

Chapter 7

Defence industry

7.1 In its second report, the committee recommended that the government strengthen and build a more collaborative relationship with Australia's defence industry. It urged the government to engender a co-operative environment in which industry is encouraged to marshal its resources in support of a broader Australian shipbuilding industry capable of acquiring and building a highly capable fleet of submarines.¹ The committee made this recommendation because it could see great potential for Australian industry to become involved as subcontractors in the replenishment ship project.

7.2 As part of the 2015 May budget, the Minister for Defence announced that:

The Government is prepared to invest in the skills and knowledge base of the Australian naval ship building industry, and is prepared to commit to a long-term investment to make sure this important industry enjoys a future in Australia and these critical skills are maintained.²

7.3 The First Principles Review, released 1 April 2015, acknowledged that the outputs of Defence industry should be viewed as a Fundamental Input to Capability and be integrated into the acquisition life cycle. It stated that this approach could:

...well mean a more imaginative use of a small number of potential contractors early in the process or the extension and use of already existing collaborative mechanisms (such as rapid prototyping, development and evaluation) at the very early stages of requirements development.³

7.4 Both statements should give hope to defence industry that the government and Defence are fully committed to ensuring that Australia has a vibrant, productive and engaged industry into the future. The committee's firm conclusion, however, in both its first and second reports was that the government and Defence, contrary to their stated position, were not enthusiastic or even active in promoting and supporting defence industry: that the government was not a strong advocate for the domestic shipbuilding industry.

1 Economics References Committee, Part II, *Future of Australia's naval shipbuilding industry: Future submarines*, November 2014, p. ix.

2 Department of Defence Ministers, Minister for Defence—Budget 2015: Defence Budget Overview, 12 May 2015, <http://www.minister.defence.gov.au/2015/05/12/minister-for-defence-budget-2015-defence-budget-overview/> (accessed 18 May 2015).

3 Australian Government, *First Principles Review, Creating One Defence*, David Peever and First Principles Review Team, 2015, <http://www.defence.gov.au/publications/reviews/firstprinciples/Docs/FirstPrinciplesReviewB.pdf> (accessed 19 May 2015).

7.5 Indeed, in part 1 of its report, the committee expressed its concern about the relationship between the Defence procurement element in Defence and defence industry. This concern remains. As Mr Saltzer, BAE, explained:

You have got to have cooperation. When it comes to major defence projects, especially things like submarines and warships, you have got to have a real cooperation between the government and the industry that is going to support it. Because they have to take those ships not only from design through to construction but throughout their entire life when they will be upgraded, refit, modified et cetera.⁴

7.6 In the previous chapters, the committee highlighted the importance of defence industry as a vital partner in developing and building Defence's capability. The committee, however, also noted industry's disappointment and frustration with what it perceives as a lack of support for, and recognition of, its contribution to naval shipbuilding. It has referred to industry's concerns about the downturn in production, and the absence of a strategic naval shipbuilding plan that would provide industry with some hope for the future.

Economic benefits of local builds

7.7 In its first and second reports the committee outlined the benefits of having a domestic naval shipbuilding and repair industry including the broader economic gains, innovation, and importantly, the strategic imperative of self-sufficiency in maintaining and upgrading its fleet. The committee does not seek to repeat or duplicate the evidence that unequivocally demonstrated these advantages. It does, however, want to respond briefly to the uncritical attention that was given to the finding in the recent RAND report that:

...relative to U.S. shipbuilding costs, the premium for ships entirely built in Australia ranges from 30 percent to 45 percent. For ships built partially in Australia, this premium is lower. Combatants (frigates and destroyers) seem to have a consistent premium of around 30 percent to 40 percent. The premium for amphibious ships is lower, but it is still some 12 percent more than a U.S. basis.⁵

7.8 Firstly, the RAND report made absolutely clear that this premium could be reduced significantly with a continuous build and the gains in productivity that flow

4 *Proof Committee Hansard*, 14 April 2015, p. 21.

5 John Birkler et al, *Australia's Naval Shipbuilding Enterprise: Preparing for the 21st Century*, Santa Monica, CA: RAND Corporation, 2015, p. xxxv, http://www.rand.org/pubs/research_reports/RR1093 (access 18 May 2015). The RAND study concluded that, 'Overall, the three benchmarking methods indicate a modal premium of about 30 to 40 percent for naval warships built entirely in Australia. This perceived premium, it should be noted, can be significantly influenced by foreign exchange rates, and any consideration of foreign or domestic build must take into consideration currency exchange factors and risks'.

from such a policy approach.⁶ It also recognised, as the committee has done in its previous reports, the benefits from a local build—employment, innovation, incentives and opportunities for SMEs to grow and, importantly, strategic self-sufficiency by minimising dependence on foreign sources.

7.9 The committee is not convinced by assessments that dismiss the economic benefit from a vibrant domestic shipbuilding industry. Mr McClymont explained some of the flow-on benefits for the economy from just one SME in the supply chain:

I have employed quite a lot of electricians and I have done an estimate of wages over a two-year period, and we paid \$26.5 million in wages. That is money you are going to take out of the general community, so that is going to effect the general community. One hundred and eighty people were employed on that project. What is going to happen to those 180 people? Are they going to go back onto the dole and drag more money out of the general community? I think the effect is more on the general community than on an individual organisation. Yes, we will survive, but people will obviously lose their jobs and have to go onto other benefits. There is not enough work in Victoria to keep them all employed.⁷

7.10 In respect of money returned to the government through taxation and other mechanisms, Mr Burns explained that the 2012 study in the UK for the Royal United Services Institute showed that '36 per cent was returned to the government for defence work undertaken in Britain'. He reasoned:

While tax structures may be different in Australia, a similar figure could realistically be expected. With these considerations in mind, there is no premium if it is stated as being 30 to 40 per cent. And finally, such comments only serve to reinforce in people's minds both in Australia and offshore the self-defeating idea that Australian industry is inefficient and essentially not up to the job.⁸

7.11 Mr Dunk also referred to the 2012 UK study that found 36 per cent of Defence money contracted into the UK was returned to the government. He did not think that Australia had conducted a comparable study noting that:

If you look at the money from a Defence budget point of view, then \$1 billion spent in Australia is the same as \$1 billion spent offshore. It is money that comes out of the Defence budget. So, in the Defence budgetary sense, there may well be some additional money that comes out of the

6 John Birkler et al, *Australia's Naval Shipbuilding Enterprise: Preparing for the 21st Century*, Santa Monica, CA: RAND Corporation, 2015, pp. xxxvii and 123, http://www.rand.org/pubs/research_reports/RR1093 (access 18 May 2015). The RAND study noted that the premium could be reduced if the following changes were made: engage in a continuous-build strategy; improve acquisition practices to have more-mature designs at the start of construction and to minimize change during construction and encourage industry to shift to a continuous-improvement culture. p. 146.

7 *Proof Committee Hansard*, 6 March 2015, p. 4.

8 *Proof Committee Hansard*, 14 April 2015, p. 28.

Defence budget to do this work. What is not factored in is the amount of that Defence budgetary spend which flows back into the government coffers. In that sense, what we are talking about here is an accounting mechanism to ensure that the Defence budget can take into account the money that flows back into government coffers from doing the activity in Australia. If that accounting mechanism can be put into place, then the problem goes away.⁹

7.12 Referring to the dividends to government through taxes, the Hon Mr Martin Hamilton-Smith, the South Australian Minister for Defence Industries, stated that:

...by the time you add in income tax, payroll tax, GST, the benefits flowing through the economy of having a vibrant shipbuilding industry, and you then weigh in the cost of having to provide funds to soften the collapse of the shipbuilding industry and having more people on the dole, when you look at the entire offering you are infinitely better off...¹⁰

7.13 There are also the opportunities for Australian SMEs to grow and to innovate through the opportunities opened up by working with overseas companies with subsidiaries operating in Australia. Mr Wardell provided a practical example:

Five or six years ago, we were a backyard engineering company and now we consider ourselves to be a tier 2 engineering-contracting business, operating in potentially three states of Australia. We are very sophisticated. We are partnering with BAE in bids for LAN 400 and other projects they have. We are engaged in their global supply chain. That sort of opportunity for a company like Shadbolt Engineering would not have happened if you did not have a BAE doing what it is doing in Australia. There is an enormous drag-on effect with an industry like the naval shipbuilding industry. It brings technologies and the need to upskill our industries, and that filters down. We have gone to our suppliers and made sure they have got QA systems and quality control programs.¹¹

7.14 It is very hard to place a value on the role of naval shipbuilding in securing a strong industrial base in Australia supported by a skilled workforce making a positive contribution to the economy. But, as noted in the first report, naval shipbuilding is not purely an economic, research and development or job creation activity, it is above all a defence activity with national security its foremost concern. In this regard, a healthy, vibrant and competitive indigenous naval shipbuilding capacity is central to Australia's national interest. Most countries are more than willing to pay a price premium for this security.

7.15 The committee notes that this inquiry has been conducted in an environment of significant macro-economic adjustment. The concerted efforts by the Reserve Bank

9 *Proof Committee Hansard*, 14 April 2015, p. 29.

10 *Proof Committee Hansard*, 14 April 2015, p. 24.

11 *Proof Committee Hansard*, 6 March 2015, p. 2.

of Australia to depreciate the Australian dollar have been largely successful (since the inquiry was initiated in June 2014, the trading price of the Australian dollar has fallen from US\$0.94 to US\$0.77 at the time of writing). It would be remiss of the committee not to acknowledge that any currency depreciation—deliberate or otherwise—significantly weakens the economic argument for overseas ship purchases. The committee notes, for example, that the Chief Executive Office and Managing Director of Austal, Mr Andrew Bellamy, recently opined that claims of a 40 per cent 'cost premium' for local Australian builds were a myth. Given the long-term nature of any shipbuilding contract, a sovereign, domestic shipbuilding industry significantly reduces the economic risks associated with currency fluctuation and international market movements.

Conclusion

7.16 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.

7.17 The committee is concerned that efforts to denigrate Australia's shipbuilding capabilities have focused on 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 Australia's domestic shipbuilding industry efficiency.

7.18 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.

7.19 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.

7.20 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

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

7.22 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 spill over and multiplier effect of domestic shipbuilding, including that expenditure generates a level of economic expansion beyond its initial value.

**Senator Sam Dastyari
Chair**