



## QUAD Discussion 31 March 2021

### 1. Introduction

Much has happened both domestically and globally that has affected Australia in 2020 and continues into 2021. Without question, the COVID-19 pandemic has had the greatest effect on the global environment for the last century. Australia, like most of the world's economies, has been severely impacted by the pandemic. Exports have been reduced and the domestic economy impacted. The Australian government has legislated some of the greatest stimulus and social welfare packages of the modern era. The Australian deficit is likely to be in excess of a Trillion Australian Dollars.

Australia through the efforts of both the Federal, State and Territory Governments has managed to reduce the impact on Australia through managing the spread of virus and providing economic protection. Australia is now emerging from the pandemic and the early signs are that the economy is recovering rapidly.

Recently the Government reaffirmed its commitment to all the planned defence expenditure and increased it to include additional expenditure on cyber security. Of significance, the Australian government decoupled the defence budget from Australia's GDP, which due to the shrinkage of the Australian economy, in effect pushes defence expenditure from 2 per cent of GDP to between 2.3 per cent and 2.6 per cent of GDP. This is a significant policy shift.

The Prime Minister has identified defence as one of the areas of expected economic stimulus for the Australian economy.

Prior to the pandemic the Australian Government was coming under significant political pressure to ensure that there was more expenditure of the defence budget domestically. The Government's desired policy outcomes required a redefining of how the Department of Defence acquired equipment. This led to a series of reviews and undertakings being given by both the Minister for Defence and the Minister for Defence Industry.

The Minister for defence Industry has taken an active hands-on approach to ensuring that the Department delivers on the Governments requirements, and whilst this at time cause some level of friction there is the early signs of a shift in how the Department does its business.

In November 2020, a review had been completed of the Centre for Defence Industry Capability (CDIC), the terms of reference for auditing contracted Australian Industry Involvement in all programs have been agreed, updated Australian Defence

Contracting (AUSDEFCON) terms and conditions have been released for review and updated policies have been released.

There will be a higher level of scrutiny on all defence programs to ensure that Australian companies are able to compete in a fair and equitable way for workshare on the Australian programs.

Increasingly, there is a drive to ensure that the large multinational Prime Contractors, that have carriage of the vast amount of defence programs, are ensuring that the supply chains are established and maintained in Australia, more importantly that work is not being sent overseas to their current supply chains, therefore not achieving an economic return on investment for Australia.

In effect, this means that higher levels of justification will be required to take work overseas.

There is a broad acceptance that Australian industry will still require assistance in many areas of the supply chain until they are able to undertake the required technology transfer, use of Intellectual Property and developing the know-how, know-why and know-what to undertake this activity.

The opportunity's for QUAD companies therefore remains high, however the manner in which they can become part of the Australian programs fundamentally have two routes to market:

- Providing sophisticated equipment not produced in Australia; and
- Forming relationships with Australian companies so that they can transfer their knowledge and equipment.

The formation of Joint Ventures and establishing subsidiaries in country are viable methods to increasing exports from QUAD partners to the Australian programs.

## **Background to Australian Defence Acquisition Policy and Industry**

### **Australian Government Defence Acquisition Strategy**

The Australian Government will acquire over A\$275 billion of new defence equipment over the decade 2021-2030, however the total defence spend over this period will be in the order of \$550 billion, including acquisition, sustainment, in effect the entire defence ecosystem. The Government's policy position since the worsening fiscal outlook essentially caused by COVID-19 has been to decouple defence expenditure from the Australian GDP, in effect driving this percentage in the order of 2.4 per cent versus 2.0 per cent.

The opposition party has not endorsed this strategy however it is unlikely that at this stage they would state an opposite view.

This remains the largest allocation of equipment modernisation in Australia's post Second World War history.

The Government also has the ambition is to lift Australian defence exports to a level where Australia positions itself in the top ten defence exporters globally.

The scope of this acquisition remains multi-dimensional, it is across all spectrums of defence equipment; maritime, land, air, cyber, and space.

### **Political considerations**

Since the 2019 election, political considerations have shifted from announcing large contract wins and talking about the potential defence boom to managing large programs and ensuring Australian companies get their fair share of the defence pie.

The only large project yet to be awarded in the near term is Land 400 Phase 3.

### **Australian Defence Industry**

The size of the Australian Defence Industry is relatively modest.

For any company that is not a Prime Contractor, the target customer will most likely be a large defence company and not the Australian Government. As a result, contracting with the primes is almost always the way to make a sale.

A remaining challenge for the Australian defence industry is that materials normally comprise around 55 per cent of the total expenditure on Australian programs. The remainder of the expenditure fits under the broad term of labour.

Australia as a country does not produce many of the components required for the types of programs being undertaken. Items such as fibre optic cables, electrical cables, connectors, pumps, displays et cetera are imported and traditionally the Australian entity acts as the in-country original equipment manufacturer. It is therefore vital that a reliable, cost competitive and quality overseas producer is sourced to ensure that these components are available.

As a result of Australia producing so few components domestically, the opportunity to export these types of supplies to Australia remains a real opportunity.

### **Australian Defence Supply Chain**

The Australian Government has reaffirmed that the creation and sustainment of an Australian defence supply chain as a fundamental requirement for the country to achieve defence sovereignty.

There remains tension between the Department, Government and Industry in the areas of Australian Industry Involvement. This tension is fundamentally created by the Government's political desires, the expectations of industry and the poor definition of an Australian company.

Currently defence is defining Australian Industry as follows:

- a. Australian business entities that perform work in Australia with Australian-based employees and have an Australian Business Number (ABN); and
- b. New Zealand business entities that perform work in New Zealand with New Zealand-based employees (consistent with the Closer Economic Relations Trade Agreement between Australia and New Zealand) and have a New Zealand Business Number (NZBN).
- c. Australian Industry also includes subsidiaries of overseas companies (e.g., equipment manufacturers) based in Australia or New Zealand, that meet the above criteria.

Defence is reviewing the definition of what an Australian entity is and is considering the following two possible options of an Australian Entity.

Option 1 – registration-based means:

- a. a company registered under the *Corporations Act 2001* (Cth) or a company registered under the *Companies Act 1993* (New Zealand);
- b. a body corporate, partnership, or association formed or incorporated in Australia or New Zealand; or
- c. a foreign-owned company with an on-going business presence in Australia or New Zealand, and which has a registered body number (i.e. ARBN or NZRBN).

Option 2 – tax-based means:

- a. an Australian or New Zealand tax resident:
- b. a person who:
  - (i) is a tax resident of a country other than Australia or New Zealand with which Australia or New Zealand has a tax treaty; and
  - (ii) is carrying on business through a permanent establishment in Australia or New Zealand; or
- c. a person other than a person under paragraph a or b who:
  - (i) if a tax treaty were in place between Australia or New Zealand and that person's country of tax residence, would be considered to be carrying on business through a permanent establishment in Australia or New Zealand; and
- d. is subject to income tax in Australia or New Zealand.

The Government has undertaken several reviews and tasked Defence to liaise with Industry on these matters. What is clear is that Australian-owned Industry is not satisfied with the current definitions of Australian Industry or Australian entities. Australian Industry believes the following three points need to be included into the current definitions:

- The area of where control of the entity is vested
- Where intellectual property is held
- The empowerment of the entity to make independent decisions.

To date, the Department has been slow to adopt the Government's stated policy requirements primarily because of the fiscal constraints imposed upon it by the Government and the requirement to adhere to strict schedules.

## **Australian Defence Acquisition Organisation**

The Capability and Sustainment Group (CASG) remains the area within Defence that is responsible for acquisition and sustainment. It is also increasingly responsible for acquisition within the Department of Home Affairs equipment.

CASG has become under increasing pressure to ensure that a great expenditure of the defence budget is allocated to Australian Industry.

As the current definition of an Australian Industry is not generally accepted by Australian Industry, there is a concerted effort currently underway to review this definition to be more along the lines of how businesses are structured in the Australian environment, these being:

- an Australian controlled and operating business,
- Foreign controlled but Australian operating; and
- Foreign controlled and foreign operating.

Whilst this is yet to be agreed, it is highly unlikely that the simplistic ABN based definition can survive due to the resistance from Australian controlled businesses. Equally the Small to Medium Enterprises (SMEs) definition is likely to be modified to remove the ability for foreign owned subsidiaries to be treated as SMEs.

### **Defence Industry**

The Australian defence industry remains relatively small and dominated by the large foreign-owned traditional defence prime contractors. However, medium sized foreign-owned subsidiaries are establishing themselves in the domestic market, creating further friction with the Australian-owned businesses. The current Government has a requirement to establish a sovereign industrial capability in Australia for sustainment purposes. However, the current reality is that without Government policy that directs defence to support Australian industry, it is unlikely that this requirement can be met.

It is therefore in this area that potential opportunities exist for collaboration and export.

Australian defence industry has not gained broad community endorsement. Very few Australians work in the industry and as such the industry has relatively little ability to influence the decision makers.

Broadly speaking the dominant industries in the Australian context are the offshore oil and gas industry, the general mining industry, and the agricultural industry. These industries are the largest of the employers within Australia and are vital elements to the export enterprise within Australia.

Australian defence industry has thrown its full support behind the Government's commitment to increasing defence exports. It is through this endeavour that the defence industry will be able to increase its ability to influence and drive more positive outcomes for the sector as a whole.

Significantly the Australian defence industries that are becoming most influential are those which have moved from foreign-managed companies to locally managed companies.

The perception of “Australianising” is vital for success within the current Australian market. It is well understood by all that Australia will not be manufacturing components and sub-elements for systems; it simply is not cost effective to establish the required infrastructure to do so. What is required is the ability to source these elements from trusted and secure supply chains in order to ensure that operational capability is not compromised.

### **Dealing in the Australian Environment**

While the DoD has produced a variety of fact sheets and documents on how to deal in the Australian defence acquisition and sustainment environment, and the information is a valuable source, it fails to address the complexity of the relationships that need to be mastered in order to position an organisation for the greatest possibility of success.

Australia, like the QUAD members, is a first world procurement country. Australia is a middle power, both in terms of military and economy. It is extremely important to approach the Australian defence market from the position of dealing with a sophisticated and informed customer.

It is also important to acknowledge and accept that the Australian Government and DoD are heavily influenced by the United States military. This does not mean that US companies automatically secure contracts, however advice is sought, advice is offered, and advice is accepted in the vast majority of acquisition programs.

Although the UK has been in steady decline as a country of influence in the DoD, this is not to say that the advice of UK experts is not offered or listened to. Rather, since the end of the Second World War, Australia has chosen to link itself to the US for geopolitical and security reasons. The US is viewed as Australia’s most significant ally and the country that Australia firmly believes will provide the greatest support in times of need.

Australia has a long history of acquiring the most capable equipment on offer internationally. It has acquired weapons and weapon systems from the US, UK, Sweden, Germany, Italy and France, just to name a few nations. It has also acquired combat systems from the US, France and Sweden.

It should be assumed that Australia will source what it believes to be the most capable systems irrespective of country of origin. The only other credible suppliers of military equipment that Australia will not source from is China and Russia.

When wanting to operate within Australia it is important to consider the following approach:

The Australian Government and the DoD accept that the vast majority of equipment will be sourced internationally, however, there is a greater emphasis being placed on in-country sovereign capability, especially for sustainment. This requirement for in-country capability and support has become a priority for the Government and will in due course be adopted by the Department. This has come about from systematic failures in the supply chain when dealing internationally. There have been several

occasions when Australian equipment has been unserviceable or unrepairable due to failures in international supply chains. The Government and the Department continue to review their policies to ensure that this situation is unlikely to occur in the future.

## **Engagement**

It is important to understand that there is a shift in how Defence is undertaking acquisition. The Department is moving to require the large Primes and Major Service Providers to take on the role of full management of the supply chain, so in effect tier 2 and below subcontractors now have the Prime Contractor as their point of contact.

Whilst it still makes business sense to initially engage with the Department, the reality today is that companies will be directed to the relevant Prime Contractor, as they are responsible for the engagement with the lower-level suppliers. It is only in the areas of advanced warfighting applications that direct engagement is of a higher level.

The vast majority of components will be acquired by either a prime contractor or a sub-contractor to the prime. Becoming part of the global supply chain is therefore a fundamental requirement to succeeding in exporting to Australia.

## **Industry Engagement**

Industrial engagement is, for the most part, likely to be the avenue for entry into the Australian market.

Essentially there are three methods for entry, these are;

1. Establish a subsidiary,
2. Establish a joint venture, and
3. Direct Export to an Australian Company

All of the above are acceptable avenues to enter the Australian marketplace. The method chosen will ultimately be determined by undertaking a business case.

**Option 1** will be the most expensive and create the greatest risk for the company, however it does allow for the best Australian narrative to be told.

**Option 2** will have reduced cost and risk and enables a positive Australian narrative to be told.

**Option 3** is the lowest risk to company and the most cost effective. However, this option will require effort to create the supply chain need. Furthermore, any company in this position will be considered a simple supplier that could be changed out at any time.

For all interactions whether it be at the industrial, political, departmental, or media level, the reality of having credible in-country representation remains front and centre until the company has established its in-country presence.