



The Future for Industry supporting the Australian Defence Force

Mr Mark Reynolds, Head, Commercial and Industry Programs, Defence Materiel Organisation spoke to the USI of ACT on 17 August 2011

The United Services Institute of the ACT hosted a presentation in Canberra by Mr Mark Reynolds, the Head of Commercial and Industry Programs in the Defence Materiel Organisation. He outlined the plan for future industry support to the Australian Defence Force, providing a snapshot of the current conditions under which the Defence Materiel Organisation (DMO) operates to deliver on its acquisition and sustainment targets, from the 2009 Defence White Paper, through to the 2010 election, and the present day. Mark discussed the availability of industry programs to help Australian industry focus itself to be more competitive, efficient and successful, and where this focus should lie: in particular, the significant challenges for Defence's procurement agenda in the next decade, and possibilities for industry 'future-proofing' against significant change.



Introduction

Good evening Ladies and Gentlemen, and thank you for the opportunity and privilege to speak to you tonight.

I titled the presentation "The Future for Industry supporting the ADF" because I thought, at the time – now back in March – that the industry landscape may have been settling down, or at least stable enough to reasonably predict where life was heading. I could not have got that more wrong if I tried. Every time I turn around there seems to be a new dimension to this big puzzle. However, in for a penny, there has never been a better time to try and tease out and understand how the future might look for the Defence business.

This is probably true for any industry, but especially the defence industry. The fact that Defence budgets, almost universally, have been targeted to try and claw back the huge deficits created in the flurry of activity to try and shore up economies in the wake of the Global Financial Crisis, and the more recent example in the US of the gamesmanship over setting the Defence budget as the default target should Debt reduction measures not be agreed now places Defence industry globally in the trenches – an experience they have not had for a long time. For Australia, these conditions generate some

unique circumstances that the Department and Australian industry must face in trying to deliver to the government's and the public's expectations of us, and continue to deliver capability to our war-fighters serving at home and abroad.

I would like to tackle the topic in three pieces:

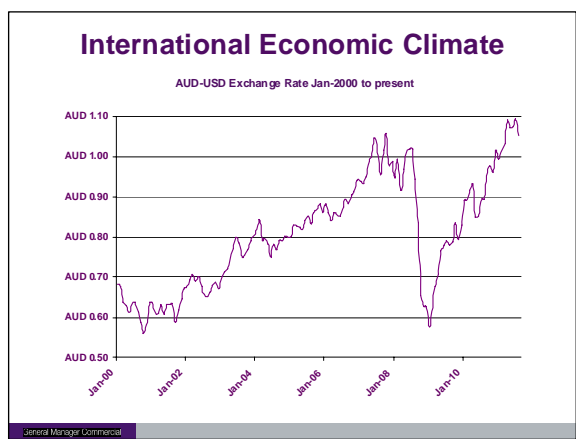
- First, let me set the scene as I currently see it, including a bit on how we got here;
- Second, let me talk about what Defence and the government offers to help industry operate in the current and future environment; and
- Finally, let me scope out where I see Defence industry needing to focus over the next five to ten years and the challenges that may entail

The Current Scene for Defence & Industry

The best place to start talking about the current climate is the 2008 global financial crisis. I think the details, or entrails, have probably been pawed over sufficiently by the many, many commentators on this issue, so suffice for me to say that the downturn in economies world-wide has affected the Defence market very differently to most, particularly in the manufacturing areas. The very long lead times meant that Defence industry did not really feel the GFC on the shop floor – but like everyone it felt it on the stock

exchanges. The real impact on Defence industry has been the downstream effect of orders drying up, and now the prospects of declining Defence spend. Of course, for Australia a bigger downstream effect to date has been the appreciation of the Australia dollar and its effect on both our ability to export, and the cost of value adding in Australia to offshore products.

The rollercoaster that is the Australian dollar has been one of the most polarising aspects for the Australian economy. From most business perspectives it has really hurt, but from the taxpayers perspective, outside the workplace, it has been a real bonus. This slide of the ride I find really fascinating, because the worst point at which to announce a new Defence White Paper and the subsequent Defence Capability Plan is pretty obvious, and our dart hit the bulls-eye.



The 2009 Defence White Paper came as both a beacon and a cage for Defence and Defence industry. The government's continuing commitment to Defence capabilities and its vision for Force 2030 provided industry with the confidence to continue to commit. It also imposed a number of constraints on Defence.

Defence Funding - White Paper 2009

- Defence Budget growth
 - 3 per cent real growth (2017-18)
 - 2.2 per cent real growth (2018-19 to 2030)
 - 2.5 per cent fixed indexation to the Defence budget from 2009-10 to 2030
 - \$445 million (2009-2020) for industry programs to support local Australian industry capability.
- Defence will reinvest savings from its Strategic Reform Program back into priority Defence capabilities as agreed by the Government.
- These savings have already been factored into the Defence budget forward estimates.

Source: Defence White Paper, 2009

They are listed here, and I am sure all of you could probably recite them in your sleep. The kicker, which government quite rightly imposed, was the Strategic Reform Program and its requirement for savings over ten years from 2009, which were already factored into the twenty year plan which is Force 2030. Within a week of the White Paper announcement, we had the 2009-10 Budget announcements which started the further tightening needed by government to meet its commitments to deliver the further fiscal stimuli which are credited with the speed and quality of Australia's recovery from the GFC.

Almost immediately, the Australian dollar began its relentless rise, and while government provides Defence with a no-win no-loss position on foreign exchange, setting a spending plan at 67 cents on the dollar, and being at 90 cents before you even start, has meant a lot of handback in the two years since.

Defence Expenditure Top 15 in US\$ billions, 2010

Rank	Country	Spending (US\$ bil)	Spending per capita (US\$)	Average annual growth rate, 2001-2010 (% p.a.)	Change, 2001-2010 (%)
1	USA	698	2,198	6.2	81.3
2	China	119	88	11.2	189.0
3	France	60	952	2.0	21.9
4	UK	59	958	0.3	3.3
5	Russia	59	418	6.2	82.4
6	Japan	55	429	-0.2	-1.7
7	Saudi Arabia	45	1,725	5.0	63.0
8	Germany	45	551	-0.3	-2.7
9	India	41	34	4.4	54.3
10	Italy	37	616	-0.6	-5.8
11	Brazil	34	171	2.7	30.0
12	South Korea	28	569	3.8	45.2
13	Australia	24	1,116	4.1	48.9
14	Canada	23	673	4.3	51.8
15	Turkey	18	231	-1.3	-12.2
	World	1680	236	4.2	50.3

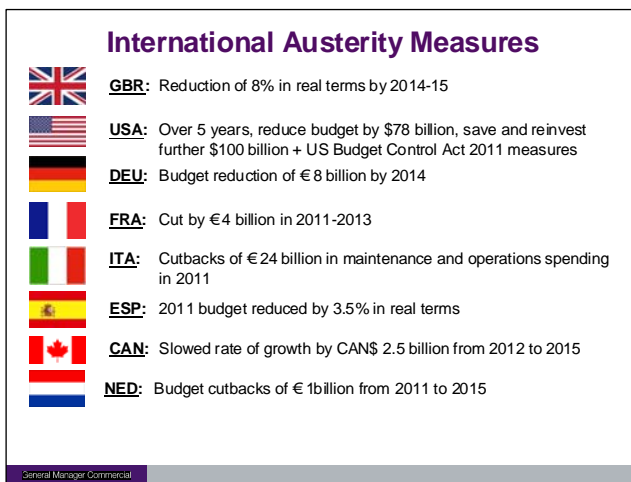
Source: SIPRI Yearbook - Military Expenditure, 2010

So, while Australia has done well as a whole coming out of the crisis, we are now seeing world Defence production faltering in the aftermath.

In 2009, world economic growth was negative - the first time this has occurred since records began in 1971. Nevertheless, even with the GFC, figures from 2001 to 2010 still show encouraging global defence expenditure figures, in spite of the recent impact of tough austerity measures put in place by governments around the globe. Let's look at the US. Over the last 10 years, expenditure has risen at an average of over 6% a year, a total increase of around 81%

on the 2001 figure. In 2010 the US outspent its nearest rival, China more than 6 times.

But for many developed countries, the trend of the last decade is set to change. While Australia is forecast to see a 10% growth in Defence expenditure to 2015, the United States forecast predicts a 10% drop (and this could go even higher if the debt reduction plans do not eventuate), and the United Kingdom's defence expenditure will potentially shrink by 23%. Meanwhile, China and Russia will see expenditure growth of more than 50% - not quite our traditional markets.



Expenditure reduction is largely the result of significant austerity measures put in place by most Western governments. The Jane's forecast for these countries shows an average expenditure reduction of 10% over the next 5 years. In light of this figure, Australia's expected growth of 10% is definitely a positive statement for our local defence industry.

Since July 2009, Defence and Defence industry has been on a similar rollercoaster to the dollar. In 2009-10 our expenditure met forecasts and we achieved our SRP target under Smart Sustainment. In 2010-11 we had an underspend attributable to several issues including the pace of project approvals, changes to rates of effort, and underperformance against acquisition and sustainment contracts. In 2010, we also had a Federal election, and while Defence issues, other than our involvement in Iraq and Afghanistan, were not high on the agenda, both sides made the firm commitment to bring the budget back to surplus in 2012-13.

This requirement appears to have been woven into the fabric of this government and Defence can expect to be a significant contributor to that policy aim.

Recent Developments

The capability side of Defence has also not been short of its own reviews and reports. Following on from concerns expressed by the Ministers, in May they announced the need for Defence to speed up the implementation of the Mortimer Reforms; in July we had the release of the Rizzo Review into Ship Repair and Maintenance Practices; early this month we had the release of the Black review into Defence accountability; and last week we had the first public hearings of the Senate Standing Committees on Foreign Affairs, Defence and Trade inquiry into Defence Procurement.

- Reform of Amphibious and Afloat Support Ship Repair and Management Practices – Mr Paul Rizzo (the 'Rizzo Review')
- Review of the Defence Accountability Framework – Dr Rufus Black (the 'Black Review')
- Senate Inquiry into Procurement procedures for Defence capital projects
- Export Controls Reform

The outcomes of the Rizzo Review will add an interesting dimension to the requirements of the savings under the Strategic Reform Program. Its conclusions lead to the need to invest more in the maintenance and support of our fleets, which will put greater pressure on other elements of the Smart Sustainment strategy.

Of particular note for industry in the Black Review will be the creation of Associate Secretary for Capability with responsibility for detailed acquisition and sustainment reform and integration of capability development work carried out by the Strategy and Capability Development Groups, the DMO and DSTO. DMO will remain a prescribed agency. The Associate Secretary provides the focal point for accountability in Defence for the complete capability development life cycle.

The Senate Inquiry is still in its early days and therefore it would be inappropriate for me to comment, however the first hearings certainly covered a wide range of topics brought forward by industry and the ANAO. DMO certainly looks forward to speaking to the committee in the near future. There is no doubt that recommendations will come from this inquiry and government will give them due consideration.

I should also mention that Dr Coles is in Australia this week as part of his task to review Collins support and sustainment.

Finally, let me mention that the government is in the process of enhancing export controls. The Department released the draft of the *Defence Trade Controls Bill 2011* yesterday for comment. The Bill covers the introduction of the Defence Trade Cooperation Treaty with the US and additional strengthening controls to Australia's export control system to bring it in line with world's best practice.

The strengthening controls will impact on all companies that export military and dual-use goods on the Defence Strategic Goods List though introduction of controls on intangible transfers, services and brokering. Whereas, the Treaty will enable licence-free trade of controlled military goods between approved communities in the US and Australia for specified end uses. The Treaty is expected to provide increased opportunities for Australian companies in the US defence market.

ADF Budget 2011-12

2011-12 Australian Defence Budget

Defence

- \$30.6 billion in 2011-12
- 2% of Australia's GDP

DMO

- \$10.2 billion of funding to support the ADF in 2011-12
 - \$5.1 billion on Acquisition
 - \$5.1 billion on Sustainment
 - \$0.1 billion on Policy, Management & Industry Programs

(Excluding the service fee to deliver)

Source: Portfolio Budget Statements, 2011-12, Rounded for Display

General Manager Commercial

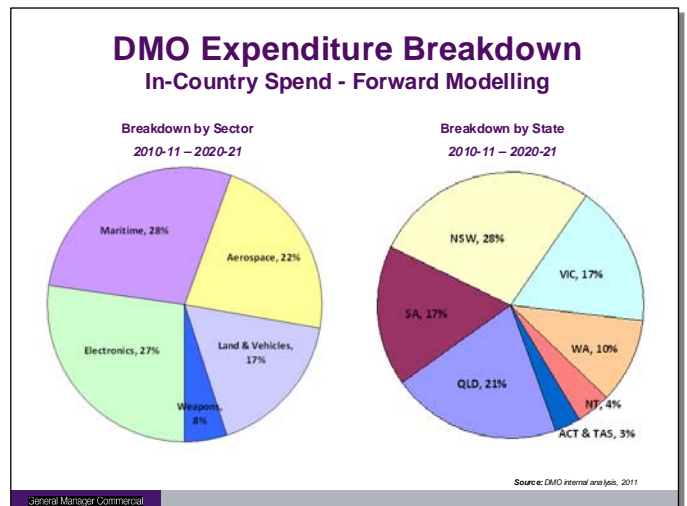
Finally, this year the budget is \$30.6 billion, and of that the Defence Materiel Organisation has been allotted \$10.2 billion to acquire and sustain

equipment for the Australian Defence Force. This figure does not include DMO's labour and overhead costs. So here we are, and during 2010-11 we will see the outcomes of the Force Posture Review, which is likely to have some significant implications for Defence industry regarding the sustainment of capabilities and support for the ADF.

Let me now quickly mention the programs that Defence offers to industry. I want to do this because many companies are now doing it tougher than before, and the parameters I have outlined give you some of the reasons why.

DMO Expenditure Breakdown

To set this scene, the slide shows you our current assessment of in-country spend by sector and by State over the next 10 years. This is a slide that can start a lot of arguments, particularly about the split by State, and we are working with the State bodies to establish a consistent and agreed methodology for measuring and reporting spend. Suffice to say, however, that this is the breakdown we are using. The sector spend forecast is of particular use to us in prioritising our spend on programs.



Defence Industry Programs

Given everything already said, our conclusion is that uncompetitive, inefficient and overpriced business models will not survive for long in this climate. To win work locally from Defence, to engage with overseas contractors on DMO projects, and to be part of a global supply chain, Australian industry needs to be a lean, cost-effective and professional option.

In 2010 government released The Defence Industry Policy Statement to assist Australian defence industry to reach this goal. The document outlines a number of initiatives, from better communication practices, a clearer view for industry on Defence forward planning, and grants programs to support up-skilling, professionalisation, and overseas business opportunities.

The overarching aim of the policy was to quantify the \$445.7 million commitment government has made to Defence industry over the period 2009 – 2019. We're going to meet this commitment by fostering a relationship with local companies to ensure that capabilities which need to be locally available in Australia, are developed and maintained.

Along with the release of the White Paper in 2009, the Government announced twelve priority industry capabilities, or PICs, and twelve broader strategic industry capabilities, or SICs. These capabilities are fluid, and DMO is currently engaged in refining the definition and an analysis of the PICs, known as the PIC Health Check, to better inform internal processes and industry externally. We are also developing the PIC Innovation Program, which will come online this financial year, and will provide grant funding to applicants for innovative developments in priority industry areas.

Assessments for this year's Skilling Australia's Defence Industry round are in full swing, with \$14 million committed over 2011-12.

Three Global Supply Chain deals between Defence and multi-national primes have been signed in 2010-11, bring the total number signed to six.

The ISPE package comprises 14 initiatives aimed at broadening the recruitment base of the Australian defence industry. Most recently the program team successfully re-contracted with the Re-Engineering Australia Foundation to continue its work encouraging school students to pursue a career in Engineering, with negotiations ongoing for a 3-year expansion of this program.

The Defence Export Unit will facilitate a visit to Australia by a senior US Army training and simulation official in September. The officer will be in Australia to observe a field demonstration of the all-terrain autonomous robotic target system (developed by Marathon Targets) with a view to purchasing similar systems for use

by the US Army. The visit has the potential to be extremely lucrative for the company.

This is just a brief update on some of the methods of assistance Defence offers for eligible companies. I strongly encourage Australian defence companies to investigate their eligibility for these programs, particular given the future challenges that lay ahead.

Future Challenges for Industry

Change is an everyday part of working for and with Defence. I think my presentation has highlighted this point very heavily.

Now I want to discuss the future challenges that Defence and industry face, and how companies may be able to prepare for the coming changes.

Future Challenges

- The Government's price on carbon, from July 2012.
- Federal Election, anytime from late 2012 to late 2013.
- Government's commitment to budget surplus by FY2012-2013, with budgetary pressures to achieve this.
- Release of a new Defence White Paper in Q1 2014, with a new Defence Capability Plan some 12 months later.
- Requisite ramp-up of acquisition and sustainment activities in 2014-15.

General Manager Commercial

I've listed on this slide just a few of the significant events we will face in the next five years. The most game-changing in the short term, is the potential shift in the way businesses operate with regards to their carbon dioxide emissions, putting a price on carbon. Suffice to say that given the nature of manufacture and sustainment for Defence, carbon pricing is likely to have an impact on how Australia's defence companies operate.

We will be due for an election by late 2013, but of course this is at the discretion of the Prime Minister. I don't need to explain that an election has far-reaching consequences, and for Defence Materiel, could mean major shifts in policy, in project approvals, minor process-based changes, or anything in between. We also have the Government's commitment to returning Australia's Federal budget to surplus by 2012-13,

reaffirmed as recently as last week by the Prime Minister, albeit with current caveats about it becoming more of a challenge to realise. Everyone will be tightening the belt where they can, and budgetary pressures in the next two budget years will reinforce the White Paper's fiscal constraints.

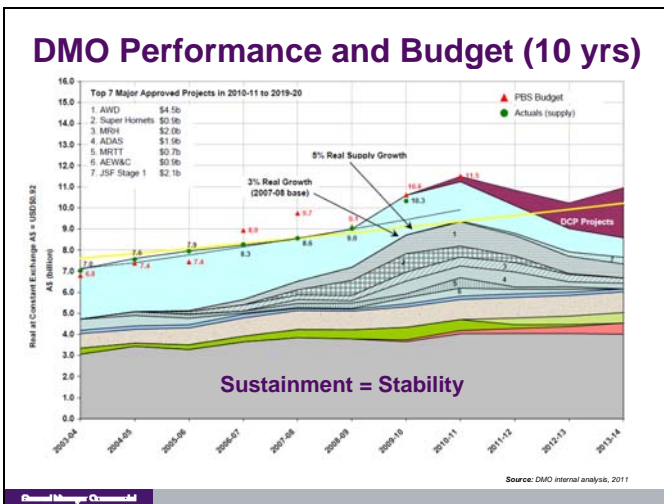
We'll see the release of a **new** White Paper in 2014, and some time following that a new release of the Defence Capability Plan. I don't intend to forecast what these documents will say, but I think we can all agree that a refined policy will provide an altered framework for Defence and industry to work within. I believe the first key to this will come with the Force Posture Review.

Finally, internal analysis supports the prediction that a ramp-up in DMO's expenditure on acquisition and sustainment will occur from 2015. So, after a tough couple of years to 2015, we will look to our Australian defence industry more than ever. The Landing Helicopter Docks, Joint Strike Fighters and fleet of new land vehicles will start to come online, to name only a few. We'll also be starting in earnest on our development programs for Future Submarines, Future Frigates, and the replacement of our land combat systems.

This is a decade of challenges. But with the right planning and management, it could also be a decade of opportunity.

DMO Performance and Budget

This chart contains a lot of information, and you might be happy to know that I won't be going through it in great detail.



The chart represents DMO's evolving budget to 2013-14. I think it's sufficient to merely point out that everything above the green wedge represents funding for acquisition, while everything below this point represents funding for sustainment. You can see that the acquisition funding varies significantly over the period.

Acquisition funding grows faster at certain points, however it is project-specific, and includes funding for DCP projects, some of which aren't yet approved. What is plain to see, even without it being spelled out, is that the most stable funding figure on this chart is for sustainment. We don't generally forecast for sustainment, but my internal analysts predictions for growth in this area are represented by the salmon wedge here.

The majority of Australian industry is already in the sustainment game and this is where the safe money is. While there will be some changes introduced by SRP, the end game of SRP is to find repeatable savings through efficiencies that are beneficial to both Defence and industry. No matter how much of a rollercoaster the acquisition game can be, the long haul and guaranteed requirement is that we need to maintain and upgrade our equipment and capabilities over the full operating life, and it is rare that the sustainment function is cost-effective from offshore.

The Mortimer Review's assessment of the acquisition and sustainment activities of DMO reinforced the view that Military Off the Shelf, and Foreign Military Sales Cases give, in general, better value for money and procurement efficiencies. The review recommended that any decisions to move beyond the requirements of an off-the-shelf solution must be based on a rigorous cost-benefit analysis.

Recent successes in FMS and MOTS acquisitions, and the comparison with mostly Australian-sourced developmental and 'Australianisation' major acquisition projects, may lead Government to select more overseas-sourced platforms in future. I don't deny that this is a space in which major primes in Australia, and to some extent small to medium enterprises, can certainly operate. However, consistent, regular work exists in the sustainment game for companies that can be competitive and efficient.

The numbers support this conclusion. There's a bigger slice of the pie for Australian companies that operate in the sustainment space. For every

dollar we put into sustainment, we see a 2:1 ratio in onshore to offshore content. For every dollar we put into acquisition, the ratio is roughly reversed. Even for FMS cases, like the Super Hornets, or MH-60R helicopters, we will see Australian industry involvement with sustainment at this 2:1 ratio.

To **acquire** the capability our war-fighters need and deserve, acquisition funding will necessarily involve Defence spend going overseas. Comparatively, to **sustain** the capability our war-fighters need and deserve, we must keep most of the funding and work here in Australia. There would be severe inefficiencies in locating sustainment elsewhere.

I think the most compelling reason for Australian companies to investigate greater focus on sustainment is the relative longevity of contracts in that space. An acquisition will, in best case terms, run for 5-10 years. The life of a sustainment activity can be anywhere from 20-40 years, and involve mid-life upgrades and higher sustainment spend towards the end of a platform's life of type (the back end of the bathtub curve).

Summary

We are certainly entering an interesting decade for Defence procurement. I expect we'll see significant changes, as I have outlined. When we

take stock in 2020 and beyond, I am confident we will be looking at a more refined Defence Department and a leaner, more competitive defence industry, both delivering technologically-advanced capabilities to a modern Australian Defence Force.

The decade will not be without its pitfalls, but these pitfalls come with opportunities. Defence is prepared where possible to assist companies to harness these opportunities for prosperity and growth, however industry must be committed to Defence's principles of value for money, efficiency and competition.

I point to sustainment as a key opportunity for Australian business, particularly small to medium enterprises, and outlined my logic for this suggestion. It is a business decision for each company to investigate this possibility, and must be made on its own financial and operational merits. I certainly do not intend to advise anyone on decisions they need to make for themselves.

Whichever path a company takes, it must understand that tough global economic conditions and a modern Defence policy framework are the realities of today. Uncompetitive practices, poor management, and artificial cost inflation will not win you work.

Thank you for your patience through this presentation and I believe we have some time for questions.

Biography: Mr Mark Reynolds is a graduate of the Royal Australian Air Force Engineer Cadet program as an Mechanical and Aeronautical Engineer. He joined the Department of Defence in 1994 and has held middle and senior management positions in the DMO involving industry, contracting and major projects. Between April 2001 and August 2004 Mark was the Director-General Electronic Warfare with responsibility for airborne, maritime and force level electronic protection, detection and surveillance capabilities, and in 2004 was appointed Director-General Electronic Systems Integration. From January 2006 until January 2009 Mark was the Counsellor Defence Materiel in the Australian Embassy in Washington DC. On return to Australia Mark worked in Helicopter Systems Division with responsibility for implementing the Strategic Reform Program. Mark was appointed Head Industry Division from 22 September 2009 and became Head Commercial and Industry Programs in July 2010 in the Commercial Group in the DMO.