

# Sale of the century on track for 2008

■ Trevor J Thomas/CANBERRA

The Minister for Finance & Administration, Senator Minchin, confirmed 11 May the appointment of legal firm Sparke Helmore, as 'process advisor' for the proposed sale of ASC Pty Ltd (formerly known as the Australian Submarine Corporation) - the 100% Government-owned maintainer of the Royal Australian Navy's (RAN) six-boat Collins'-class submarine fleet, and preferred shipbuilder for the three air warfare destroyers (AWDs) initially proposed for construction under project Sea 4000.

Minchin said Sparke Helmore had been appointed "following an open tender" to provide advice on probity and process issues relevant to the sale of ASC, and to assist in ensuring that the forthcoming sale will be "conducted to the highest standards of probity and accountability."

If re-elected at the next Federal election, it is the Howard Government's intention - as first announced 16 August 2006 - to return ASC to private ownership through a competitive tender 'trade sale', starting in late-2007 (after a likely October signature of the AWD construction contract), and concluding in the second half of 2008.

Senator Minchin had also announced 1 February that Carnegie, Wylie & Company had been appointed 'business adviser' for the sale of ASC, while Freehills had been appointed as 'legal adviser' in conjunction with the progression of a Privatisation Scoping Study.

Minchin added each firm's involvement was considered "an important element of a successful sale process ... (and meaning) the Government can now finalise a range of preparations before the sale process starts later this year." The Government is also proposing to set a foreign ownership limit of 49% in the ASC.



SA GOVERNMENT IMAGE

## Key Points

- **The Federal Government is progressively assembling** the process advisory, legal and administrative skills base required to dispose of its 100% shareholding in ASC Pty Ltd - the former Australian Submarine Corporation.
- **To date, the issuance of several open tenders** has seen the selection of: Sparke Helmore as 'process advisor'; Carnegie, Wylie & Company as 'business adviser'; and Freehills as 'legal adviser' for the proposed 'trade sale'.
- **Mid-year selection of a preferred project Sea 4000** air warfare destroyer design is to be rapidly followed by the signature of a shipbuilding contract with ASC Shipbuilders, thus providing the basic parameters for a sale valuation.
- **ASC's current level of activities and baseline annual** revenues were underpinned by the Commonwealth in December 2003, following its signature of a 15-year (plus two 5-year options) TLS contract for the 'Collins'-class submarines.

Subsequent to the Government's August 2006 sale announcement, ASC directors released 8 October a 'Statement of Corporate Intent' spanning the crucial transition period of 2006-2009, the end of which should see the company successfully transferred out of government hands and being controlled and managed by the private sector according to traditional commercial risk and reward principles.

Heading the list of over-arching corporate objectives through the disposal and re-establishment period, ASC directors said they would look "to further develop the world-class skills established within Australia for the design

and construction of the 'Collins'-class submarines, and apply them for the effective maintenance and upgrade of the class." Next came: "to secure work-share in the AWD program; and build on the company's high-end skills to undertake other major defence design, construction and through-life support projects."

The balance of transitional corporate objectives laid down by ASC directors was: to "sustain itself as a national repository of engineering capability and excellence; create a long-term viable Australian business that is responsive to the needs of its customer, provides value for money, is attractive to investors and is an em-

ployer of choice; and ensure these objectives are met in a manner that will facilitate the timely privatisation of the company."

The Statement did not contain any financial details, however noted, "submarine activities generate most (92.4%) of the ASC's revenue. The submarine Through Life Support (TLS) contract is relationship-based, and provides financial incentives for good performance. ASC is earning a high percentage of the incentives on offer ... and expects to increase its incentive even further with more in-service support experience ... and a better understanding of the customer's priorities."

Looking more broadly at the business in the run-up to its wholesale privatisation, the Statement of Intent further declared, "fair returns can be achieved when measured against industry norms. In 2006/07, a revenue stream from the AWD program will commence ... and will build up as the project develops. ASC's dividend policy is to pay a dividend of at least 60% of the company's profit, after tax and abnormals."

Following on from the Statement of Intent, ASC released 8 December its 2005/06 annual report, detailing (on the basis of \$287.3m of cash receipts) some \$260m of consolidated annual revenue (cf \$229.3m in 2004/05), and declaring an after tax profit of \$18.5m (cf \$16.2m in 2004/05) on shareholders' equity of \$114.2m (up 6% from the previous year) - thus yielding a 16.2% return on equity, compared with 15% in 2004/05.

ASC Managing Director, Greg Tunny, noted "outstanding performance outcomes" on 'Collins-class' submarine support/maintenance had helped to drive record financial results for the year. Directors also stayed true to the 'Statement of Intent' (ie: 60% of profit) by declaring a fully-franked dividend of \$11.1m (cf \$9.7m in 2004/05) on a total equity base of \$114.2m (cf \$119.4m in 2004/05, since revised to \$107.3m).

Of the \$114.2m of equity, \$10m comprised issued capital, \$31m comprised reserves, and \$73.2m comprised retained earnings. Against total assets of

\$245.9m (down 13% of \$283.9m in 2004/05), total shareholder equity in 2005/06 was \$114.2m, up 6.43% from \$107.3m, which in the latest report was revised upwards from the \$70.2m stated in 2003/04.

ASC Chairman, John Prescott, noted the profit increase had been achieved at a time the company had also incurred "substantial costs in supporting the AWD program." He added, as profits from the building of the AWDs "will not flow for some time ... the Board's objective in this regard is to ensure that ASC's earnings are sustainable and predictable over the longer term."

Further analysis of the ASC annual report indicated the company's progression of its bid for project Sea 4000, along with its preparations for the air warfare destroyer build program, had necessarily seen it incurring 'significant non-reimbursable costs', thus eating into cash reserves, which declined by \$24.7m (from the \$105.7m recorded in 2004/05) to stand at \$80.0m on 30 June 2006.

Prescott also noted it was "pleasing that the company earned a high proportion of the performance incentives available for its submarine work in the year - up on 2005 (and reflecting) the strong focus the 'Submarines' business unit has brought to bear on ensuring that the customer's operations outcomes are paramount." According to the Annual Report, twelve successful submarine maintenance activities had

been conducted by WA personnel that year, with eleven accomplished on time.

The volume of work processed over the year (which in the accounts is reflected in a \$50m reduction in 'trade and other creditors' from the \$80.3m of the previous year), was said by ASC officials to have been achieved in light of a "fundamental shift" the company had experienced in submarine upkeep usage cycles, resulting in longer but less frequent maintenance activities. The changes were explained as having been designed "to increase the overall availability of the submarines for the RAN - on the basis that there are normally five operational submarines based in Western Australia."

According to Greg Tunny, all of the above had necessitated that the ASC provide "a substantive, dynamic and responsive support capability in WA ... (and have) steadily built (our)skilled resources base in the west over the last decade to achieve this." Subsequent to release of its Annual Report, ASC confirmed 15 December 2006 that \$35m would be spent constructing a specialist submarine maintenance and upgrade facility (including office accommodation for 185 people) at WA's Australian Marine Complex (AMC).

The ASC's decision to consolidate submarine maintenance and upgrade activities in WA is designed to leverage State Government commitments to spend \$90m building additional mari-

time industry support infrastructure, which includes a floating dock integrated with the existing Common User Facility (CUF).

The investment will see a land transfer capability which will enable the ASC to move submarines into its new facility, and meaning the company will be able to carry out maintenance on as many as three submarines at any one time. ASC is planning to undertake its first AMC-based submarine maintenance docking in 2008.

The development of such capabilities could not come at a better time as - largely due to shortages of submarine crews arising from recruitment and retention program failures - the 2007/08 Budget papers noted HMAS 'Sheehan' had entered its Full Cycle Docking (FCD) nine months early, and would remain in this state for all of 2007/08.

Similarly, HMAS 'Dechaineux' will remain in FCD for all of 2007, with expected completion in late-2008. HMAS 'Farncomb' will also enter mid-cycle docking shortly after July, with expected completion in mid-2008.

This leaves the RAN for an extended period with only three operational submarines, HMAS 'Rankin', HMAS 'Collins' (which returned to service in October 2005 after a FCD), and HMAS 'Waller', which will complete its FCD in June, and including the installation of the first project Sea 1439 Replacement Combat System (RCS), and installation of the Sea 1429 Heavyweight tor-

pedo, as well as the introduction of Special Forces deployment capabilities.

Whilst unfortunate for the Navy, in terms of its sustainment of a credible rate of submarine operations - estimated at 1,000 Unit Ready Days for 2007/08 (down from 1,265 URDs in 2006/07, and slashed to 817 URDs in the Additional Estimates) - the concentration of repair and maintenance effort will boost ASC revenues for two critical years at the start of the AWD project, when expenses will be at their heaviest.

The 2007/08 Budget papers also indicated the Government had decided to progressively enhance the combat capabilities "of all six submarines" including weapons, sensors, Special Forces improvements and communications system upgrades. Such a decision potentially fattens the FCD contract value for ASC, given Special Forces upgrades were originally to be included on only two 'Collins'-class submarines.

ASC revenues for 2005/06 generated from the Osbourne (SA) site were principally driven by the FCD and RCS work on HMAS 'Waller', and similar attention being given to HMAS 'Dechaineux'. To these extents, the Annual Report noted revenues were likely to be higher, due to discovery work on previous FCDs and the volume of work to be undertaken on the 'Dechaineux' indicating the rate of expenditure "is far greater than previous FCDs."

### GETTING READY FOR PRIVATISATION: ASC Group Six Year Financials

Corporate Performance Measure	Financial Year 2000/01 (\$m)	Financial Year 2001/02 (\$m)	Financial Year 2002/03 (\$m)	Financial Year 2003/04 (\$m)	Financial Year 2004/05 (\$m)	Financial Year 2005/06 (\$m)
Revenue from Rendering of Services	195.4	141.8	148.4	243.6	217.0	254.7
Financial Income	-	3.3	4.3	4.5	5.6	5.9
Other Revenues from Ordinary Activities	5.7	1.2	6.0	7.8	6.7	0.4
Total Revenue	201.1	146.3	158.7	255.9	229.3	260.9
Operating Profit before Tax	12.4	1.7	8.9	23.6	20.5	26.3
Operating Profit after Tax	7.1	0.1	5.9	16.1	16.1	18.5
Total Assets	206.7	196.7	236.7	243.5	283.9	245.9
Total Shareholder Equity	53.1	53.2	59.1	107.3	107.3	114.2
Total Fully-franked Dividend Declared	-	-	-	5.0	9.7	11.1
Return on Equity	13.4%	0.2%	10.0%	15.0%	15.0%	16.2%



DEFENCE PHOTO

During the year, the ASC also extended its relationship with submarine capability partner, General Dynamics-owned Electric Boat Corporation, until 2008. According to Greg Tunny, the new contract would see "a continuation of Electric Boat's support to further enhance ASC's submarine technical capability, with a particular focus on continuous upgrades and supporting the company in its long-term objective of co-designing Australia's next generation of submarines."

Overall, the shift of substantive 'Collins' submarine support work to WA has better enabled ASC to advance preparations in Adelaide for the development of its own facilities (to which it is investing \$100m) for the construction of the three AWDs.

To this effect, during the year under review, ASC AWD Shipbuilder mobilised some 100 staff to the AWD Systems Centre in Felixstowe, whilst also "eagerly supporting" both the 'evolved' and 'existing' AWD design teams. The capability partnership with General Dynamics-owned Bath Iron Works (BIW) has also been continued, with work focused through 2006/07 on the AWD shipbuilding task, and effected through the integration of BIW staff with ASC shipbuilding personnel.

The Annual Report also notes 2005/06 saw the finalisation of all formal agreements with the South Australian Government in regard to the construction of a 70 hectare Common User Facility adjacent to the existing ASC site used to build and support the 'Collins' submarines. The CUF, along with inputs from ASC's facilities, will be the primary site

for consolidation of AWD modules and the eventual launch of the three ships.

ASC further supported the Port Adelaide Maritime Corporation with preliminary design planning for the CUF, with major deliverables including: dredging of the river, a new wharf and shiplift, dedicated AWD production facilities, office accommodation for 400 people, wharf support building with office space and workshops, an upgrade of existing facilities and civil works associated with supporting modules of up to 1,200 tonnes, and the fuller realisation of 'Techport Australia', formerly known as the Osbourne Maritime Precinct.

To these effects, Defence Minister Nelson and the South Australian (SA) Deputy Premier, Kevin Foley, gave the green light 30 May to construction of a \$6m Maritime Skills Centre (located adjacent to the ASC's site), and designed to provide a purpose-built facility from March 2008 to support project Sea 4000 and the AWD contracting Alliance, who are charged with delivering the quantum of critical trade and technical skills necessary to build the RAN's three new AWDs.

SA Government officials indicated some \$60m of contracts had been awarded to date for the \$250m 'Techport Australia' construction, whilst over \$20m had been invested in workforce development programs to support the skill growth required by modern shipbuilding - not only to build the AWDs, but also attract other shipbuilding and repair opportunities.

Whatever path the Federal Government takes in selecting the preferred AWD design, the ASC is

set to benefit substantively over the roughly 12-year period from 2007/08 (prospectively the last year of public ownership) through to 2019/20, which will mark the end of the first 15-year component of its 25-year (15+5+5) 'Collins'-class submarine TLS contract.

Further, company operations will have consolidated and grown in at least two States, benefiting from over \$250m worth of investment in naval construction and repair assets in South Australia, and close to \$300m of State and Federal investment (including bicentennial grants) at the CUF in Western Australia.

Bolstered by at least ten years of AWD construction revenue from 2007/08, it becomes possible to make some initial estimates on the overall financial health of the company using averages of the previous three years financial outcomes as the baseline for forward estimates.

Given that investors have previously been severely burnt on the basis of valuing Australian defence companies using the Defence Capability Plan (DCP) as a reliable estimate of likely future revenue flows, it is anticipated that potential bidders for ASC will focus narrowly on the eleven years running through to 2019/20, which should see off launching of the final AWD, as well as expiry of the first 15-year tranche of the 'Collins'-class TLS contract.

Taking the upper range of the \$6 billion project Sea 4000 cost estimate, upwards of \$1.5 billion will first be lost to ASC as a result of the predominantly imported Lockheed Martin 'Aegis' combat system, as well non-'Ae-

gis' system integration costs which will accrue to Raytheon Australia.

ASC has previously stated that 70% of the module work for the three AWDs will be contracted off-site, however, has judiciously reserved the other 30% of higher-value modules for itself, meaning the value of work likely to be retained by the company will be closer to 50% - thus suggesting the volume of revenue lost to ASC will be the lower of a range of \$1 billion to 1.5 billion.

A recent solicitation of Expressions of Interest for AWD module fabricators - which yielded 19 respondents stretching from Perth, Whyalla, Portland, Melbourne, Hobart, Wollongong/Illawarra, Sydney, Newcastle, Brisbane, Cairns, Darwin and New Zealand - saw ASC declaring it would hold value within the company by limiting out-sourcing to labour contracting, given its proposal to procure and supply to module subcontractors 'all material required for the manufacture, painting, assembly, outfitting (and related installations) of and within the modules'.

In short, net revenue accruing to ASC from the AWD construction contract is expected to be in the order of \$3 billion over the period to 2019/20. Added to this is another \$2.9 billion anticipated to accrue from submarine TLS and related capability enhancement work. Spreading the receivables from AWD construction across the forward years to 2019/20 - and loading the forward years in a manner that would see 70% of the contract value secured in the years running up to

>>> page 32



**PUTTING A PRICE ON ASC'S TREASURE:** The Government is flooding the ASC with money over the next two financial years with up to three 'Collins'-class submarines (far L) being put into maintenance or upgrade work, in part, because the Navy does not have enough crews to sustain them. Selection of either of the 'evolved' (L) or 'existing' (R) air warfare destroyer designs for project Sea 4000 will put roughly \$3 billion of net revenue through ASC over the next decade, whilst the first 15 years of 'Collins'-class through life support will add another \$3 billion. The company's prospects for a follow-on submarine replacement contract have been made even more intriguing with Prime Minister John Howard's plans to ramp up Australia's involvement in the global nuclear energy fuel cycle, including perhaps, a move to nuclear-powered and energy weaponised boats for the 'Collins' submarine replacement (far R).

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• **Land 75, Phase 3.4 & Land 125, Phase 3:** Involves the \$525-700m further rollout of the Saab Systems Battlefield Command Support System (BCSS), and acquisition of soldier systems for increased lethality (weapon sights) and survivability (body armour). This initiative also includes the acquisition of the Battle Group and below Command, Control, Communications (BGC3) system, formerly and colloquially branded 'Land 200'.

• **Land 144, Phase 1:** Relates to the \$20-30m acquisition of initial counter-mine capabilities, including a Personnel Explosive Lane Clearance Charge (PELCC) System, Improved Handheld Detectors (IHD), and 6-12 'protected hazard reduction systems' in the form of armoured vehicular mine-flails for rear area mine destruction.

**CAPITAL FACILITIES PROJECTS:** The 2007/08 Federal Defence Budget also provides \$643.6m for major and medium capital facilities projects, with the Department of Defence planning to spend \$3.270m on such facilities over the Budget and Forward Estimates period.

Having shrunk from previous highs in earlier years, the Capital Facilities Program is now forecast to grow quite considerably reflecting the need for reinvestment in the Defence estate, the construction of new facilities to accommodate equipment emerging from the Major Capital Expenditure program, and other new initiatives announced over the previous year by the government, such as the Hardened and Networked Army, and the Enhanced Land Force.

Defence bases around Australia, including a number in key electorates, are set to receive an injection over 2007/08 of \$1,039.9m in the form of: capital infrastructure (\$499m); estate upkeep (\$405.5m) and continued base security (\$135.4m).

ADBR

## ASC sale - Ctd from p19

launching of the first AWD in 2013 - ADBR has been able to build a simple picture with which to aid valuation of the company.

In short, and over the decade between Government disposal of ASC in 2007/08 and delivery of the third AWD (as well as expiry of the first 15-year tranche of the TLS contract), the company could be expected to generate over \$6 billion in revenues.

Based on averages of the previous three years' financial results to set the base for 2006/07 and converting them to ratios (as arguably, ASC has honed its submarine support activities to a high level of efficiency) - as well as expanding Total Assets to reflect the \$135m investment (and depreciation) in upgraded facilities in WA and SA - and adopting the 60% fully-franked dividend policy of the existing management, ASC would deliver around \$250m in dividend over the period to 2019/20.

Return on equity would progressively expand from the \$16.2% recorded in 2005/06 and would concentrate in the order of 35%pa in the years 2010/11 through to 2012/13, before falling as the construction program matured, and revenues began to fall back onto substantive reliance on the submarine TLS contract.

ADBR emphasises that the above projections come from simple spread-sheet modelling of historical ASC financial outcomes, moderated by some of the better known fundamentals that will drive future corporate performance, and assuming the financial directives of the current management are sustained by the company's new owners.

ADBR's estimates will be subsequently revised following the company's release of its 2006/07 Annual Report, expected around October. The above analysis also recognises that revenues from submarine support and capability enhancement activities will be substantially boosted in 2007/08

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and 2008/09, however, the impact of this boost on bottom line outcomes needs to be moderated by the reality the company will also be bearing substantial start-up costs relating to AWD construction over the same time period.

Further study of the ASC's 2004/05 Annual Report highlights two additional areas of relevance to any valuation of the company, and includes its practice of 'self insurance' in terms of risks (and costs) associated with workers' compensation (2004/05 provisions of \$2.1m), and the provision of 'warranties' to its customer (the Commonwealth of Australia) for previous submarine build phase and future work.

According to the Annual Report, "significant uncertainty relates to estimates for contracting activities as the estimates depend on circumstances particular to each contract." The Commonwealth annually provides the ASC with warranty funding, which is applied to a warranty provision that stood at \$6.2m on 30 June 2005. ADBR

capability, and Psychological Operations (PSYOPs), as the Government prefers it to be called - will provide enhanced effectiveness.

The 2006-16 DCP took the first nascent steps towards support systems to fuel ADF PSYOPs capability through promulgation of Joint Project 2076. Phase 1 of this project related to deployable production and dissemination equipment for PSYOPs products, and is very much aimed at simply providing a deployable media operations centre able to produce mass media for conventional distribution.

Still, the asymmetric demands envisaged in JO21C will necessarily require the Australian military to have sophisticated capabilities to broadcast PSYOPs products into (via displacement) the enemy's own media, and widely distribute ADF-generated material into enemy support bases - in the first instance - through leaflet drops.

The best means to achieve this is from the air, as demonstrated by the US Air Force's EC-130J

'Commando Solo' platform, which is able to broadcast PSYOPs and civil affairs information in AM, FM, HF, TV and military communications bandwidths - in effect, an orbiting radio and colour television station. The 'Commando Solo' is used to both disrupt and replace mass media with PSYOPs output, and in ADF service, would enable Australia to shape the nature of mass media communications to an enemy population.

While the technical means of PSYOPs distribution is important, the parallel development of products that achieve the desired effect on the target group is a far more valuable and more complex capability to acquire. Such aspirations will thus place more demands upon the ADF in recruiting and developing intelligence personnel with targeted cultural awareness and PSYOPS skills that may at first appear foreign to the tradition mould of ADF recruit.

Whilst transmitting the vision of JO21C might make a great conference speech, the actual develop-

ment of a concept of effective asymmetric operations is a much harder endeavour compared to envisaging it. Traditionally established militaries have generally shunned the type of thinking (ie: out-of-the-box), skills and equipment acquisitions needed to fight in an asymmetric manner.

The Defence Chief articulation of such a vision is thus a vital first step in the process, but without significant force restructuring and adjustment to the DCP by government, asymmetry will not be achieved.

An air warfare destroyer cannot deploy a conventional motorised infantry battalion, which is trained to capture and defend hills in order to execute a series of simultaneous lightning strikes on an enemy's national fibre optics internet communications system to achieve an asymmetric objective. Developing a balanced force is important, but a shift to asymmetry brings with it demands that are not met just by policy. ADBR

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