
Defence Industry Policy 2010: The Combet Iteration

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Developing defence policy for Australian industry is an iterative process. The latest iteration, released in 2010, builds on the previous 2007 iteration's attempt to formulate a strategy-led industry policy. The 2010 version makes sense of disparate industry support programs. The next iteration is likely to be shaped by greater recognition of the nexus between Australian Defence Force preparedness and industry performance; by changes in Defence organisational arrangements and policy governance; and by changes in how the United States seeks to control the international diffusion of its military technology.

On Friday 25 June 2010, the then Minister for Defence Materiel and Science (The Hon Greg Combet) launched the latest iteration of Defence policy for Australian industry entitled "Building Defence capability: a policy for a smarter and more agile Defence industry base." In doing so, Mr Combet made good a commitment¹ to build on the previous iteration of Australian defence industry policy, released in March 2007 by the then Coalition Government's Minister for Defence, The Hon Brendan Nelson.

The 2010 Combet iteration of defence industry policy is avowedly path dependent:

The main challenges for defence industry policy are not to articulate new concepts or establish new assistance programs—they are to set clearly communicated goals, develop the frameworks and processes to implement those goals as effectively and efficiently as possible, and to customise these programs for industry across the entire capability development life cycle.²

The main strength of this latest stage in the evolution of defence industry policy is its comprehensive catalogue and description of the range of practical, funded programs in place to foster the development of the Australian defence industry base.³

This evolutionary approach to policy making and associated emphasis on practical programs does, however, tend to mask some of the factors that are driving the evolution of Australian defence policy for industry. This article

¹ Greg Combet: *Force 2030 - Government and Industry*, address to the Defence and Industry Conference, Adelaide, 1 July 2009.

² Department of Defence, *Building Defence Capability: A Policy for a smarter and more agile defence industry base* (Canberra: Commonwealth of Australia, 2010), para. 3.24, p. 36.

³ For a convenient summary of these programs see Department of Defence, *Building Defence Capability*, p. 67.

explores the implications for future evolution of defence industry policy of the following change drivers:

- Australian Defence Force (ADF) Capability Managers' substantial and growing dependence on industry performance to achieve ADF preparedness targets,
- Changing defence institutional arrangements, notably the prescription of the Defence Materiel Organisation;
- How Defence uses procurement of capital equipment and in-service support to foster in industry the capabilities it needs;
- US efforts to streamline its management of the international diffusion of US military technology.

Australian Industry and ADF Preparedness

ADF preparedness is about the readiness of ADF elements to undertake specified military tasks and how long those elements can perform those tasks. Preparedness determines the ability of Australian Governments to make sovereign choices about the use of Australian armed forces. Defence industry policy is fundamentally about the materiel element of ADF preparedness. The performance of Australian industry is already critical to the ADF preparedness and, thus, to ADF operational sovereignty.

The ADF's structural dependence on industry will increase because of two mutually reinforcing factors. The first factor is the difficulty the ADF experiences in attracting and retaining technically skilled personnel. This difficulty results from demographic imperatives analysed in, for example, the *Defence Personnel Environment Scan 2025*.⁴ Defence policy needs to respond to these exogenous imperatives; it cannot sensibly attempt to change them.

The second factor is a Defence policy, sustained by successive governments since the 1980s, of privatizing government owned factories and dockyards and of contracting out in-service support of ADF materiel. The policy sought to improve the efficiency and effectiveness with which ADF materiel was supplied and supported.

This article focuses on the consequences of the privatization/contracting out program. But it must be remembered that this policy program both

⁴ See Department of Defence, *Defence Personnel Environment Scan 2025, Executive Summary*, p. xxix, <http://www.defence.gov.au/dpe/dpe_site/publications/DPES2025/index.htm> [Accessed 28 September 2010].

responded to, and was amplified by, shifts in the wider market for skilled labour.

The contracting out policy was implemented in several stages. Privatization of the naval dockyards in the 1980s reinforced Navy's dependence on private contractors (notably AMECON in Melbourne and ADI in Garden Island, Sydney) for the supply and support of its ships and submarines. Privatization of the Government munitions factories left Army (and the other services) substantially dependent on ADI (now Thales) for supply and support of munitions under the Strategic Agreement for Munitions Supply.⁵

A second phase of the contracting out policy began in the 1990s with the Commercial Support Program (CSP). This involved market testing military and civilian positions engaged in Defence support functions like warehousing, garrison support and freight forwarding. Such market testing combined with the removal of some 6570 positions from the ADF under the 1991 Force Structure Review, resulting in the full-time uniformed force falling from 68,700 in 1990 to 57,000 in 1997. Over the same period, civilian numbers fell from 24,000 to 18,000.⁶

The CSP phase established the ADF Capability Managers' dependence on contractors like SERCO for garrison support and Tenix Defence Land Division for materiel maintenance, warehousing and domestic services provision. Defence also contracted out certain non-combat but strategically important defence functions. For example, Rockwell (later purchased by Boeing Australia) was contracted to operate naval communications in Canberra, Darwin, and the North West Cape.⁷ This dependence was reinforced in a third phase of contracting out inaugurated in 1996 under the Defence Efficiency Review (DER) and the associated Defence Reform Program. Among other initiatives, the DER recommended—and the Government agreed—to extend the contracting out undertaken in the CSP by market testing an additional 7,000 military positions and 5,900 civilian positions.⁸

The later phases of these policy initiatives combined with intense competition for technically skilled personnel from non-defence sectors of the economy. The upshot was an irreversible dependence by the ADF on commercial suppliers of mission-critical goods and services. Defence

⁵ Thales, *Strategic Agreement for Munitions Supply*, <<http://www.thales-e-transactions.com/assets/0/95/389/392/556e67d1-cae1-438b-bd55-56d527387e4b.pdf?LangType=2057>> [Accessed 28 September 2010].

⁶ Mark Thomson, *The Cost of Defence ASPI Defence Budget Brief 2010-11* (Canberra: Australian Strategic Policy Institute, 2010), pp. 131-132.

⁷ Robert Wylie, 'Supplying and Supporting Australia's military capability', in CEDA, *The Business of Defence: Sustaining Capability*, CEDA Growth, no. 57 (Melbourne: Committee for Economic Development of Australia, August 2006), p. 54.

⁸ Defence Efficiency Review, *Resource Savings*, Fact Sheet no 3 (Canberra: Department of Defence, April 1997).

expenditure on sustainment provides a broad indication of the nature and scale of the ADF's dependence on commercial service providers.

Since 2005-2006, the annual Defence Portfolio Budget Statements published by the Defence Materiel Organisation (DMO) have provided increasingly refined information about proposed expenditure on ADF Capability Sustainment. In the associated Defence Annual Report to Parliament, the DMO also reports on the sustainment expenditure actually achieved.

In 2010-2011, DMO expects to spend \$5.3 billion on sustainment contracts, equivalent to 88% of what it expects to spend on the acquisition of capital equipment in that year.⁹ DMO sustainment contracts support, for example:

- Aerospace systems (C-17 Globemasters, P-3 Orions, C130s, classic Hornets, Super Hornets, Hawk Lead-in fighters);
- Electronic systems (wide area surveillance capability);
- Explosive ordnance (Navy, Army, Air Force);
- Helicopter systems (multi role helicopters, armed reconnaissance helicopters, Black Hawk helicopters, Sea Hawk helicopters);
- Land systems (general service vehicles, ADF clothing and personal equipment, protected mobility fleet);
- Maritime systems (fuels and lubricants for Navy, Army and Air Force; Collins Class submarines; ANZAC Class frigates, Adelaide Class frigates); and
- Airborne Early Warning and Control.

The essential point is that the *preparedness* of virtually all the above systems is dependent on contracts with commercial suppliers. At present, the link between ADF preparedness (a matter for the ADF Capability Managers and the Chief of the Defence Force (CDF)) and DMO sustainment expenditure is largely implicit. This has two implications for the future evolution of defence policy for industry:

- The link between ADF preparedness and contractor performance; and

⁹ *Defence Portfolio Budget Statements 2010-11*, Defence Materiel Organisation, Table 66, p.154, <http://www.defence.gov.au/budget/10-11/pbs/2010-2011_Defence_PBS_04_dmo.pdf> [Accessed 2 October 2010].

- The relationship between mission-critical contractor personnel and ADF operational capability.

For over a decade the Defence Portfolio Budget Statements have included broad information about ADF preparedness targets that Capability Managers are expected to achieve. In 2010-11, for example, the Chief of Navy is expected to manage the major combatant element of the fleet (which comprises Adelaide and ANZAC Class frigates and COLLINS Class submarines) so as to achieve some 4,000 unit ready days.¹⁰ The Chief of Navy's ability to deliver this level of capability depends on the performance of companies like Thales (Adelaide Class frigates), BAE Systems Australia (ANZAC Class Frigates) and ASC (COLLINS Class submarines). That company performance is in turn, dependent on the management of sustainment contracts with DMO. In order to help hold the DMO to account for the efficient and effective management of these sustainment contracts, the Chief of Navy concludes quasi-contractual Materiel Sustainment Agreements with the Chief Executive Officer (CEO) of the DMO (see below).

All this suggests that in the future evolution of defence industry policy, Defence resource management and related reporting to Parliament is likely to see more explicit (and public) linkage between ADF preparedness and industry performance. The Defence portfolio's current annual reports to Parliament focus on achievement of planned expenditure. Taking this reporting to the next stage and reporting on what sustainment expenditure actually achieved in terms of the preparedness of the ADF elements involved would have far reaching implications for defence industry and related policies.

The ADF's structural dependence on industry raises the issue of ADF access to mission-critical contractor personnel. In Australia, this issue has been addressed as a sub-set of a broader debate about the role of the reserve forces and associated savings.¹¹ This focus on savings has tended to obscure the wider implications for ADF preparedness. In this context, the British *Sponsored Reserve* policy is instructive.

In British practice, 'Sponsored Reserves' are employees of a contractor, under contract to the Ministry of Defence to provide a service, who have agreed to enlist with the Armed Forces as a 'Special Member' of a Reserve Force. As such, the United Kingdom distinguishes between sponsored reserves and contractors on deployed operations. The latter attract none of the benefits accruing to servicemen and women.

¹⁰ See *Defence Portfolio Budget Statements 2010-11*, p. 43, <http://www.defence.gov.au/budget/10-11/pbs/2010-2011_Defence_PBS_03_department.pdf> [Accessed 2 October 2010]

¹¹ See Thomson, *2010-2011 Defence Budget Brief*, pp. 148-149 for a detailed discussion of this issue.

Australian Defence policy on sponsored reserves is much less developed. The Strategic Reform Program provides what can only be described as grudging recognition of the potential significance of sponsored reserves.¹² And a recent presentation by the Director of the Strategic Reform Program's Reserve Reform Stream suggests strongly that Australian Defence policy on sponsored reserves remains contested.¹³

On-going competition for skills in the Australian labour market suggests that Defence Capability Managers will have increasingly strong incentives to make better use of Reserves in order to meet their preparedness targets. To this extent, the future evolution of defence industry policy is likely to be increasingly influenced by the outcome of the debate about the role of sponsored reserves in the ADF. Recognising this nexus between currently separate reserve and defence industry policy issues highlights the importance of defence institutional arrangements, a matter considered below.

Defence Institutional Arrangements

Public policy is profoundly affected by organizational structures and the processes by which organizations interact. The future evolution of Australian defence industry policy is likely to be strongly influenced by changing Australian defence institutional arrangements. The following institutional developments warrant specific mention in the current context:

- Changing institutional arrangements for managing the procurement of defence capital equipment and of associated sustainment services; and
- Efforts to establish Defence as a more strategy led organization, including shifting responsibility for defence industry policy from the DMO to Strategy Group;

The way Defence procures goods and services has been strongly influenced by:

- The *Defence Procurement Review* undertaken by a team led by Mr. Malcolm Kinnaird and published in August 2003; and
- *Going to the Next Level: The Report of the Defence Procurement and Sustainment Review* undertaken by a team led by Mr David Mortimer and published in September 2008.

¹² Department of Defence, *The Strategic Reform Program 2009: Delivering Force 2030* (Canberra: Commonwealth of Australia, 2009), para. 120, p. 23.

¹³ See <http://www.defencereserves.com/cms_resources/documents/MR_Jerome_Reid.pdf> [Accessed 22 September 2010].

The future evolution of defence industry policy seems likely to be influenced by the Government's partial acceptance of each review's recommendation that the DMO be accorded greater financial and managerial autonomy from the Defence Organisation. These recommendations were aimed at improving DMO's performance in terms of delivering projects on time, on budget and in accordance with performance specifications.

The 2003 Kinnaird Review called for the DMO to develop, among other things, a more "commercially oriented", performance-driven culture. To this end Kinnaird advocated giving DMO a separate DMO identity. In particular, Kinnaird wanted the head of DMO to have sufficient power to reject project proposals lacking adequate analysis of risk or cost. He also wanted the head of DMO to be given the authority to provide the flexible remuneration required to attract the highly skilled staff required to manage large projects effectively. To this end, he advocated establishing DMO as an executive agency (with independent discretion in both financial and employment matters), located within the Defence portfolio.¹⁴

In the event, the then government accepted the review's recommendation to establish the DMO as a more financially autonomous 'prescribed' agency but rejected the recommendation for greater autonomy in employment matters as an 'executive' agency.¹⁵

In 2008, a newly elected government commissioned another review of defence procurement. The 2008 Mortimer review was prompted by several "high profile problem projects" inherited by the new Government from its predecessors. Mortimer argued that previous reforms of the DMO had not delivered the necessary accountability, authority, independence and control over inputs for the organisation to be fully results driven and commercially oriented. In particular, he argued that the Secretary of Defence's ability to remove delegations from the DMO CEO and to reject or delay workforce

¹⁴ Malcolm Kinnaird et al, *The Defence Procurement Review* (Canberra: Commonwealth of Australia, August 2003), pp. 35-38.

¹⁵ Executive agencies are generally non-statutory bodies established by the Governor General on the advice of the Prime Minister. The agency head is appointed by, and directly accountable to, the Minister responsible for the agency. Executive agency provisions are intended to provide a degree of separation from department management where that is appropriate to the function of the agency and something less than the autonomy of a statutory authority is warranted. The Financial Management and Accountability (FMA) Act 1997 enables an agency to obtain financial autonomy from a department of state by being prescribed in a Schedule to the Financial Management and Accountability Regulations 1997. The prescribed entity should be sufficiently independent in legal or administrative terms to justify financial autonomy. This will generally require formal consideration by parliament or the prime minister. Wherever possible, the Chief Executive of the prescribed agency would be the person with prime employment powers on behalf of the relevant body.

adjustments proposed by the DMO mean that DMO does not have full control over its business.¹⁶

Like Kinnaird, Mortimer also recommended establishing the DMO as an executive agency while retaining its current status as a prescribed agency with a view to improving DMO effectiveness by making it fully accountable for its performance,¹⁷ improving the transparency of its performance in both financial and non-financial terms,¹⁸ and giving its CEO full control of personnel inputs.¹⁹

The new Government eventually rejected Mortimer's argument for much the same reasons its predecessors had rejected Kinnaird's arguments five years earlier.²⁰ At present, therefore, the DMO is a prescribed agency with substantial financial autonomy but with qualified autonomy in the recruitment and remuneration of staff. The CEO DMO is required to exercise this autonomy within the framework of defence policies. The administrative arrangement for giving practical effect to this requirement is the quasi-contractual purchaser-provider arrangements concluded between the DMO and:

- the Chief Capability Development Group (Materiel Acquisition Agreements)
- the Capability Managers (Materiel Sustainment Agreements).

¹⁶ David Mortimer et al, *Going to the Next Level: The Report of the Defence Procurement and Sustainment Review* (Canberra: Commonwealth of Australia, September 2008), p. 45.

¹⁷ With respect to accountability, the review argued that the head of an executive agency is responsible, under the agency minister, for managing that agency and as such is accountable to parliament, the government and the public in the same way as the secretary of a department of state. In contrast, the management of a prescribed agency is split between the agency head and the departmental head with the agency head being accountable to parliament and the government through the latter.

¹⁸ With respect to transparency, the review pointed out that the head of an executive agency must help the agency minister fulfil that minister's obligations to account to parliament for the resources used by providing factual information about the operation and administration of the agency. Under prescribed agency arrangements, however, the transparency provided by annual reporting requirements is reduced because the agency head's report is submitted through the departmental secretary.

¹⁹ With respect to control of inputs, the review notes that the head of an executive agency has all the rights, duties and powers of an employer in respect of Australian public service employees of the agency. But the head of a prescribed agency has the rights, duties and powers of an employer as delegated by the secretary of the department concerned. This delegation of authority impedes the ability of the DMO CEO to impose commercial disciplines on the defence procurement process. To remedy this, the review advocated not only establishing the DMO as an executive agency but also mandating that the DMO CEO should have significant private sector and commercial experience (Mortimer et al, *Going to the Next Level*, pp. 59-62).

²⁰ See Joel Fitzgibbon (Minister for Defence), *The Response to the Report of the Defence Procurement and Sustainment Review* (Canberra: Department of Defence, 2009), pp. 35-37, <http://www.defence.gov.au/publications/Mortimer_Review_Response.pdf> [Accessed 5 August 2009].

In administrative terms, both Materiel Acquisition Agreements and Materiel Sustainment Agreements are very much a work in progress. To date, the Defence Portfolio has not accepted the suggestion by Parliament's Joint Committee of Public Accounts and Audit that the Defence Annual Report to Parliament include information on such purchaser-provider arrangements.²¹ As a result, there is little reliable information on the efficacy of these arrangements publicly available.

But it is likely that Defence Capability Managers, preoccupied with raising, training and sustaining forces, will lack the skilled administrative resources required to hold the DMO fully to account via these arrangements. In these circumstances, these agreements focus on the relatively simple metrics of cost, schedule and equipment performance targets. Importantly, the anecdotal evidence suggests that Materiel Sustainment Agreements between Capability Managers and the CEO DMO do not expressly link the Capability Managers' preparedness obligations to the sustainment deliverables for which DMO is responsible.

This administrative subtlety matters: Under the Commonwealth Procurement Guidelines, the DMO is required to award sustainment contracts on a best value for money basis. But in judging the relative value for money of competing sustainment proposals the DMO has little or no incentive to promote the development of local industry capacity with a view to fostering contingent in-country support. Thus, while the DMO is well placed to advise on the relative cost of local and overseas sustainment arrangements, it is poorly placed to advise on their relative value, taking into account ADF preparedness requirements in these arrangements.

Against this background, the assignment to Defence's Strategic Policy Group of responsibility for producing future statements of defence industry policy is particularly significant. This allocation of responsibility is intended to ensure that future defence industry policy is closely aligned with the Defence White Paper 2009 and other strategic guidance:

Strategic Policy Division will also work closely with DMO and other agencies in the future to ensure there is alignment between Defence's industry policies and programs and its broader policy and capability needs. This will result in a more strategy-driven approach to a range of industry policy issues. DMO's Industry Division remains the point of contact for all industry programs.²²

This division of labour between *policy development* (by Strategic Policy Division) and *policy implementation* (by a prescribed Defence Materiel Organisation) has potentially far-reaching implications for the future evolution

²¹ Department of Prime Minister and Cabinet, *Requirements for Annual Reports for Departments, Executive Agencies and FMA Act Bodies* (Canberra: Commonwealth of Australia, 2010), p. 7.

²² Department of Defence, *Building Defence Capability*, para. 4.32, p. 44.

of defence industry policy. The 2007 iteration of defence industry policy describes in considerable detail the processes by which Defence envisaged developing a strategy led defence industry policy. Those processes are aimed at identifying clear priorities for in-country industry capabilities. Such priorities, it is argued, are an essential input into designing procurement strategies for the supply and support of the ADF: unless Defence knows which industry capabilities are strategically valuable, it is argued, Defence cannot design procurement strategies to support them. Clear priorities for industry capabilities would also inform Australian industry's investment and business planning.²³

Defence applied this logic in the course of developing the Defence White Paper 2009. In order to identify priority industry capabilities, Defence reportedly considered a wide range of critical industry capabilities and assessed the credible contingencies where the capability would be required. In doing so, Defence took into account possible risks to ready and reliable supply of each capability. The upshot of this process was a series of priority industry capabilities which would confer an essential strategic advantage by being resident in Australia and which, if not available, would significantly undermine defence self-reliance and ADF operational capability. The priority industry capabilities so developed were endorsed by a senior Defence committee and subsequently agreed by government.²⁴

But the output of this process risks conflating ends (ADF preparedness) with means (local industry capabilities). Industry investment planning and associated decisions would seem better informed if Defence concentrated policy attention on defining, in terms that can be made publicly available, what levels of preparedness it requires the various force elements to achieve. Industry is best placed to determine the best way to achieve those levels of preparedness having regard to cost premiums for local supply and support and the risks associated with reliance on overseas supply. In this process, the DMO is well placed to advise on costs and local industry capacity. But it is a matter for Strategic Policy Division, working with the Capability Managers, to advise on the acceptability of those costs and whether or not the risks inherent in overseas supply are tolerable.

This raises the issue of how Defence, as a monopsonist, can best use its procurement to foster in industry the capabilities the ADF needs to meet preparedness objectives.

Using Procurement to Foster Defence Industry Capabilities

As already indicated, the Australian Government had largely extricated itself from ownership of the means of defence production by the late 1980s. The

²³ Australian Government: *Defence and Industry Policy Statement 2007* (Canberra: Commonwealth of Australia, 2007), pp. 9-12.

²⁴ Department of Defence, *Building Defence Capability*, paras 4.9-4.10, p. 38.

COLLINS Class submarine builder, ASC Pty Ltd, remains the single most important exception. And in ASC's case, the Government has gone to considerable trouble to separate its interests as owner (Minister for Finance) from its interests as customer (Minister for Defence). In these circumstances, Defence choices about what goods and services it buys and Defence decisions about how it buys those goods and services have profound implications for the future evolution of Australian defence industry capacity. Particularly significant in this context is DMO's requirement for tenderers bidding for defence capital equipment contracts to include Australian Industry Capability (AIC) Plans in their bids.

The AIC program aims to maximise Australian industry participation in Defence procurement of major capital equipment on a best value for money basis. The AIC program's antecedents include the Australian Industry Involvement Program in the 1990s and the Australian Industry Participation Program in the 1970s and 1980s. According to AIC Toolkit, the AIC program is a mechanism to:

- Retain those essential local industry capabilities and skills required to meet Australia's sovereign, military and self-reliance requirements in support of ADF operational capability; and
- Create the commercial environment to provide local industry with opportunities to openly compete for domestic and international defence work, based on best value for money principles.²⁵

To this end Defence requires tenderers bidding for all Australian defence procurements worth \$50 million or more, or tenderers bidding for Australian defence capital equipment projects with priority industry capability implications, to submit an AIC Plan as part of their tender. In these AIC Plans, tenderers must demonstrate how they intend to maximise opportunities for Australian companies, including assessing their capabilities and competitiveness. Defence will assess each AIC Plan on a *value for money* basis and as part of the tender evaluation process. The successful tenderer's AIC Plan is included in the contract as an enforceable provision.

At issue here is who decides what constitutes "value for money". The Combet iteration of defence industry policy sheds no more light on this issue than its predecessors. According to the AIC toolkit, Defence will determine the requirement for specific in-country industry capabilities on a project-by-project basis. Defence groups such industry requirements into the following categories:

²⁵ Defence Materiel Organisation, *AIC Toolkit* (Version 1.2) (Canberra: Department of Defence, no date given), para. 1.1.2, p. 1-1.

- Strategic industry capabilities—capabilities which confer a national security and strategic advantage to Australia by being located in Australia and which, if denied, may affect the way the ADF operates;
- Priority Industry Capabilities—a narrower sub-set of strategic industry capabilities that confer an essential national security and strategic advantage by being resident in Australia; and
- Project Specific Industry Capabilities—industry capabilities that the project prefers to be resident in-country such as maintenance and sustainment activities.²⁶

Within this framework, Defence requires tenderers' AIC plans to address:

- Activities that the tenderer or its principal sub-contractors will undertake in order to establish, develop and sustain the required industry capabilities in Australia;
- The cost to Defence for each proposed individual activity identified for each industry requirement, including any flow-on cost impacts on areas of the project such as purchasing, project management and through-life support;
- An assessment of those risks associated with undertaking each of the proposed industry requirements in Australia; and
- The potential impact of each industry requirement activity on the project including schedule, performance and project management.²⁷

This data is an essential input into judgments about the relative value for money of competing solutions to Defence capital equipment requirements. But the judgments need to be made in the broader context of ADF preparedness requirements and not restricted to capital equipment project-by-project assessments.

The consequences of weak links between AIC Plans and preparedness are apparent in the focus of the AIC Implementation Unit. The Unit is to work within the DMO to ensure that the AIC program is fully integrated into other industry programs like the Defence Export Unit, the Global Supply Chain Program and the Defence Innovation Centre. The Unit will conduct random audits of System Project Offices to ensure that AIC Plans embedded in contracts are enforced.²⁸ This focus risks conflating ends (preparedness) with means (contractually enforceable AIC plans).

²⁶ Ibid. para. 2.4.3, p. 2-3.

²⁷ Ibid, para. 2.4.4.

²⁸ Department of Defence, *Building Defence Capability*, para. 5.32, pp. 71-72.

Defence's willingness and ability to use its procurement of capital equipment to foster local industry's capacity to provide in-service support is further undermined by the Defence Organisation's reduced appetite for procurement risk. This is most clearly manifest in the formal embrace of Military-off-the-shelf (MOTS) and Commercial-off-the-shelf (COTS) solutions to capability requirements. Following the Government's acceptance of Mortimer's recommendations, DMO will only consider indigenous solutions or adaptations of overseas solutions to suit Australian-unique requirements in exceptional circumstances and only after the most stringent justification.

According to the Australian Strategic Policy Institute, *off-the-shelf* equipment:

- Is already established in-service with the armed force of another country or Australia;
- Is sourced from an established production facility (not just a MOTS design); and
- Requires at most minor modifications to deliver interoperability with existing ADF and/or allied assets.²⁹

The Australian defence customer's preference for MOTS and/or COTS solutions has major implications for the future evolution of Australian defence industry capabilities. Hence a brief summary of the background to this preference is warranted.

In his 2008 report, Mortimer argued that setting requirements beyond that of off-the-shelf equipment generates disproportionately large increases to the cost, schedule and risk of projects. By contrast, Mortimer argued, off-the-shelf purchases avoid the considerable risks to costs and delivery schedules inherent in developing new weapons systems. Any decisions to move beyond the requirements of an off-the-shelf solution should therefore be based on a rigorous cost-benefit analysis of the additional capability sought against the cost and risk of doing so. Defence should clearly communicate this analysis to Government to inform the latter's procurement decisions.³⁰ Defence accepted this recommendation, recognizing that, in many cases, it would entail acquisition from overseas: Pursuing an off-the-shelf approach will certainly produce cost and time efficiencies, though this needs to be balanced against the Government's intent to support Australian industry, Defence's need for a strong supply chain, and against a continuing need to ensure that equipment purchased meets Defence's operational needs.³¹

²⁹ Mark Thomson, *The Cost of Defence ASPI Defence Budget Brief 2008-09* (Canberra: Australian Strategic Policy Institute, 2008), pp. 161-162.

³⁰ Mortimer et al, *Going to the Next Level*, pp. 17-20.

³¹ Fitzgibbon, *The Response to the Report of the Defence Procurement and Sustainment Review*, p. 22.

This predilection for MOTS solutions—overwhelmingly overseas supplied—is a potential barrier to entry by local firms—irrespective of whether they are Australian or overseas owned—into the defence market. The notion of *risk appetite* provides a useful link between, on one hand, the case for a less risk-averse approach to local industry involvement in defence procurement and, on the other hand, the value for money to be gained in fostering a more robust and flexible local supply chain. Here “risk” encompasses both downside threat and upside opportunity.³²

In terms of *downside threat*, Defence’s leaning towards MOTS (and COTS) suggests that it considers the level of cost, schedule and technical risk inherent in local projects for the production and sustainment of equipment as being too high. Put another way, this preference suggests that, in a resource constrained environment, the cost to Defence of reducing the level of risk inherent in local equipment projects is unacceptably high to Defence. Conversely, and in terms of *upside opportunity*, Defence’s predilection for MOTS suggests that its perception of the value to be gained by undertaking local equipment production and sustainment projects is outweighed by the cost it would incur in reducing the risk involved to a level it would consider tolerable. Put another way, Defence’s MOTS predilection suggests that it is neither willing nor able to actively put at risk the potentially significant management and financial resources required to capture the value inherent in the opportunity.

As a prescribed agency, DMO has little incentive to broaden its perspective of value for money beyond relatively narrow cost, schedule and performance specification. Conversely, the Defence Capability Managers who are responsible for meeting the CDF’s preparedness directive in raising, training and sustaining their respective forces may have greater appetite for downside cost, schedule and technical risk associated with local supply and support arrangements if those arrangements can be shown to provide better value for money in terms of meeting the ADF preparedness requirements for which they are responsible. Similarly, the Capability Managers may accord greater value to the upside opportunities in terms of a responsive local supply chain fostered by local equipment production and sustainment projects. An increasingly important element of Defence governance is the Materiel Sustainment Agreements concluded between each Capability Manager and the CEO DMO. These agreements would seem to be the appropriate administrative instrument for capturing and giving practical effect to the above, broader notion of value for money.

This discussion of the nexus between defence procurement and industry capability development has focused on domestic developments. But the ADF relies on access to US technology in order to develop and maintain, at

³² H.M. Treasury, *The Orange Book* (London: Her Majesty’s Stationary Office, October 2004), p. 23.

acceptable cost, the Australian military capabilities required to undertake the strategic tasks set by the Government. This reliance on US technology—reinforced by Defence’s predilection for MOTS solutions to ADF capability requirements—has far reaching implications for the future development of defence industry policy.

United States Technology Transfer Controls

The current Defence White Paper has reaffirmed the fundamental importance to Australia of its alliance with the United States:

Without access to US capabilities, technology, and training, the ADF simply could not be the advanced force that it is today, and must be in the future, without the expenditure of considerably more money.³³

For its part, the US Government views controls on the sale, export, and re-transfer of defence articles and defence services as integral to safeguarding US national security and furthering US foreign policy objectives. The US Government therefore actively controls the export of militarily significant goods and services by US citizens, US companies, US Government agencies and other US interests. The statutory basis for such control is the Arms Export Control Act (AECA—Title 22 of the US Code). The regulatory instrument for exercising this authority pursuant to the AECA is the International Traffic in Arms Regulations (ITAR).

The Bush Administration attempted to work with Australia and the United Kingdom to streamline ITAR-related controls on access by these two close allies to advanced US technology. The focus of these efforts was the conclusion of bilateral Treaties on Defense Trade Cooperation, now ratified by the US senate.³⁴ The Obama Administration has complemented these bilateral initiatives with a concerted, unilateral effort to streamline ITAR and ITAR-related US export control arrangements. This section analyses these US initiatives in terms of what they could mean for the future development of Defence policy for Australian industry.

In 2007 President George W. Bush signed virtually identical Treaties on Defense Trade Cooperation with, respectively, British Prime Minister Tony Blair and Australian Prime Minister John Howard. The Treaties are intended to provide a framework for managing the transfer of defence goods and services (both unclassified and classified) between the US and these two close allies. According to Wylie, these arrangements are intended provide sufficient protection of US defence and security interests to obviate the need

³³ Department of Defence, *Defending Australia in the Asia Pacific Century: Force 2030* (Canberra: Commonwealth of Australia, 2009), p. 93.

³⁴ Defence Media Centre, *Australia Welcomes US Senate’s Agreement to Ratify Australia-US Defense Trade Cooperation Treaty*, 1 October 2010, <<http://www.minister.defence.gov.au/Smithtpl.cfm?CurrentId=10903>> [Accessed 2 October 2010].

for licenses and other written authorization for selected goods and services.³⁵ Both Treaties are primarily intended to facilitate the kind of US-led coalition operations now concluded in Iraq and currently underway in Afghanistan. To this end they apply to goods and services required for an agreed list of:

- Joint military or counter-terrorist operations, exercises and training conducted by the US with UK and Australian forces;
- Cooperative security and defence research, development and production and support programs covered by a valid international agreement between the US and its two allies; and
- Specific defence and security projects where the Government of Australia (and the United Kingdom) is the end user, including Australian acquisitions under US Foreign Military Sales (FMS) arrangements.

To give effect to the Treaties the British and Australian Governments will need to accord US-origin technology in their respective jurisdictions US-standards of protection. This protection will comprise the following elements:

- The list of specific combined military/counter terrorist operations, cooperative materiel projects and FMS procurements already mentioned;
- The establishment of a trusted “Approved Community” of US and Australian Government and non-government actors (including US and Australian companies) among whom certain US defence goods, technology and services exported in support of listed operations, programs and projects will be able to circulate without the need for transfer approvals or export licenses;
- The compilation of companies and related non-government actors to be included in the above “trusted community”;
- Exclusion of non-Australian citizens from access to defence goods and services to which the Treaty applies; and
- A list of specifically identified US-origin goods and services to which the Treaty *does not apply* and which would continue to be processed in accordance with existing case-by-case licensing arrangements.

³⁵ Robert Wylie, ‘Facilitating Defence Trade Between Australia and the United States: A Vital Work-in-progress’, *Security Challenges*, vol. 4, no. 3 (Spring 2008), pp. 115-134.

The criteria used to select companies for inclusion in the “trusted community” will have major implications for Australian companies’ ability to supply and—more importantly—to repair, maintain and adapt US-origin platforms and systems. The criteria include:

- Permission to receive and handle classified information and materiel granted by the Australian Government pursuant to the Australian Defence Industrial Security Regulations;
- The nature and degree of foreign ownership, control or influence;
- Infringements of US or Australian export control laws and regulations;
- The US export licensing history of the company; and
- National security risks, including interactions with countries identified or proscribed by Australian or US laws and regulations.

As already indicated, President Obama has supplemented these bilateral initiatives by his predecessor with his own potentially far reaching proposals for a major streamlining of the ITAR and related US export controls. On 20 April 2010 US Defense Secretary Robert Gates proposed³⁶ a single export control list focused on those critical technologies and items that underpin US military technology advantage and that no foreign company or government can duplicate. He envisaged expediting approval for the export of items that have no significant military impact, or that use widely available technology. He proposed a more dynamic, tiered control system in which the administering agency could cascade an item or technology from a higher to a lower level of control as it becomes less sensitive.

US export control responsibilities are currently dispersed among the US State, Defense and Commerce Departments. Gates proposed establishing a single licensing agency to administer the above single export control list. That agency would have jurisdiction over both munitions and dual-use items and technologies (responsibility for which is currently shared by the US Commerce, Defence and State Departments). The intent would be to streamline the review process and to ensure that export decisions are consistent and based on the real capabilities of the technology. Gates also proposed enhanced coordination of the US’ currently dispersed enforcement effort. Better coordination of US enforcement activity, and closer coordination with the US intelligence community, would make for more effective enforcement, particularly abroad. Finally, Gates proposed a single,

³⁶ Robert Gates, *Speech to Business Executives for National Security (Export Control Reform)*, Washington DC, 20 April 2010, <<http://www.defense.gov/speeches/speech.aspx?speechid=1453>> [Accessed 2 October 2010].

unified Information Technology (IT) infrastructure to supercede the current system of multiple data bases run by Commerce, State and Defense Departments. A single online location and database would receive, process and help screen new license applications and end-users.

Gates concluded by outlining a phased process for implementing the above reforms:

- The first phase, to begin in 2011, would involve the executive branch of the US Government and would begin the transition from the current system to the single list and single licensing agency;
- The second phase, again a matter for executive action, would involve completing the transition to a single IT structure, implement the tiered control system and prepare the way for a single licensing system; and
- The third phase would require congressional action to approve the actual establishment of a single licensing agency and a single enforcement coordination agency.

The Combet iteration of defence industry policy acknowledges the above US initiatives.³⁷ But it stops short of assessing their implications for either the future evolution of the policy or for the future development of defence-related innovation. The above discussion of defence risk appetite suggests that the more readily Australia has access to US technology, the weaker its incentive to invest in indigenous innovation. At issue here is the extent to which, in the words of the United Kingdom's Defence Industrial Strategy,

this may constrain the choices we can make about how we use our armed forces—in other words, how we maintain our sovereignty and national security.³⁸

A major challenge for Australian defence policy makers is judging the appropriate balance between inherently risky indigenous innovation, potential compromises to sovereign decision making in the use of armed force and the implications for ADF military advantage of the obsolescence implicit in MOTS equipment. If the future evolution of defence industry policy is to include an effective response to this challenge, we are likely to see less emphasis on defence industry policy as such and greater emphasis on defence innovation policy. The seeds of this evolution are already apparent in Mr Combet's 2010 defence industry policy, which provides for expenditure

³⁷ Department of Defence, *Building Defence Capability*, p. 21.

³⁸ Ministry of Defence, *Defence Industrial Strategy* (London: Her Majesty's Stationary Office, December 2005), p. 6.

of \$44.9 million over the next decade on a Priority Industries Capability Innovation Program.³⁹

Conclusion

The Hon. Greg Combet's iteration of defence policy for Australian industry was published in June 2010, some two months before the calling of a Federal election that resulted in his being appointed to an entirely different, non-defence portfolio. Mr Combet's defence materiel responsibilities have since been assumed by the Hon. Jason Clare MP. The latter was appointed on 14 September 2010 as Minister for Defence Materiel, operating within policy guidelines set down by the new Minister for Defence, the Hon Stephen Smith MP.

Mr Combet has bequeathed Messrs Smith and Clare a solid policy legacy. In putting his stamp on defence policy for Australian industry, Mr Combet expressly eschewed any attempt to break new conceptual ground. This gave him and his advisers greater scope to present in coherent way a range of practical initiatives for fostering the Australian industry capabilities the ADF needs in maintaining its preparedness to undertake the strategic tasks set by the Australian Government.

Messrs Smith and Clare are now well positioned to respond to the continuing need to refine defence policy for Australian industry pressure in the light of experience gained in applying it and, at the same time, to adapt it in response to new circumstances. The analysis undertaken in this article suggests that Messrs Smith and Clare (and their advisers) might well consider a new iteration of defence policy for Australian industry that responds to:

- ADF Capability Managers' substantial and growing dependence on industry performance to achieve ADF preparedness targets;
- Changing defence institutional arrangements, notably the prescription of the DMO;
- How Defence uses procurement of capital equipment and in-service support to foster in industry the capabilities it needs; and
- US efforts to streamline its management of the international diffusion of US military technology.

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³⁹ Department of Defence, *Building Defence Capability*, paras 5.9-5.14, pp. 68-69.