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Submission: Defence industry - the policy challenge Gregor Ferguson Rumour Control, Sydney

With the recent takeover by BAE Systems Australia of Tenix Defence, ownership of the last of Australia's major defence prime contractors has gone offshore. As a result, future decisions on significant levels of industry investment or workforce recruitment are also likely to be made offshore.

Those decisions will be shaped by a number of things: firstly, expectations of the volume of Australia's defence market and the type of work available to companies located in Australia; secondly, foreign companies will look at the risk and profit potential from this work. Thirdly, they will examine the growth potential they can unlock in Australia, either through achieving a bigger market share or through exporting out of Australia.

Therefore, the Defence White Paper, along with the Mortimer Review of defence procurement and sustainment, will be read very carefully by businessmen in North America, the UK and Europe.

The Mortimer Review, which was published on 24 September, 2008, highlights key features of Australia's defence market. It is small; the primary customer is risk-averse; and the cost of building or modifying equipment in relatively small numbers to suit the specific needs of the Australian Defence Force (ADF) can be extremely high.

The inescapable conclusion is that the ADF is being drawn to much higher use of Military Off The Shelf (MOTS) equipment. This equipment may be brought into service largely unchanged (for example, the recently ordered C-17 Globemaster III cargo aircraft) or lightly modified (the Hawk Mk127 Lead-In Fighter Trainer).

This contrasts with so-called 'bespoke' equipment and capabilities, such as the Boeing Wedgetail Airborne Early Warning & Control (AEW&C) system; the SH-2G(A) Super Seasprite helicopter; the Jindalee Operational Radar Network (JORN); Collins-class submarine; and Anzac-class frigate. Most of these projects, with the conspicuous and laudable exception of the Anzac frigates, incurred serious delays and cost overruns for both customer and contractor.

While MOTS equipment carries fewer cost and schedule risks, it also provides fewer opportunities for Australian firms to participate in its design and manufacture. And where ADF requirements demand a bespoke solution, this is increasingly acquired through the mechanism of a prime contractor or prime systems integrator responsible for integrating equipment and sub-systems acquired in the main from overseas manufacturers. Examples include the Collins Replacement Combat System (RCS).

Defence's stated needs of defence industry increasingly revolve around the systems integration skills which are principally the domain of the large prime contractors, and the skills necessary to sustain equipment in ADF service. There is little support, explicit or otherwise, for the idea of local manufacture of equipment; indeed, the industry (especially small and medium enterprises, or SMEs) perceives a bias within the ADF against local manufacturers that goes beyond the expression of the Australian defence market's inability to support a large and diverse population of manufacturing firms.

Defence faces two potential dangers: firstly, it may prove difficult to support and upgrade complex, modern defence equipment without having been involved in its design and manufacture; secondly, the increasing adoption of MOTS equipment may result in the gradual run-down of Australian industry's design, engineering and systems integration

skills below the level that enables local firms, even subsidiaries of foreign prime contractors, to perform the role of Prime Systems Integrator or to maintain and upgrade complex defence equipment.

While it is frequently uneconomic to design and manufacture, or even simply assemble, small quantities of bespoke equipment for the ADF, the Defence Materiel Organisation's plans to spend about \$100 billion on capital acquisition and sustainment over the next decade or so demand that as much of this as realistically possible is spent in Australia, both to provide a local economic benefit and to help grow the sustainment skills the ADF says it prizes so highly.

This in turn demands more overt support from Defence for local companies which seek to export directly or to form part of the global supply chains of the foreign prime contractors which supply the ADF. Defence can and should use the leverage of its purchasing power to help competitive Australian defence manufacturers. It has begun doing this: Government (Defence and DISSR) support for Australian companies in the Joint Strike Fighter, among other programs, is a good example.

But this effort must be intensified. The benefits will be significant: interesting, challenging defence work will attract engineers; the manufacture and export of equipment (as opposed to providing systems integration and sustainment services solely for Defence) will sustain a more competitive and capable industry base; this in turn will be better able to support the ADF. Australia's wider economy will benefit. And foreign prime contractors will feel more comfortable about making significant investments in their Australian operations.

Defence points out that some 60 per cent of the DMO's annual budget already goes to companies in Australia. But the majority of that money is spent on sustainment - a minor and declining proportion of the capital equipment budget is spent in this country, and that is the expenditure which attracts the major investment in capital facilities and workforce skills by the prime contractors and their local sub-contractors and suppliers.

Defence industry policy must recognise the interconnectedness of the different elements of the defence market. If Defence plans to spend most of its acquisition dollars in Europe or the USA, why would companies there invest in significant manufacturing and production facilities here? Demands for companies to invest in workforce skills, recruitment and modern facilities will be ignored if Defence then fails to support the companies which make these investments. Foreign prime contractors will not invest in Australia if they feel there's no hope of generating a return - and without prime contractors, Australia's SMEs will be deprived of the most significant part of their market.

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