

Chapter 2

Government response to committee's first report

2.1 On 6 June 2014, the government announced that it had given approval for Defence to conduct a limited competitive tender between Navantia of Spain and Daewoo Shipbuilding and Marine Engineering of South Korea (DSME) for the construction of two replacement Auxiliary Oiler Replenishment ships (AOR).¹ Based on the evidence, the committee found that there were no significant impediments preventing the ships being built in Australia. In this chapter, the committee notes and considers the government's response to the committee's first report on the tender process for the new replenishment ships.

First report—tender process for new supply ships

2.2 Although the committee had only started its inquiry into the future sustainability of Australia's naval ship building industry, its consideration of the proposed tender process for the supply ships [SEA 1654–3] highlighted a number of concerns. They related to the lack of contestability and competition in the limited tender for the two ships, the insufficient level of industry engagement in the process so far and the absence of long-term strategic planning that led to the decision. As such, the committee recommended that:

- the tender process for the two replacement replenishment ships be reopened to include Australian companies;
- the tender must make clear that a high value would be placed on Australian content in the project; and
- the government undertake open tender processes for any future naval acquisition.

Government response

2.3 The government tabled its response to the committee's findings in April 2015. In its response, the government disagreed with the committee's recommendation to re-open the tender and allow Australian companies to tender. It explained that the schedule, the cost effects of an Australian build and the imperative to replace HMAS *Success* in the 2021–22 timeframe were the key determinants in reaching the decision to go off-shore.

1 'Minister for Defence—Boosting Australia's maritime capabilities', 6 June 2014, <http://www.minister.defence.gov.au/2014/06/06/minister-for-defence-boosting-australias-maritime-capabilities/> (accessed 4 August 2014).

Timing and schedule

2.4 According to the government, navy's highest priority was to replace both HMA Ships *Sirius* and, in particular, *Success* because the vessels were 'essential enablers of operational capability'.²

2.5 In this context, the government dwelt on the fact that the construction of the supply ships in Australia would extend the production schedule, making it highly unlikely that the delivery of the first ship would meet the required in-service date to replace *Success*. This delay in construction could pose the real risk of a gap developing in navy's capability to deploy combat power. The government also indicated that, given the lead time to commence construction of an Australian build, a decision to conduct an open tender would have no effect on impending job losses in Australian shipyards. To support this contention, the government cited a number of examples of the time taken to arrive at the construction stage:

Experience with AWD and the ANZAC Ship Projects and more recently the Canadian Joint Support Ship (JSS) Project (two supply ships for the Canadian Navy) suggests five to six years is required from the initial approach to industry for a design through to the contract award and 'cut steel'. For example:

- The initial Risk Reduction studies for AWD were commenced in early 2004, yet construction did not start until January 2010.
- Designs for the ANZAC Ship Project were tendered in 1986, with Defence selecting Blohm+Voss (Germany) as the designer. Work (cut steel) started approximately six years later in March 1992 (Note: production started well before the detailed design was completed in September 1993, resulting in significant rework). Although delivered in March 1996, HMAS ANZAC was not accepted into naval service until mid-2000.
- In November 2010, Canada announced a decision to commence design studies through release of a Request for Proposal to Navantia and TKMS [ThyssenKrupp Marine Systems of Germany] for the JSS Project. The JSS specification is closely aligned with that produced for

2 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I - Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [1], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

SEA 1654–3 [project to acquire two replenishment ships]. The JSS build contract is currently scheduled for December 2016.³

2.6 According to the government, these extended schedules for the construction of supply ships were associated with 'the requirement to adapt the design and where appropriate the shipyard facilities to achieve productivity gains associated with larger block construction'. Based on such factors, it concluded that:

...Australian industry would be unable to deliver the capability sought by SEA 1654–3 prior to 2022–23; whereas unsolicited proposals from Navantia and DSME for an offshore design and build suggest 2019–20 delivery is achievable.⁴

2.7 The government also drew attention to the costs of keeping *Success* operational. It noted that Defence had commenced a program, being undertaken by companies in Australia, to improve *Success's* materiel state and was allocating around \$365 million to sustain the ship to financial year 2021–22 (forecast Initial Operational Capability of the first replacement ship). Furthermore, the government stated:

Activities to sustain *Success* even further past its planned withdrawal from service, to accommodate an open tender process, are yet to be assessed. However, due to the obsolescence of equipment fitted to HMAS *Success*, these activities are likely to come at a considerable cost above what has already been committed.⁵

2.8 The committee understands fully the essential role that navy replenishment ships have in supporting naval deployments and the strategic imperative to purchase replacement ships to avoid a capability gap and to stem the continuing high costs of

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- 3 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [2], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015). The JSS project will deliver two ships with an option for a third. The ships are intended to provide core replenishment capabilities, plus added capacity for limited sealift and support to operations ashore and enable a Naval Task Group to remain at sea for extended periods of time. See National Defence and the Canadian Armed Forces, 'Joint Support Ship (JSS)', <http://www.forces.gc.ca/en/business-equipment/joint-support-ship.page> (accessed 15 June 2015).
- 4 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [2], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).
- 5 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [1], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

maintaining the current ageing vessels. The urgency of this situation highlights the need for government to have a realistic and practical long-term capability plan.

2.9 It is worth noting that no-one denied that navy needs replenishment ships to service the rest of the fleet and that their replacement is overdue. Even so, a few witnesses had proposals that, in their view, would maintain the afloat support capability and not cause significant delay to the acquisition of the vessels. Indeed, a number of witnesses put forward proposals that could address this potential shortfall in capability but without having to resort to a limited tender.

2.10 Importantly, it should be remembered that no-one suggested that the vessels be built entirely in Australia. At least two unsolicited proposals for a hybrid build were tendered to government.⁶ For example, BAE Systems informed the committee that it had submitted an unsolicited proposal to government in September 2012 setting out a hybrid build program, with part of the ship built overseas and part of the ship built in Australia.⁷ Referring to BAE's joint proposal together with Navantia, Mr William Saltzer, BAE Systems, informed the committee in April 2015:

Nobody in Australia has a design for a replenishment ship. We thought together with Navantia that the same solution that we created on LHD, a hybrid build, would be an ideal solution for the replenishment ships as well and it would allow us to put work into Australian industry as well as into Spanish industry, quite frankly, because they would build the hull, just as they did on LHD.⁸

2.11 BAE estimated that the additional time required to produce the replenishment ships according to its proposed hybrid model would be approximately six months.⁹ In effect, the hybrid proposals were intended to address the potential shortfall in capability and negate the need for a limited tender.

2.12 In its response, however, the government noted:

Preliminary analysis of unsolicited proposals from Navantia/BAE, Navantia and DSME indicate an approximately 40 percent cost premium, compared with a full offshore build, if 40 percent of the build was undertaken in Australia. Noting that the specific details of the unsolicited proposals remain commercial-in-confidence, Defence has not quantified the

6 See, for example, Mr Christopher Burns, Chief Executive Officer, Defence Teaming Centre, *Proof Committee Hansard*, 21 July 2014, p. 42.

7 *Submission 9*, p. 1.

8 *Proof Committee Hansard*, 14 April 2015, p. 18.

9 *Submission 9*, p. 2.

additional cost premium associated with fully building the supply ships in Australia.¹⁰

2.13 The decision to conduct the limited tender effectively dismissed outright the unsolicited proposals for a hybrid build in Australia that endeavoured to address some perceived concerns about current capacity in Australia and possible capability gap. These solutions not only remain untested but, as mentioned on a number of occasions, sent an unfortunate message to Australian defence industry.

2.14 Overall, the committee was concerned that the strategic and economic imperative to acquire the vessels led to a decision that effectively closed off options before they were given any due consideration and prevented a more open, competitive and, indeed, fairer process. There was never a genuine attempt to test the economic and strategic merit of the hybrid proposals or the cost premium to build in Australia. Furthermore, as noted in the committee's first report, the disregard shown to Australian industry through this limited tender process, the lack of consultation and engagement by the Australian Defence Organisation (Defence) with Australian industry stood in stark contrast to Defence's stated industry policy. There have been no developments since then to persuade the committee otherwise.

Industry's capacity

2.15 To support the grounds for a limited tender that excluded Australian companies, the government cited a 2007 report by a UK company, Appledore International, which undertook an assessment of Australia's capacity to construct the forward section of the Landing Helicopter Dock ship (LHD). In addition, it referred to another report commissioned by Defence—a 2013 report by an internationally recognised consultancy within Royal Haskoning DHV, First Marine International (FMI), which conducted an assessment of the Australian shipyards' capacity to support construction of the supply ships. According to the government's response, the conclusions from both reports supported the contention that:

Australian Shipyards currently do not have the capacity to build these ships at similar productivity levels to those achieved during the construction of the Spanish Supply Ship Cantabria without making a significant investment in infrastructure, which is unlikely to be amortized over a two ship build.¹¹

10 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, pp. [2–3], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

11 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [2], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

2.16 The government's response also noted that Defence SA had previously advised that:

...upgrade options (to support construction of the supply ships) for the shiplift include a \$20m upgrade for lift capacity increase, a \$50m upgrade for lift and length capacity increase and up to a \$175m upgrade for the shiplift to be useful for sustainment of any naval ship.¹²

2.17 In its response, the government acknowledged that there would be some return on investment in facilities for future sustainment of the ships. Referring to experience gained on the ANZAC Ship Project, the government suggested, however, that productivity saving associated with learning curve effects including facilities upgrades would not be realised with a two-ship build.

2.18 The government's response has not swayed the committee from its initial findings about the importance of holding an open tender for the supply ships and the capacity of Australian shipyards to build the vessels. In its response to the committee's recommendation, the government introduced no new evidence nor did it produce convincing analysis that would support its decision to limit its tender to two suppliers and to deliberately exclude Australian companies from participating.

2.19 The committee stands by its findings that an open tender would have allowed matters, including the amount of investment required to upgrade current facilities and the long-term benefits of this investment, to be fully explored and contested. Thus, while the committee acknowledges that there are currently shortfalls in the capacity of Australian shipyards to construct a large AOR as contemplated in the Defence Capability Plan (DCP), the deficiencies are not insurmountable. With some investment, local major shipyards could be upgraded to meet the challenge. Furthermore, the initial upfront costs for the improvements should not be considered in isolation but with a view to the long-term benefits, especially when such infrastructure could be regarded as a fundamental input to capability.

Australian content

2.20 In its first report, the committee also looked at the much broader economic benefits that accrue from a local build or Australian involvement in the production of a naval vessel. They included the development and maintenance of a highly skilled workforce, the benefits that innovation brings to the wider economy and the economic and employment growth that flow from investment in research and development.

2.21 The committee also recognised the importance of having the skills base, experience and local know-how necessary to support navy's vessels through their

12 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [2], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

operational life. This self-reliance is central to Australia's national interests. Taking account of the myriad advantages in having Australia build its naval ships in-country, the committee urged the government to place a high priority on maximising Australian content in the acquisition of the supply ships.

2.22 Accordingly, the committee recommended that Defence become actively engaged in encouraging and supporting Australian industry to explore opportunities for Australian industry involvement in naval shipbuilding. The committee made this recommendation because it could see great potential for Australian industry to become involved as subcontractors in the replenishment ship project. The government agreed in principle to the committee's recommendation.

2.23 In its response to the committee's recommendation that a high value be placed on Australian content in the tender, the government informed the committee that Defence sought to influence the designer's commitment to Australian content through the 'commonality' requirements set out in the Risk Reduction Design Study statement of work.¹³ It informed the committee:

The ship design shall investigate commonality with equipment currently in service, or planned to be in service in the Royal Australian Navy.

- This may include areas of commonality leading to lower life-cycle costs, such as with training requirements, through life support (including sustainment) and other areas that would contribute to lowering the cost of ownership of the capability.¹⁴

2.24 The government also responded to the committee's recommendation for Defence to become actively involved in encouraging and supporting Australian industry to explore opportunities in the construction of the replacement replenishment ships. The government agreed in principle with this recommendation and identified such prospects including but not limited to:

- design and installation of C4I systems;
- specialist Integrated Logistics Support (ILS) Systems; and

13 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I - Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [3], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

14 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I - Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [3] http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

- development and support of RAN specific 'support products'.¹⁵

2.25 The government explained further:

Overall, decisions on industry options will consider Value for Money assessments and the trade-off between enhancing local industry capability and the delivery of the required capability on time and within budget.

In accordance with Defence's Australian Industry Capability policy, Defence continues to encourage and support Australian industry. Prospects for Australian content in Project SEA 1654–3 will be further developed during the preparations leading up to the release of Requests for Tender for both the Prime Acquisition and Sustainment contracts. It is expected that both designers will engage with Australian industry during the development of their responses to the Prime Acquisition and Sustainment RFTs [request for tender].¹⁶

2.26 Despite these assurances, the committee feels compelled once again to underscore the importance of the government making every effort to maximise Australian content in the construction of the two supply ships. This means going beyond statements of commitment to putting in place practical and effective measures to achieve this goal.

2.27 Importantly, the government and Defence must be seen to be actively encouraging and supporting Australia's defence industry and earn industry's trust that the government will stand by its stated commitments. At the moment, however, the government and Defence have failed to secure that trust. As shown repeatedly in the committee's first report, Australia's defence industry was bitterly disappointed with, and confused by, the government's decision to exclude Australian companies from the tender process for the new supply ships. Mr Christopher Burns, Defence Teaming Centre, captured industry's sense of dejection when he spoke of a sector that wanted to be recognised and respected for its significant role in the development and delivery of ADF 'military capability and the preservation of the nation's sovereignty'. He referred to an industry that was looking for:

...the opportunity to compete under the construct of holistic whole-of-life benefit to the nation and on a level playing field, where the lowest price is not the determinant of value for money; an industry that would rather collaborate and partner with government and Defence than be subjected to

15 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I - Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [4], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

16 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [4–5], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

orchestrated campaigns to discredit it in order to justify going offshore to acquire low-risk hardware at the cheapest price.¹⁷

2.28 The way in which the government and Defence have managed the tender process so far has had a demoralising effect on Australia's defence industry and runs counter to their stated defence industry policy—in fact their actions have neither encouraged nor supported the industry.

Open tenders

2.29 The committee also argued in favour of having an open tender process for future major naval acquisitions. Defence disagreed with this recommendation. It noted that:

Without the ability to limit tenders through the use of the Commonwealth Procurement Rules there is a potential that the cost of tendering for industry will increase. This is a constant concern expressed by industry in relation to DMO procurement. Procurement strategies are developed on a case-by-case basis in consideration of the global market and the ability of industry to deliver the capability that is required on time and on budget. The ability to limit tenders is also paramount to Commonwealth National Security, with sensitive capability requirements and considerations being classified, and specifically quarantined from non-allied nations.¹⁸

2.30 It noted that the Pacific Patrol Boat replacement, which was planned to be a tender limited to Australian Industry, would be affected should the government adopt a policy that would require open tender processes for naval acquisitions. Defence stated further that:

An inability to use limited tender will also impact interoperability and the ability for the Commonwealth to meet international obligations. Specifically, we would be unable to draw on Government to Government procurement arrangements for supply of naval weapons, and communications systems.¹⁹

17 *Proof Committee Hansard*, 21 July 2014, pp. 40–41.

18 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [4], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

19 Australian Government, Australian Government response to the Senate Economic References Committee report: Part I—Inquiry into the Future of Australia's Naval Shipbuilding Industry Tender Process for the Navy's New Supply Ships, p. [4], http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Naval_shipbuilding/Additional_Documents (accessed 24 May 2015).

Conclusion

2.31 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.

2.32 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.

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

Recommendation 1

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.**

2.35 In the following chapter, the committee turns to the acquisition of the future submarines and considers further this principle of openness, competitiveness and fairness in the tender process as it related to these boats.