



The Thales Defence Relationship: Securing the Benefits of Reform in Australia's Defence Industry

Paul McClintock AO, Chairman, Thales Australia spoke to the USI of ACT in Canberra on 16 February 2011

The United Services Institute of the ACT hosted a presentation by a leading proponent of reform in Australia's Defence Industry. Paul McClintock provided an overview of the relationship between Thales Australia and Defence, spoke about the evolution of Thales Australia's operations and how it mirrors the major reforms in defence industry and defence procurement over the past 25 years which have achieved dramatic improvements in productivity, quality, safety and efficiency. He also provided a perspective on the major challenges currently facing defence industry in Australia, and key strategies for maintaining the reform momentum and safeguarding the benefits reform has delivered. The evening was introduced by USI Vice-President (Program) Mr Vern Gallagher.

Background



Thank you Vern for that introduction, and for the invitation to talk to you about the Thales-Defence relationship. Both Chris Jenkins, my MD, and I appreciate this opportunity, especially as we believe we are at a pivotal moment in the history of Australia's defence industry- again!

Looking at the media this morning I feel the topic of defence industry remains current.

Most of you would know something about Thales. As a company, we are European in origin and global in outlook. This global outlook is reflected in the evolution of the Thales business here in Australia.

Today our businesses have some 3300 employees across 35 sites, and a heritage stretching back more than a century in this country. We operate some iconic defence facilities – the Garden Island dry dock, the Lithgow small arms factory, munitions and vehicles manufacturing – along with non-defence businesses such as Air Traffic Management, which is a major export earner, and transport systems.

Tonight I want to briefly canvas that evolution of Thales Australia, talk also about the current state of defence industry in Australia and why it is important to our national security and defence aspirations, and offer some remedies for the difficulties facing defence industry at present.

The past is instructive – it provides context. The future is not predetermined – it will be what we make it.

And right now we are at a critical point where the decisions we make will help shape the defence industry of the future.

Thales in Australia

The story of Thales in Australia tells us a lot about the company, but also a lot about the significant reforms to defence industry over the past 25 years.

The Thales “model” has involved:

- Investment for the long haul;
- Technology transfer;
- The building of a highly skilled workforce; and
- A determination to win export customers as well as servicing local markets.

Broadly this is the model that Thales has followed in Australia since it began in the Underwater Systems sector in the mid-1980's. That business has grown to be the largest local producer of sonar systems and mine counter measures, and globally Thales has equipped more than 500 warships.

In Air Traffic Management, Thales won the contract to provide Australia's new ATM system in the mid-1990's. From that initial investment, technology transfer and further investment has seen the Thales Australia ATM business grow to more than 400 highly skilled people, exporting to 50 countries and generating more than \$1 billion in exports over the past decade.

The largest investment of course was in Australian Defence Industries – ADI – where we first took a 50% share in 1999, and then 100% ownership in 2006.

And here again significant investment has followed that initial major investment, in munitions, in small arms manufacture, at Garden Island and in protected vehicles.

To put this all in context, I think it is useful to have a look back at the days when a significant part of what is now Thales Australia's business was owned by the Commonwealth, and operated largely under the auspices of the Office of Defence Production. Over time, it became very clear to many people that these facilities, as well as other ordnance facilities such as the Government Aircraft Factory, were operating way below any acceptable standards of productivity.

They were slow, difficult, and propped up by many millions of taxpayer dollars.

I'm not sure that today we remember how bad this situation was and why subsequent actions had to be taken, so here's a reminder.

In financial year 1979/80, the munitions factories incurred costs of \$100 million, yet returned only \$54 million in earnings from sales, with taxpayers making up the shortfall.

At the Government Aircraft Factory, a leadership structure was in place where the manager's role was rotated, with a departmental official taking it in turns with the head of the union group to run the place.

What's more, 50 people for whom no useful employment could be found were placed in a shed and described as a 'think tank'.

And here's a favourite... Again at the start of the 1980s, the Department of Productivity's own publicity material said that at the Office of Defence Production's 12 establishments, only 44% of output was for the Australian Defence Force - 19% was for private industry, 11% was for government non-defence work, and 9% was for export...*No attempt was made to explain the remaining 17%.*

The Defence Minister at the time, Kim Beazley, confirmed his awareness of 'a clear sense of outrage within Defence that they should be carrying an organisation with extraordinary industrial practices and such a poor record of delivery.'

His adviser, Syd Hickman, went a step further, saying the aircraft factory was the worst industrial site in the whole of Australia, and putting it into context with the others: "Williamstown was maliciously and deliberately inefficient," he said. "The aircraft factory was ideologically weird, a real social experiment. Garden Island was inefficient too, just not so maliciously as Williamstown."

When the decisions were made to commercialise large parts of defence production, and then privatise it, they were based on very sound principles: to increase investment, to improve

productivity, to boost exports and to enhance Australian self-reliance.

Speaking in May 1989 at the time of the creation of Australian Defence Industries, Beazley said: "The facilities have suffered from low morale, chronic undercapitalisation, excess capacity and totally unsatisfactory industrial relations... Our aim has been to make the government factories and dockyards not just competitive, but an integral part of Australian industry... Defence, like the economy at large, is best served by an industry structure that can hold its own in the world market, capable of recognising opportunities and seizing them."

He concluded by saying that along with a clear definition of Australia's strategic environment, the second major pillar of government policy was "a competitive, technologically proficient and adaptable industry base, able to supply and support the changing requirements of the Defence Force."

Now obviously in the intervening two decades there has been a lot of water under the bridge, and in particular the doctrine of self reliance is not as strong as it used to be.

But one constant, however, is that governments of both persuasions have actively encouraged investment in Australia's defence industry.

And this investment has produced results. In 1984/5 the value of annual production/sales achieved per employee was \$20,000. By 1996/7 it was \$180,000, while today at Thales Australia it is over \$300,000 – that's a 1400% increase from the earliest figure, and over three times the original figure adjusted for inflation and the economy-wide productivity improvement rate.

This productivity improvement is the product of investment, improved work practices, technology transfer and incentive.

Thales has certainly invested in Australia. Along with the price of purchasing ADI and then buying out the joint venture to assume full control in October 2006, we have invested over \$100 million in self-funded Research and Development, and spent at least half that again on infrastructure, upgrades, training, and so on.

We have also made huge advances in safety and in industrial relations. The industrial practices of the 70s and 80s are gone, and we have in general good relationships with the unions, including a Constructive Relationship Agreement that is working well.

In safety, we are light years ahead of where we were in the bad old days, and many of our workers owe their injury-free status to a professional, modern and committed approach to health and safety that is consistently implemented and reinforced across the company.

So we've brought significant investment, expertise and global resources to the table, and we are not the only prime to have done so. BAE bought Tenix, Raytheon has actively invested in Australia, and so have the other primes. There can be no doubt that those reforms launched in the 1980's and continued in the 1990's – tough as they were at the time – brought real and lasting gains for Defence and for the nation.

The White Paper and industry policy

If we fast forward to the release of the most recent White Paper in May 2009, we find industry's ability to deliver at the very centre of the most crucial and sensitive elements underpinning the future of the ADF. We, Australian industry, with our global partners, need to deliver:

- 12 Future Submarines
- 8 new surface combatants
- Systems for LHDs and AWDs
- Systems and support for a radically advanced fleet of both fixed and rotary wing aircraft,
- And a whole suite of capabilities in the land domain, including advanced vehicles, soldier systems, communications, sensors, and other vital elements.

If you just stopped at the first example – 12 submarines – that would be enough to make the point. As we saw with the public perception of the Collins submarine program, if industry fails the ADF gets hit with a 'double whammy' – it has to make do with delayed or reduced levels of actual capability, and public confidence that the defence

forces can do their job effectively can be massively eroded.

Apart from these complex acquisitions there is also the core promise of structural reform contained in the Strategic Reform Program which cannot be achieved without significant industry contribution.

So the industry challenge and opportunities contained in the White Paper cannot be underestimated.

With that as our base you would expect that right now the primes and SMEs in the defence sector would be furiously investing, building up their skilled workforces and attracting global interest in readiness for this surge of major projects.

But the reality today, almost two years after the launch of the White Paper, is the opposite.

We believe that today there is a crisis of confidence in the defence industry - a crisis of confidence emanating from a pipeline of defence work that has almost completely stalled, resulting in industry layoffs and question marks about the viability of continued investment in Australia.

It is exacerbated by an ambivalence in defence industry policy about just what sort of defence industry Australia wants or needs.

This crisis of confidence is severely curtailing investment, and over the past few months, hundreds of people in the defence industry have lost their jobs. Companies large and small are looking nervously to the future.

We subcontract large amounts of work to SMEs, because we believe in a competitive, flexible supply chain that enables us to deliver cost effective capability to Defence. We continue to ramp this up, with future programs predicated on an increasingly higher percentage of SME contribution.

But some of these SMEs are telling us they are getting out of the defence industry because the expected returns are not there, and the risks of continued investment are too high. Predictably, they're looking at the mining industry and seeing greater opportunities.

This means that their capabilities, often valuable technologies, skills or niche products, are drifting away from defence. They will also not be investing in Australia's defence industry, nor building the skills that would support our national defence capability.

The most recent Defence Industry Policy – “Building Defence Capability: A Policy for a Smarter and More Agile Defence Industry Base” – states: “Despite the primes’ prominence in the local industry landscape, they would not be able to meet the needs of customers without SMEs. Around one-third of Defence’s spending on acquisition and sustainment goes to SMEs. Estimates suggest that there are over 3,000 SMEs in Australia’s defence industry, mostly subcontractors to the primes.”

It goes on to say that the SMEs are a “vital source of innovation and niche capability in the local defence marketplace”, and that SMEs employ about half the defence industry workforce.

Well, the alarm bells are ringing, as some of this innovation is now going out of defence. And once it goes, it's going to be very hard to get back.

And what about the primes, most of whom are foreign owned?

According to the Defence Industry Policy, about 70% of the value of defence materiel produced in Australia for the DMO is initially sourced from the primes, with 30% of that subcontracted out to SMEs

But only a small percentage of the primes’ global revenue comes from Australian sales and exports. For us, BAE and Saab it's around 3%. For Raytheon it's 1.3%, and for Boeing, Lockheed Martin and Australian Aerospace / EADS, it's less than 1%.

So decisions to keep investing in Australia will become harder to make, take longer, and be more difficult to justify if growth slows and other opportunities arise. It's a collective decision-making process that takes into account both local and global perspectives, balancing them according to the expected rate of return, opportunity cost and, above all, the primes’ main duty to generate returns for their shareholders.

In short, these are decisions that will be made not only in Sydney and Canberra, but also in London, Paris, Stockholm, Chicago, Massachusetts and Maryland.

You can ask why the Industry Policy has had limited impact. My answer is perhaps best given by taking from an analysis I have used for the past two years at my speech to the Defence and Industry Study Course where I argued that a defence industry policy could be analysed through a template of five criteria:

- Clear definition of objectives
- Whole of government process
- Usable – especially for investment decisions
- Realistic
- With clear responsibility for implementation.

I was not sure the policy when released passed any of those criteria, but today I will focus only on the first – what are the government's objectives in having this policy.

This question can be put another way – does Australia want a deep local defence industry capability, or a shallow one?

By deep, I mean the industrial base that government policy has encouraged since commercialisation – an industrial base that has a wide range of R&D, design, manufacturing and maintenance capabilities built up over many years and strengthened by exposure to global skills and the global marketplace. It's the industrial base that successive governments have talked about since the 1980's – technologically proficient, competitive, and able to support the changing requirements of the ADF.

On the other hand, there is the shallow option. By this I mean a mixture of SMEs providing local skills and technologies, mixed in with the global primes acting as shopfronts for their international product portfolios. Here you'd see a very limited Australian manufacturing capability, with most of this geared towards tailoring overseas products to local requirements.

Investment in R&D would be noticeably lower than the deep option, as would capital expenditure on facilities, skills and training. Far fewer people would be employed in the defence

industry, fewer SMEs would participate, and the primes' commitment would be lower, given the ease with which they could pack up shop to pursue opportunities elsewhere. The ADF and the Department of Defence in general would have a much reduced pool of technologies and skills from which to draw, creating a self-fulfilling prophecy with the slack of a dwindling industrial base being filled by more imports from overseas.

There are also, of course, strategic considerations that have to be taken into account. What kind of capabilities do we need to keep in Australia, if any? And how would this affect preparedness for the various roles the ADF could be called on to play?

These two options, deep and shallow, can each be defended, but my point is that you need to choose. You cannot swing from one to the other within a few years without clearly signalling what you are doing and why, and you cannot make policy and procurement decisions that may be interpreted as pursuing both options at once – it simply won't work, and industry will not invest in the face of such inconsistency.

The current layoffs and the uncertainty among SMEs are the direct result of a pipeline of work that has stalled. Therefore, the choice for what's ahead must be made clear, because the industrial capacity we have today can be lost very quickly.

To me, local industrial capacity in defence is like reputation – it takes years to build, but you can lose it overnight. To again quote the current Industry Policy: "Experience shows that capacity in defence industry cannot be taken for granted. Industrial capacity needs to be planned, built, managed and continually re-shaped – industry must plan, and must be able to plan, to ensure it can play its part." We couldn't agree more.

If Australia decides to take the shallow path, then it needs to be clearly signalled. The immediate slowdown in investment as a result of any such decision would be a prelude to the shopfront model I outlined above, and the start of a painful period of downsizing and readjustment.

As I mentioned earlier, the Defence White Paper places industry right at the sharp end of delivering the Force 2030 aspirations. It clearly

envisages the continuation of a deep industrial capability in turn delivering a real capability edge to Australia's Navy, Army and Air Force.

At the most fundamental level, deep local industrial capability is critical to national security. What makes a nation-state is its ability to maintain its internal integrity and protect its borders. Without that ability, there are no nation-states, no countries, no clearly defined political boundaries. In peacetime this is too easy to forget, but in war, when the very existence of nation-states is often threatened, it becomes critical.

A solid industrial base also creates jobs, bringing skilled employment opportunities and long term careers for talented people. Whether on the technical or commercial sides, many people appreciate the chance to work and build their careers in this area. They help promote scientific progress, while enhancing economic activity through winning new business, employing more people, hiring subcontractors and generating tax revenue.

Commonwealth statistics say Australia's defence industry employs around 29,000 people and supplies over \$5 billion worth of materiel and services to Defence each year. That's a lot of careers and a lot of economic activity.

So how do we maintain this, and grow it for the future? How can we address this current crisis of confidence ?

I believe there are four key areas where improvements can be made, deepening and strengthening our local capability.

The first is greater collaboration – between industry, Defence and research sector agencies such as the DSTO. Here we agree with the Defence Industry Policy, which calls for a stronger relationship between Defence and industry. In the US and the UK, the relationship between government and industry is much closer than it is here in Australia, and I believe they both benefit from that immeasurably. Close relationships leads to clear strategic intent, and a willingness to trust each other and work together to secure long term goals. I do not see any reason why we cannot pool resources to a much greater extent than we do here in Australia today.

This pooling of resources applies to both government and industry, and of course within industry itself. Through greater collaboration we will have greater alignment, lower costs, and increased trust and cooperation to deliver vital capabilities while securing value for money for taxpayers through economies of scale – one of the goals of the Strategic Reform Program.

Pooling resources will also enable us to meet the intense challenges that are arising due to the increasing proliferation of very advanced and highly sophisticated technologies, many of which can produce massive amounts of data that will take analysis and analytical tools to whole new levels. A prime example of this is in space, which will become increasingly important.

The second key area is the early engagement of industry. When it comes to R&D and capability development, I firmly believe that industry should be involved at the very earliest stages of development and thinking, because in many cases it is industry that will ultimately be asked to deliver the resulting capabilities. Working together and shaping these requirements will generate better outcomes for all parties – whether it's new technologies, new processes, new platforms, or even new contracting models. Cooperation at such an early stage would boost innovation by combining the strengths of Defence and industry. It would also help avoid costly mistakes, because both parties could work together to generate a complete risk profile from the start, then work cooperatively to fully identify and manage these risks.

Practical steps to improve the early engagement with industry should include giving the Capability Development Advisory Forum a real role in the capability development process.

I note that in his speech to the ADM Conference this morning the Minister for Defence Materiel Jason Clare committed to a number of measures including a much stronger role for the Capability Development Advisory Forum to increase industry input into the DCP – and I welcome this as an encouraging step forward.

Further, to both encourage investment here in Australia in R&D and to focus that R&D effort more sharply on service needs, why not consider

a 'try before you buy' facility whereby new products developed here in Australia could be trialled with the Defence forces ahead of a formal procurement.

Which brings me to the third, and probably the most important area needing attention – the fostering of the right investment climate. I spoke about this earlier, but want to reiterate a couple of important points. The Defence Industry Policy talks about the need to set clear investment priorities for industry, but I believe that today there is uncertainty which is killing investment.

We in business still feel there is a tendency in parts of government to see a good return for a company in a specific project as a 'waste' of taxpayers' funds, or a failure of contract teams to negotiate hard enough.

However, the historical average for a defence company such as Thales Australia is a pre-tax return on sales of around 5%. That's ok by this industry's standards, but much less than impressive when compared to competitors for invested capital like banks and the mining industry.

The most common criticism comes at the point where the total cost of individual contracts is being discussed. But to take a contract-by-contract view is quite naïve. To stay alive as a company, and be around to provide support, there are things we must do other than satisfying the terms of each contract.

For instance, as a global company Thales spends around \$4 billion on research and development. Here in Australia we have upgraded a range of facilities, and provided many new capabilities.

We have also made Australia a Thales world centre of excellence for visual and sensor databases, air traffic management, and sonar systems, and Thales Australia also hosts one of our few global integration centres for complex transportation systems.

Given this, let me make the following point very clearly, as it is crucial. The owners of companies in this industry will not invest over the long term in local R&D and infrastructure unless profitability is at a level that justifies that expenditure. This

applies to profitability both in absolute terms, and also in comparison to other potential investments around the world.

There has to be the expectation of a reasonable rate of return for companies to continue investing in the Australian defence industry, and it has to be measured, at least in the primes' case, with what the primes can expect elsewhere. This was one of the core reasons why back in the day the Commonwealth commercialised and then sold off its defence manufacturing operations – to encourage appropriate investment from industry, with the assumption that this investment would be rewarded with an appropriate rate of return.

Fourth, but by no means last, is flexibility on the part of the DMO. This includes the two key attributes of rigour and speed. We are not against more rigour being introduced into defence procurement, not against it at all, because we firmly believe that Defence is entitled to innovative, cost-effective solutions from industry, for the benefit of end users, the DMO and the taxpayer.

Everyone acknowledges that over the past few years there has been significant improvement in this area, with greater pre-procurement analysis and requirements definition, the introduction of the DMO Scorecard, and also the identification and rectification of projects of concern.

We applaud and fully support these actions, but also believe that the DMO can go further in introducing greater rigour into its operations and processes, and we are more than willing to play a part in this process.

While still maintaining rigour, we believe there are many opportunities for the Commonwealth to speed up the decision-making process. Beyond industry, the ADF itself would benefit from the introduction of new capabilities and upgrades as early as possible, to help them do their jobs while enhancing national strategic capability.

Let's go back to the Defence Industry Policy subtitle – "A Policy for a Smarter and More *Agile* Defence Industry Base". Agility is key, and a goal we should all strive for. We can promote agility through the earlier engagement of industry, but there are also many other areas where gains can be made. These include shortening the length of

the bidding process and the red tape that goes with it, faster decision-making on the DMO's part, and greater involvement of DMO personnel with industry through the bidding cycle. I understand probity, but cooperation also has its advantages, and an arms-length relationship will not maximise industry potential.

Beyond rigour and speed, we actively encourage the exploration of new contracting models, which can reduce risk for the customer while giving industry extra incentives to perform, especially in the shape of contract extensions for good work. We are pleased to see the Commonwealth has moved towards this way of thinking in some areas, and once again, we are more than willing to participate in exploring these issues further.

These four key areas – greater collaboration, early engagement with industry, the right investment climate and DMO flexibility – have the potential to bring real benefits to the ADF, the Commonwealth and industry. By acting in these four areas, we can continue to develop Australia's defence industry according to the deep model I outlined earlier.

This deep model is, I believe, crucial for Australia's national security. The shallow option will not, and *cannot*, deliver the industrial capabilities needed by this country to develop,

deliver and maintain the platforms and technologies needed by the ADF over the coming decades.

The consistent policy of governments of both persuasions since the 1980s has been to develop and encourage a robust industry led by private enterprises who make long term investments that result in cost-effective solutions to the customer. This is the path we have taken, the road we have walked down together for 30 years. But will it continue?

At a time when we are facing an uncertain geopolitical environment, a strengthening regional power in China, and other powers emerging on the global stage, I would argue that this model has to continue, in order to safeguard our national security and our national interests.

Even ignoring all the other benefits of a deep local capability – all the employment, the tax revenues, the skills and the research – the fact is that the ADF needs to be properly equipped and trained, and this requires a strong industrial base of committed primes working in concert with large numbers of SMEs and the Department of Defence.

Thank you, and I'm now happy to take questions.

Biography:

Mr Paul McClintock, AO is Chairman of Thales Australia, Medibank Private Limited, the COAG Reform Council and St. Vincent's Centre for Applied & Clinical Research. He is also a Director of Macquarie Infrastructure Group, Perpetual Limited and McClintock Associates Securities Limited. From July 2000 to March 2003 he was Secretary to Cabinet and Head of the Cabinet Policy Unit in the Australian Government reporting directly to the Prime Minister as Chairman of Cabinet with responsibility for supervising Cabinet processes while, as Head of the Cabinet Policy Unit, he was the Prime Minister's most senior personal adviser on strategic directions in policy formulation. Mr. McClintock's former positions include Chairman of the Expert Panel of the Low Emissions Technology Demonstration Fund, Symbion Health, Affinity Health, Ashton Mining, Plutonic Resources and the Woolcock Institute of Medical Research. He was also a Director of the Australian Strategic Policy Institute, a Commissioner of the Health Insurance Commission and a member of the Australia-Malaysia Institute Executive Committee.