



Defence First Principles Review

Australian Manufacturing Workers' Union Submission

October 2014.

Introduction

The Australian Manufacturing Workers' Union welcomes the opportunity to make a submission to the Defence First Principles Review.

The Australian Manufacturing Workers' Union (AMWU) represents approximately 100,000 members working across major sectors of the Australian economy. AMWU members are primarily based in manufacturing industries but the AMWU also has civilian members within the Department of Defence, including each of the Armed Services and the Defence Materiel Organisation and Defence Science and Technology Organisation (collectively, the APS). It also has members within various prime contractors to Defence, including BAE Systems, Thales, Boeing, ASC and Raytheon, and within related sub-contracting firms.

The AMWU has long held a position that Australia's defence capability cannot be separated from our defence industry capability. This is a truth that is readily accepted in other countries but has been increasingly ignored, if not in the rhetoric coming from government, then certainly in government actions.

That is why the AMWU has recently conducted a dedicated campaign aimed at ensuring Australia maintains a strong naval shipbuilding industry.¹ We fear that the fast approaching drop off in contracted work to Australian shipyards places the jobs and livelihoods of thousands of workers and the future viability of the entire industry in grave jeopardy. Without the bringing forward of shipbuilding projects by the government, the loss in employment, skills and industry capacity will represent an unprecedented blow to our naval shipbuilding industry, with obvious dire implications for Australia's strategic Naval capability.

The AMWU feels that the shipbuilding situation is just one example of the broader challenges facing the defence sector, namely a lack of strategic planning, capability building and skills investment that places our entire defence capability in jeopardy. Rather than being determined by carefully designed strategic plans aimed at supporting and achieving identified defence capabilities, our nation's defence industry capabilities are increasingly determined by an ad-hoc approach which places simplistic notions of 'value for money'

¹ The AMWU has proposed a wide ranging response to the current shipbuilding situation in our report, Australian Naval Shipbuilding, available at: http://www.amwu.org.au/content/upload/files/Ships_Campaign_13/AA_AUST_NAVAL_SHIPBUILDING.pdf

above all else. This effectively assumes that private international markets can effectively take the place of strategic defence capabilities, and will be able to do so indefinitely into the future. This not only ignores the unique context of defence needs (such as strategic risk and its implications), it also ignores a more realistic and honest assessment of 'value for money'.

Industry capability and defence capability

Countries around the world have historically identified their defence industry as a strategic capability and they continue to do so. This flies against the decades' long general trend of a shrinking role for government, increased privatisation, abandonment of industry planning, promotion of free trade and the erosion of government budgets and capabilities. The recognition of the strategic importance of the defence industry has meant that countries around the world have restricted free market reforms and the erosion of the state when it comes to defence capabilities. Practically, what this recognition means is these countries have refused to allow the laws of economics to determine the fate of their domestic defence industries. This can be seen in the former Soviet Union countries, the USA, China, the EU and all the centres of major defence production.

As a result of the strategic nature of the defence industry, defence procurement decisions are not subject to restraints by trade agreements, whether bilateral or multilateral. Such restrictions would place restrictions on the level and type of support governments can provide these industries. For obvious reasons, no nation has been willing to place such restrictions on their defence industries.

Defence industries are supported by governments, through defence procurement programs, law and regulation. This support serves two purposes; to ensure a strong domestic industry and to limit competition from overseas defence suppliers. Unlike Australia, other countries are explicit and make no apologies about this support. As an example, the USA Department of Defense, Defense Procurement and Acquisition Policy states:²³

access to the U.S. defense market is complicated by many laws and rules that prevent or discourage DoD use of non-U.S. products (e.g., Berry Amendment restrictions, Buy American Act, and Small Business Act preferences) or prevent or

² Available at: <http://www.acq.osd.mil/dpap/cpic/ic/about.html>

³ For a comprehensive list of import and other restrictions placed on US defence procurement, see: http://www.acq.osd.mil/dpap/cpic/ic/restrictions_on_purchases_from_non-us_sources.html

impair the ability of non-U.S. entities to perform defense work (e.g., national disclosure policy, export controls on information and technology).

This is just one example of what is the norm in all countries, with the possible exception of Australia.

Australia has embraced pro-market reforms even in the realm of defence capabilities. An approach that is based on overly simplistic notions of value for money has come to dominate both the public administration of defence capabilities and policies with respect to the defence industry and its capabilities.

This tendency has led to Australia increasingly ignoring capability issues, both in industry and in the defence forces and APS, which represents a significant threat to Australia's ability to play the role our allies and political leaderships envision for us, as well as our national security more broadly. This is an issue that has recently come to the fore in the debate about the future submarine project, but it is an issue that extends far beyond the question of future submarines.

While not a lone voice, one of the more prominent on this issue is the Manager of the Australian Business Defence Industry Association, Graeme Dunk. Writing for the Australian Strategic Policy Institute recently, Mr Dunk has said:⁴

“Decisions on military acquisitions and support seem to be made on the basis of the balance sheet rather than any deeper consideration of strategic importance. Repeatedly, statements are made that the ADF needs to get the best capability for the available money, and that defence isn't a job-creation programme. At face value both of those statements are sound, but they don't take into account the longer-term ramifications of in-country industrial activity able to support the defence force.

And,

How do we compare with other countries? Quite simply, abysmally. Most countries that fancy themselves as middle powers support their defence industry. They see value in doing defence-related activities, particularly the support and upgrade of military capability, in country. They put a premium on the development and retention of local skills. They see a link between indigenous defence-industry

⁴ See: <http://www.aspistrategist.org.au/what-future-for-the-australian-defence-industry/>.

capability and the mitigation of strategic and sovereign risk. It appears we don't. What makes Australia so different that we're happy off-shoring our industrial defence capabilities? Why do we naively believe that it doesn't matter, that it isn't worth the investment, and that someone else will pick up the pieces for us?"

And finally,

"Why should we blindly accept the inherent contradiction between the current industrial position and the DWP 2013 statement that 'The highest priority ADF task is to deter and defeat armed attacks on Australia without having to rely on the combat or combat support forces of another country'? The fact that we'll need to rely on the industrial support of another country (or countries) either escapes attention, or isn't considered relevant."

The last paragraph quoted above articulates both the current situation's absurdity and its danger. However, it does not present a comprehensive analysis of the implications of the current approach to defence procurement, capability and skills.

To do so, several other impacts of the current approach need to be considered. These include:

- Investment in skills, including in the APS,
- Direct economic impacts, including jobs, skills, taxes etc...,
- Flow on economic impacts, including innovation, design, technology, intellectual property, etc...
- Flow on impacts on sustainment/through life costs,
- Flow on impacts on future industry opportunities such as defence exports, and
- Direct defence support impacts.

Before considering the impacts of the current approach to defence procurement, the defence industry and ADF and DMO capabilities, it is useful to provide a brief summary of what this approach entails.

What is the current approach?

The current approach to defence procurement lacks long term strategic planning, and is based on either ad-hoc political considerations or the application of the Commonwealth's Government Procurement Guidelines, which have an extreme focus on obtaining the lowest contract price and explicitly rule out any conscious industry capability building role for government procurement. As a result, decisions are not being made as part of a larger plan that brings together industry capabilities and our long term defence needs to ensure the ADF has the industry support it needs and industry has the certainty it needs.

The current situation with the future submarines program is an excellent example in point.

While the DoD and DMO has had a process that assesses various aspects of a future submarine decision, a process that incidentally is not inexpensive in its own right,⁵ it appears that a single briefing by the Japanese with the Prime Minister has overruled this entire process and led to a decision based on little more than a seemingly attractive price tag and a desire to befriend the Japanese Prime Minister. By all accounts, the Prime Minister was impressed with how cheaply the Japanese could supply submarines and has decided this option will be pursued and justified regardless of all other considerations. As collateral damage to this decision are considerations of;

- A true assessment of value for money; whether that includes broader economic costs and benefits or whether it includes an open tender process,
- impacts on relations with other nations, notably China,
- domestic shipbuilding capability impacts,
- industry skills impacts,
- sustainment cost impacts,
- actual suitability of the Japanese option to Australia's needs,
- costs of modifying the Japanese option for Australian needs,
- costs of potentially relocating submarine basing around the country,

⁵ A \$214 million study into the various future submarine options has as far as the AMWU is aware not been completed. This study was designed to make recommendations and inform decisions that it would appear to have been pre-empted by decisions already taken. Media release available at: <http://www.minister.defence.gov.au/2012/05/03/prime-minister-minister-for-defence-minister-for-defence-materiel-joint-media-release-next-stage-of-future-submarine-project-announced/>

- broader economic impacts on the strength, complexity and level of sophistication of our industrial base and therefore broader economy.

Based on the public debate, public statements by the government as well as leaked statements, we have absolutely zero evidence that a decision to purchase submarines from Japan, apparently made in the space of a day or too, has taken any of these crucial aspects into account. Indeed, the whole affair around the future submarine decision looks like a rushed decision was made, based on political and budgetary considerations rather than a fully informed formal or official process, and once the decision was made, relevant people and agencies have been tasked to fill in the gaps to give the decision the appearance of being one that was informed and followed due process, rather than politically opportunistic and ah-hoc.

Naval shipbuilding expert and co-author of the Coalition's review into the Air Warfare Destroyer, Dr John White, has told the Senate:

"There is still sufficient time available, with adequate contingency, for the competitive PDS (Project Design Study) to be carried out and to build the Future Submarines in Australia."

[Dr John White, Senate Inquiry- 13 October 2014]

This evidence has been supported by former submarine commander, Retired Commodore Paul Greenfield, who told the Senate there was no reason why the future submarines couldn't be built in Australia:

"If Government wants to avoid a capability gap, the timing of delivery and the rate of delivery can be arranged so that the new submarines can be introduced in lockstep with the Collins submarines as they are withdrawn from service."

[Commodore Paul Greenfield – Senate Inquiry – 30 September 2013]

The state of the future submarine decision is now in a complete shambles, with the latest reports⁶ stating the contract will go to open tender but in a move reminiscent of the Navy supply ship decision, the Australian Submarine Corporation (ASC) will be excluded from bidding. These reports come only 12 days after reports that Australia had already formally asked Japan to contribute to the building and design of the future submarines.⁷ One would be forgiven for thinking the future submarine program is being run by the Prime Minister's press office, rather than a process that befits a multi-decade, tens of billions of dollars, key strategic asset purchase.

Given this history and this state of affairs, few should take comfort in any formal announcement by the government that they will now engage in a genuinely open tender for the future submarines. In any such tender, if Japan wins the contract, it will be seen as evidence the tender was a charade to give legitimacy to the decision that has already been made, wasting time and public as well as private money. On the other hand, if Japan does not win the contract, serious questions should be asked, such as; why has the government advocated so strongly for a Japanese option, knowing it was alienating our largest trading partner in the process? Why has the government only now decided a tender is needed, which has led to ditching the promised Japanese option and in the process breaking promises to our second largest trading partner? And why has the ASC been barred from bidding when a joint ASC project with an overseas partner could see submarines delivered on time and Australia's hard won submarine industry capacity saved? It is hard to imagine such a process being handled any more ineptly than it has been by this government.

This is just one example of the current process at work, but others abound. The decision to source Army boots from Indonesia rather than Rossi boots in Adelaide, descended into farce as the blatant inequity and short-sightedness of the decision attracted industry and political criticism. Likewise, no legitimate reason has been given for the locking out of Australian shipbuilders from the tender to supply two new supply ships for the Navy.

Chaotic processes based on a short sighted interpretation of value for money has led to a persistent neglect and decline in Australia's defence industry. According to the Australian

⁶ See: http://www.afr.com/p/national/blow_builder_local_jobs_as_government_Sf6r98wHZPDJrrIDV340eK

⁷ See: <http://www.abc.net.au/news/2014-10-17/australia-asks-japan-for-help-to-build-submarine-fleet/5820744>

Business Defence Industry Unit,⁸ from 2007 to 2012, the proportion of defence procurement contracts that were awarded to Australian companies fell from 80 per cent to just over 50 per cent, representing a loss of \$8 billion for our defence industry over just these 5 years.

Again, Graeme Dunk writing for the Australian Strategic Policy Institute states:⁹

“Projects decisions are made solely on a case-by-case basis, seemingly with no consideration of the impact on industry, and reflect what Chris Jenkins at Thales has described as a ‘series of random outcomes’.”

It should be no surprise that decisions based on pure contract price considerations as well as political opportunism can seem like ‘a series of random outcomes’ to industry. It is this approach that has led to the now well known ‘valley of death’ in the Australian shipbuilding sector, as well as skills shortages in the ADF and the costly building up of capacity only to be followed by the loss of the same capacity due to neglect.

As flagged above, Australia’s defence procurement policy is not subject to restrictions imposed by trade or any other type of agreements (unlike general government procurement). However, the Government has consistently and over many years voluntarily subjected Australia’s defence procurement policy to the Department of Finance and Deregulation’s Government Procurement Guidelines, going so far as subjecting it to rules in these guidelines that should obviously not apply to defence procurement.

Such rules effectively prohibit the ability of defence procurement to be used to support and grow domestic defence industry capabilities, regardless of how crucial these capabilities are to sustaining the nation’s defence forces. The most astounding example is rule 5.3, which states:

*“All potential suppliers to government must, subject to these CPRs, be treated equitably based on their commercial, legal, technical and financial abilities and not be discriminated against due to their size, **degree of foreign affiliation or ownership, location, or the origin of their goods and services.**” (Bold added)*

⁸ Available at: <http://www.nswbusinesschamber.com.au/News-Media/Latest-News/Media-Releases-2013/Analysis-reveals-Federal-Government-exporting-Aust>

⁹ Available at: <http://www.aspistrategist.org.au/wanted-a-defenceindustry-decision-framework/>

If taken seriously, this rule prohibits the ADF or the Government from considering the strategic relationship between a foreign country and Australia when we are considering whether to rely on that country as a source of key national security assets. Its application literally implies when making a procurement decision, all else held constant we are indifferent between relying on a firm owned by a Russian Oligarch close to the Russian leadership, a Chinese state owned corporation and a privately listed US company with strong links to the US defence department. Indeed, we are explicitly prohibited from taking into account the firm's ownership, location or foreign affiliation.

It is clear from the above that defence procurement not only lacks strategic planning and direction, when it comes to taking into account the issue of defence industry capability, defence procurement is actively barred from taking such considerations into account. This is clearly the case in so far as any serious attempt to ensure our defence industry capabilities are best able to support the ADF requires the government to differentiate between domestic and off shore industry.

Implications of the current approach

It is easy to see that the current approach as outlined above leads to a severe lack of long term strategic planning, neglect of industry capability retention and building, missed opportunities and seemingly random decisions being made.

Its implications span the economic, the social and of course the military.

The AMWU has long held the view that the government procurement guidelines are fundamentally flawed in that they fail to take account of a holistic notion of value for money, instead focusing just on cost minimisation.

Due to this focus, a procurement decision made under the current guidelines does not consider the skills, jobs, tax, industry capability including technological, sectoral, community or other factors that are actually at play. A true concept of value for money would not make this mistake, taking into account the benefits as well as the cost of various procurement options.

As an illustrative example, consider a contract for a fixed amount of a homogeneous good such as ammunition. One potential supplier will import the ammunition while another will produce it at a factory in Tasmania, with no other difference between the options besides the importer having an infinitesimally small price discount compared to its competitor. The

current procurement guidelines award the contract to the importer based on the price difference, regardless of how small this difference is. In addition, it would do so regardless of the situation of the Tasmanian factory, still awarding it to the importer if the Tasmanian factory were the major employer in a regional town, even if it was facing closure as a result of not winning the contract, leading to job losses, lost capacity and even the death of the entire town.

In fact, these additional circumstances concerning the Tasmanian supplier would be considered as totally irrelevant and be barred from consideration under current procurement guidelines. This is even though the closure of the factory will have significant implications on the public balance sheet, as unemployed workers will receive unemployment benefits rather than pay income tax. They will reduce their consumption affecting indirect tax revenues such as GST, and their Superannuation will be smaller as a result, increasing the likelihood they will draw the pension in retirement. Their children in school will be forced to move, potentially damaging their education as they struggle to fit into a new school just as they should be focussing on attaining sufficient grades to enter higher education, leading to some missing out, further lowering future taxes. The list of impacts goes on.

It is not difficult to see that a real assessment of the costs and benefits would take some account of these contextual and flow-on factors, but the current procurement framework does not acknowledge their existence, let alone encourage their quantification or consideration. It simply equates value for money as being equivalent to price, which is a gross simplification and a denial of any economic benefits stemming from the government's procurement budget outside of the items actually being procured. Indeed, it is a denial of the interlinked and mutually dependent nature of the economy and society more broadly.

This example is hypothetical, but it plays out in reality to varying degrees every time the government makes a procurement decision. In the realm of defence procurement, where the location of design work and production are key in terms of future industry capability, sustainment costs and skills, to ignore these benefits is doubly myopic and damaging. This is for several reasons:

- It fails to take into account the direct economic and tax benefits of different procurement outcomes, in an arena where our decision making is not constrained by international treaties. The tax implications of different procurement outcomes

can easily be estimated and they have an obvious implication for real value for taxpayer money. In addition, these ignored tax implications are likely to be significant. A recent study¹⁰ in the UK has estimated that for every GBP spent on the domestic defence industry, the government receives 36 pence (or 36%) back through the tax system.

A similar effect would not be surprising in the Australian context. Based on the \$8 billion fall in contracts awarded to domestic businesses from 2007 to 2012 outlined above, a 36% tax effect would translate to \$2.88 billion in taxes forgone, due to the decreased use of Australian businesses for defence work. Applied to the 2014-15 defence procurement budget, which sits at \$12.6 billion, spending this at home rather than abroad would generate over \$4.5 billion in taxes, even before other positive economic effects were taken into account.

- The industries that are often at the centre of procurement decisions; shipbuilding, vehicle manufacture, communications, are some of the most advanced industries in Australia. They provide crucial impetus to other advanced industries, provide skills and technology transfer as well as support advanced supply chains. Their health is crucial not only to our defence capability, but for the health of the broader manufacturing sector and indeed, the entire economy, especially as the economy is in danger of an over-reliance on mineral and energy exports.
- It fails to take into account longer term national goals around the supply and support of Australia's defence needs, both in times of peace and in times of conflict. For an island nation like ours to allow our navy to be entirely reliant on foreign supply, or any other branch of our military to be similarly totally reliant on foreign supply, is irresponsible from both an economic and a national security standpoint. And yet this is the trajectory on which we currently find ourselves.

A crucial component of this consideration is the impact of decisions on through life sustainment costs and capabilities. Having sustainment performed overseas on major defence assets is clearly not compatible with maintaining national security and managing strategic risk. This implies that such sustainment will always need to be performed by Australian industry. However, in order to be as capable of this

¹⁰ Available at: <https://www.rusi.org/publications/other/ref:N4F194E71B2404/>

sustainment as possible, Australian industry should also be involved in the design and the building of these assets and capabilities. It is through the design and building process that the capabilities for sustainment are best learned and it is only when these capabilities are at their peak that refinement, adaptation and further development can also be performed. Recognising this, the Department of Defence is itself on the record stating that the through life sustainment costs for the ANZAC ships are two or more times less than they would have been had these ships been built overseas.¹¹

A rational approach to defence procurement decisions would take into account the up front costs, but it would also take into account:

- How 'fit for purpose' various options are,
- Implications for future sustainment costs,
- Implications for generation of technology, innovation and skills,
- Implications for investment particularly as it relates to future potential uses for that investment on other projects,
- Tax and other economic implications,

Out of the factors listed above, the last three are totally ignored, with the first two given some consideration, but the degree seems to vary from project to project. The AMWU believes all 5 additional factors should be considered in as much depth as possible, especially for large projects. Indeed, as part of project design all of these aspects should not only be taken into account, they should be managed to generate the most benefit for the ADF and for the economy more broadly.

Skills

The issue of skills in supplying, managing and maintaining our defence capabilities is also one that has seen years of neglect and is now at risk of representing a crisis. This is not an issue that is restricted to defence contractors and their inability to invest in training new staff due to future work uncertainty. It permeates through the entire defence sector, including at DMO, DoD as well as major contractors.

¹¹ Tasman AIG report into the ANZAC frigates.

In 2012, the Department of Defence commissioned Deloitte to perform an independent review of the Defence Australian Public Service engineering and technical job family.¹² The report's findings present the engineering and technical skills of the APS as fast approaching a crisis.

The Deloitte report states:

“the APS engineering and technical workforce is central to the management of the integrity, worthiness and safety of capability over its lifetime. The workforce plays a critical role in delivering required capability through providing advice, assurance and risk management. The workforce also plays an essential role in ensuring that industry continues to deliver Defence capability through cost effective and productive partnerships between industry, the Australian Defence Force (ADF) and APS.

This is certainly correct. Any effective, efficient defence capability can best be thought of as a partnership between the ADF, the APS and private industry contractors. The capabilities and skills of all three are crucial for an effective partnership to exist. The APS has a crucial role to play in risk management, planning and scheduling and the provision of advice and guidance, both internally to government and externally to contractors. An APS that lacks the necessary technical skills to perform these functions will inevitably lead to poorer risk management, poorer matching of needs and capabilities, poorer management of work and assets and generally poorer defence outcomes with additional costs. Indeed, as documented in reports such as the Deloitte report and the Rizzo Review (2011),¹³ skills limitations already present in the APS have already contributed to inferior outcomes.

This is also not a new problem. The Deloitte report, drafted in 2012, noted:

It has been well documented that a range of changing dynamics has been affecting Defence's engineering and technical capability for some time. A number of reviews such as Black (2011), ANET (2010), Rizzo (2011) and Skills Australia (2012) have highlighted how the skill issues are impacting the provision of capability.

¹² Available at: http://www.defence.gov.au/dpe/pac/aps/TRFW_fullreport_stage3.pdf

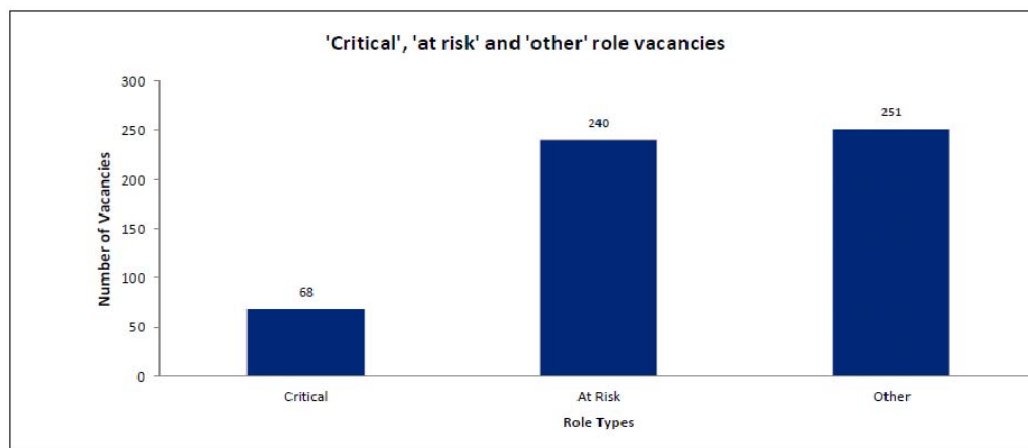
¹³ Rizzo, P 2011, *Plan to Reform Support Ship Repair and Management Practices*, Ministerial and Executive Coordination and Communication Division – Defence, Canberra

The problem, born of a mixture of a lack of planning for demographic challenges, a nation wide neglect of technical and engineering capabilities and an aging workforce, and continued APS funding cuts, is yet to be addressed. This is even with dire and predictable consequences of inaction, as well as ample warning. The Deloitte report notes:

Research conducted as part of this review suggests that the workforce that is in place today will continue to evolve and, if not managed, will result in a loss of critical skills, knowledge and experience.

In addition, chart D21 from the Deloitte report (re-produced below) illustrates the current situation well. It shows the vacancies in the APS defence engineering and technical jobs family by whether the role is critical, at risk or other. As can be seen in this chart, more than half of vacancies are either critical or at risk skills. A situation that needs urgent redress.

Figure D21: Critical 'at risk' and 'other' role vacancies



Source: Defence demographic data provided by Defence Workforce Planning, June 2012

Conclusion

This submission has provided evidence concerning the inadequacy of how defence procurement operates, how assets and projects are planned and how the skills needed to support defence capabilities are being allowed to dissipate. These issues need to be addressed in a thorough and timely fashion in order to abate the continued degradation of Australia's ability to plan, support and execute ADF operations, including the identification and acquisition of new capabilities.

While Australia doesn't have the capacity to domestically provide for all the needs of our modern ADF, we should not be fooled into thinking the millennia old link between defence supply, maintenance and operational performance has been broken. International markets,

shipping lanes and friends are reliable in good times, but it is when these are under threat or not accessible that the ADF needs to be secure in its ability to protect our national interest. The ADF should serve as a protector of these factors and as such should rely on them as little as possible. It would be ironic if we found ourselves in a situation in which, due to having lost a domestic defence industry capability from neglect, the ADF found its ability to operate beholden to stable international factors such as open shipping lanes, rather than as a guarantor of these factors.

All that is required is recognition of the importance of rigorous holistic planning, investment in skills, technology and capacity, broader economic benefits and the interdependent nature of the defence industry, its capabilities, the economy and the ADF's requirements. We can learn from numerous other countries that do recognise the importance of industry in supporting their national defence, and are able to do so without compromising broader economic progress.

Such a recognition would not only serve to better align the needs of industry to the needs of the ADF, it would serve the broader economic goal of expanding our advanced manufacturing base, providing good high skilled jobs, increasing the complexity and technological sophistication of the economy and the skills base of our workforce.