- c. Industry scalability and capacity to meet the quantity demands of overseas requirements
- d. Supplier pre-qualification with international Primes and experience in bidding into international RFT's

In terms of positioning Australian SME's for exports, the following represents a perspective of the success attributes for Australian companies seeking defence exports;

- a. The company has a product or capability developed through innovation that is of world standard that is sought by other countries
- b. The company has spent time marketing the product or service to prime contractors and international governments very early in the acquisition process. They have hosted potential buyers and travel to international locations to meet with potential customers.
- c. The company has demonstrated that they have excellent quality and schedule performance on previous contracts.
- d. The company can demonstrate their financial stability and that they have engaged a professional management team.
- e. The company has an appropriate facility, personnel and management systems to do international work
- f. The company understands the Australian export and country-of-import procedures
- g. The company begins the process early and has continuous follow up over the long term.

8. THE ROLE OF INTERNATIONAL DEFENCE PRIMES

International Primes resident in Australia have a specific role and opportunity to support and foster Australian defence industry exports, specifically through Commonwealth programs like the GSC Program, but also more generally as part of the Australian defence industry landscape. Australian defence exports can, and should, come from the major Primes and also from the SME community. Hence Australian Government support for Australian defence exports should not be limited to just the SME's, albeit special measures could and should be considered for companies of that size. Moreover, international defence primes in Australia should be making a major contribution to local innovation and defence exports as part of their normal business, in addition to a strong participation in domestic defence acquisition programs.

Some of the key elements required from International Primes in supporting Australian defence exports are as follows;

- a. Sponsorship of the program at the CEO and country executive level, that assure the program is often discussed at the senior executive level within the company, and gives support to the leader of the program.
- b. A carefully selected and dedicated leader of export initiatives, of sufficient rank and technical breath, to reach across the company to find opportunities for Australian suppliers.
- c. A leader that is crossed trained, or is staffed, with knowledge in technical requirements, Australian export regulations, US export and import regulations, contracting principles, a basic knowledge of Australia laws, and financial accounting principles and monitoring techniques.
- d. A company who respects and seeks to support Australian industry; that remains engaged at all levels within the national and state governments and is available to all SME who seek assistance, explanations, training and opportunities to bid.
- e. A company who has unquestionable ethics, and whose employees always act with professional decorum and appropriate behaviour with Australian suppliers.

9. INNOVATION

Whilst defence industry participation in the GSC Program is yielding increasing results for defence industry exports, which is to be applauded, this should not be the only mechanism of Governmental support to defence exports. In the longer term, securing defence exports will ultimately depend upon ensuring that Australia is developing world class innovations within the defence sector which can command exports.

Without ongoing innovation, Australian Industry will not have the world leading capability offerings to attract export sales. Whilst it is recognised that these innovations will come from industry, the Government should be focussed on ensuring that an environment exists such that the defence industry sector is encouraged to conduct world leading innovation in Australia. This starts with ensuring that the taxation system for R&D credits is world competitive, as otherwise Australia will continue to lose innovation to overseas jurisdictions with more attractive R&D tax treatment. The Government should also consider continuing to strengthen and foster innovation through the Capability Technology Demonstrator (CTD) programme, and the PIC Innovation Programme (PIC IP). Recent reductions in the CTD programme funding and the Australian CRC program is of particular concern.

Research and development is ongoing across the sector, both at the level of the Primes and the SME's, and should be further encouraged as a core element of the defence industry sector development.

10. CONCLUSION - RECOMMENDATIONS

Government Policy in supporting defence exports should be viewed, as it is in many other developed countries, as an integral element in strengthening Australia's own national defence capabilities.

Developing defence industry exports not only provides an economic benefit for Australia in terms of growing and strengthening a new high technology export sector, but can also significantly underpin the development of real defence "Priority Industry Capabilities" for the nation, as a planned element of national security, and can also help strengthen regional and bilateral national relations on an industrial basis.

As discussed in this paper, there are a number of actions which the Government could consider in the immediate term, which would act to improve support to defence exports;

- a. **Defence Industrial Policy.** Defence Exports should not be looked at independent of the overall national industrial policy for Defence Industry. Defence Industry Policy should be moved upward to a level of consideration integrated with the development of military capability in the Defence Capability Plan (DCP) and Force Structure Review (FSR). A new Industry Capability Plan (ICP) should be developed to articulate the industrial capability development required by the nation in order to support its overall national defence objectives. DMO as the Defence procurement agency is not the appropriate location within the Departmental process for such policy consideration and determination. It is unreasonable to expect the procurement agency to be in a position develop and enact an industrial investment and innovation development policy, whilst delivering on a mandate of lowest risk procurement. This should be the responsibility of elements of the department earlier in the capability development cycle and conducted in conjunction with the development of the DCP. Defence Exports can then be considered within an industrial policy framework which correctly recognises the intrinsic nature of Australia's defence industry's contribution to national security.
- b. **Re-assess Australia's Priority Industry Capabilities (PICs).** As part of the current development of the next Defence Capability Plan, and consideration of the required defence industrial capability development needs (ICP), a reconsideration and review of Australia's Defence Priority Industry Capabilities should be undertaken, so as to re-select and re-align these areas of industrial focus with the coming requirements for national security capability. This will then provide a framework for focussing innovation and R&D investment within Australia's defence industrial base, and will provide the underpinning for establishing future innovation which can firstly meet Australia's defence needs, and then be available for defence export opportunities.
- c. **Governmental support to access foreign defence markets through Free Trade and Defence Cooperation Agreements.** Australia's bilateral trade and defence agreements provide an opportunity for Government to assist Australian defence industry to a greater level to secure defence exports. Programs like the C130H gifting and refurbishment program for Indonesia represent a good example of the dual benefit of strengthening bilateral ties, expanding Australian defence exports, and establishing new international industrial relationships. Efforts in this regard with Australia's bilateral partners such as the United States and now Japan should be redoubled, to ensure that there is a focus on securing an appropriate balanced level of defence exports as part of these important trade and defence agreements.
- d. **Develop International Co-Development opportunities:** Australia's current defence procurement policy relies heavily upon the procurement of existing MOTS systems from overseas, and contains a proportion of Foreign Military Sales (FMS) procurement from the United States. This is unlikely to change in the medium term as it reflects the reality of Australia's defence Alliance arrangements, and the globalised nature of the defence industry

Northrop Grumman Australia

Inquiry into Government Support for Australian Defence Industry Exports - 11 July 2014

and marketplace. Particularly with respect to the procurement of FMS U.S. systems Australia is periodically presented with the opportunity for co-development of elements of these systems. These Co-development opportunities provide Government with the opportunity to assist Australian companies accessing these major programs. This requires active consideration and should be aligned with the revised PIC's to bring Australian Innovations into these major programs. Too often in the past this has not been an active consideration by Australia when joining these major US programs, and indeed Australia has pulled out of co-developments preferring to rely upon the FMS approach.

- e. **Fostering Defence Industry Innovation.** Securing defence exports is to a large extent underpinned by ensuring that Australia is developing world class innovations within the defence sector which can command exports. Without ongoing innovation Australian Industry will not have the world leading capability offerings to attract export sales. Whilst it is recognised that these innovations will come from industry, the Government should be focussed on ensuring that an environment exists such that the defence industry sector is encouraged to conduct world leading innovation in Australia. This starts with ensuring that the taxation system for R&D credits is world competitive, as otherwise Australia will continue to lose innovation to overseas jurisdictions with more attractive R&D tax treatment. The Government should also consider continuing to strengthen and foster innovation through the Capability Technology Demonstrator (CTD) programme, and the PIC Innovation Programme (PIC IP).
- f. **Procure Australia's defence innovations and then support through the DEU.** A critical attribute in securing successful defence industry exports from Australia is to have the reference and endorsement of the Australian customer. It is very challenging to secure export sales from an foreign buyer if the company has not already secured sales in its home market from the Australian customer base. Nevertheless, there are a number of instances where suppliers have succeeded with off shore exports prior to Australia having procured from them. In the main, Australia is respected on a world basis as an intelligent and demanding defence customer, and the reference of an Australian sales success with the ADF is an advantage in the export domain. The Defence Export Unit (DEU) also represents a significant asset and advantage to the local industry in chasing defence exports overseas, and should be further supported into the future, noting the above comments with respect to the location of this capability within the Defence Department.
- g. **Continue the Global Supply Chain (GSC) Program and prioritise on PICs.** The GSC program has been generating encouraging and growing results in focussing international primes on securing real opportunities for local Australian firms in international programs. The program has successfully brought a substantial number of Australian SME's, largely in the manufacturing sector, up to a standard where they are familiar with and competent at bidding into opportunities with the major primes, and capable of executing to the required standards, costs and schedules. However, the program could be further refined and implemented within a policy framework that looks to support industrial capabilities and exports which are aligned to the defence Priority Industry Capability (PIC) areas. Whilst broad based engagement and involvement in global supply chain programs across the manufacturing sector is to be applauded, there could be an additional benefit and focus on PIC areas designed to foster greater development in these important areas for Australia's national defence, thereby securing a dual benefit for the nation.