

Submission from Graham Spurling to the Productivity
Commission inquiry into post 2005 assistance to
automotive manufacturing

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Overview

Profound structural change is refashioning the global automotive industry. This creates strategic challenges of great difficulty and importance for an automotive manufacturing industry of the size of Australia's. Vehicle manufacturers are increasingly outsourcing design, development and financing of the major systems in vehicles to 'tier one integrators' who are becoming the real architects and co-ordinators of automotive manufacturing.

This creates major problems for Australian suppliers, who, because of their small size, have a higher cost of capital than their customers have. Also, despite consolidations, the supplier sector is still fragmented. Market forces alone are an insufficient remedy to fragmentation as they are part of the problem. Vehicle assemblers resist single supply arrangements and capacity sharing because their culture reflects the realities of foreign parents operating in much larger markets. This is a luxury that is not so costly in those larger markets that are of an order of magnitude larger than Australia's.

The next ten years will determine whether the Australian industry is able to build the strategic strengths – particularly in its supplier base – to be an integral and prosperous player in the global automotive industry. If we do not rise to these challenges, we will become a backwater.

Tier one supply, and indeed the supply of a range of components in Australia, has substantial 'natural monopoly' characteristics. Some sectors in which rationalisation can be taken much further include:

- Seating and interior trim;
- Ride Control;
- Toolmaking;
- Rear wheel drive transmission;
- Sheetmetal Stampings; and
- Engines.

Our industry cannot prosper without excellent industrial relations. Strikes are particularly debilitating. Having already outlawed 'secondary' boycotts and industrial action in pursuit of pay claims that threaten to cause significant damage to parts of the economy, we have actually gone a long way towards removing the unfettered right to strike in the industry. We should take the final step and recognise that permitting strikes that damage vastly more people and firms than those involved in the strike is in no one's long term interest.

Strikes also intensify the incentive assemblers have to split their supply orders. They also discriminate against Australian design. Firms

assembling foreign designs may be able to fly in critical parts in order to resist a strike. Firms with high levels of Australian design have no such option.

We have gradually been lowering levels of assistance and focusing assistance more tightly on capacity building. We should keep going in this direction using a combination of two instruments – ‘tilted playing fields’ and discretionary assistance. A ‘tilted playing field’ would direct assistance to firms according to pre-set criteria – removing the politics and heat that inevitably attends discretionary assistance. Nevertheless, the criteria would be pre-set to ensure that assistance helped firms with capacity building, rather than production, and went to firms that were using it to grow and transform themselves, rather than just continue a ‘hand to mouth’ existence.

We should probably also retain some assistance for more strategically significant projects on a more discretionary basis. A joint industry/government body – the National Automotive Strategic (NAS) group – could exercise the discretion. The NAS group would explore with the industry means to:

- establish a more sustainable structure for existing capabilities; and
- develop strategies for establishing capabilities which do not currently exist.

An integrated and national program, to be known as ACIS II, should accompany whatever tariffs are appropriate and replace existing state and federal assistance. For the sake of continuity it should resemble the ACIS scheme and be further optimised in the following ways:

1. It should be national and integrated. Vehicle manufacturing states should contribute and then be constrained from offering special, discretionary assistance of their own.
2. Benefits should assist firms expand their capabilities. It should be subject to a performance hurdle to weed out firms without a strong commitment to, and track record of, strong growth in Australian sales and investment in physical and/or intellectual assets.
3. A newcomer firm could only qualify for assistance where it was providing the industry with some enhanced or new capability rather than simply entering an already crowded market.

The next decade will determine whether our automotive manufacturing industry is finally to emerge as an internationally competitive force. There are good reasons for optimism. However, without a mechanism to make rationalisation happen, we will resume our old role as a backwater.

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1. Introduction

This submission draws on a lifetime of experience in the management of manufacturing operations including CEO positions in both an Australian vehicle manufacturer (Mitsubishi Motors Australia Ltd) and an Australian-owned, American-based supplier of batteries to the automotive, telecommunications and electric vehicle industries. I have been involved in several automotive industry policy reviews by the Commission and others since the Car Industry Council in 1983, which led ultimately to the landmark Button Car Plan of 1984.

I have maintained my involvement with automotive manufacturing and within industry more generally. As I have done so, it has become clear that changes are underway that have dramatic implications for our industry.

Last year I was involved in setting out a strategy for the South Australian industry to respond to the challenges of the future. However this strategy was really national in scope and intention. This submission then is a further development of the thinking set out in my report to the South Australian Government *South Australia: Productive, Creative, Competitive*.

2. Strategic issues for the global industry

Changing technological possibilities and changing organisational paradigms are bringing about profound changes in the industry. These changes are accompanied by the continuing inexorable search for cost reduction made more urgent by the impatience of investors who have endured poor returns over a long period. These changes may be summarised under the following headings.

Modularisation and the reorganisation of 'centres of cost reduction'

Major leaps forward in automotive production have generally involved some new approach to managing manufacturing complexity, in the presence of diverse consumer demands and strong economies of scale. The production revolutions of Henry Ford, Alfred P. Sloan and the Japanese production system all involved new departures in managing these issues. Today another revolution is underway. It involves reconfiguring the industry to redefine organisational roles.

Much greater outsourcing of design to component suppliers was a hallmark of the changes of management that took place as part of the Japanese revolution in managing automotive manufacture. Component suppliers came to be seen more and more as the appropriate source for designing as well as supplying components that had previously been designed by vehicle assemblers.

These ideas were taken up with a vengeance by vehicle manufacturers in the West in response to the competitive pressures unleashed by the Japanese. Today they are being taken further. In addition to increasing the design and technological input of suppliers, vehicle manufacturers are moving towards a model in which they operate as the brokers and co-ordinators of 'tier one' suppliers who supply them with the most of the contents of the vehicle in 'modular' form. This is not just design and supply, but also taking on the full financial risk of the project and the management of the logistics of sub-assembly.

These changing dynamics are underpinning a substantial re-ordering of the capital structure of the industry, with vehicle assemblers merging to share 'platforms' and component suppliers forming huge 'tier one' systems integrators capable of designing, financing, supplying and in some cases even assembling on-site modules for constructing the vehicle.

Rationalisation and reinvestment

The industry in developed markets has been replacing people with machines and also reducing capacity. Nevertheless, capacity is also being continually augmented. Some new 'greenfields' investment is occurring even in traditional heartlands of automotive manufacturing driven by a desire to exploit new production methods, the most notable being full modular assembly. This motive tends to overlap with the desire to capture some of the new opportunities thrown up by liberalisation of trade and investment.

Substantial investment is also driven by excessive government assistance in developing countries with aspirations to become players, or become larger players in the automotive industry. Many of those developing countries adding capacity for export have egregious protection in their home market. Vehicle producers have become well practised at playing off one country against another and within countries, one state or province off against another. This occurs within the United States of America, the countries within the EU and sadly, between the states of Australia.

Mergers and acquisitions

Huge mergers are transforming the capital structure of the industry, at both the assembler and supplier level. Minimum economic scale appears to be rising, while the public demand for diversity continues to expand as it did throughout the twentieth century.

The six dominant automotive producers are now

- GM-Saab-Isuzu-Suzuki
- Ford-Jaguar-Volvo

- Toyota-Daihatsu
- VW-Audi-Seat-Skoda
- Renault, Nissan (including Infinity)
- Daimler-Benz-Chrysler-Mitsubishi

This new process of consolidation is global. It involves the production of far more vehicles than previously. The technologies which are coordinated by the industry are now vastly more complex.

In every case, the purchaser of an established marque seeks to lower costs by

- Servicing technical needs from a much more substantial intellectual and technical base
- Sharing components, systems and/or platforms with other vehicles.

Thus for instance Ford is able to build its Thunderbird, Lincoln LS and the small Jaguar from the same platform. In Europe a single platform is used for small vehicles across the VW, Seat, Skoda and Audi ranges.

The supplier industry has also seen the emergence of global 'mega-suppliers' such as Lear Corporation, Johnson Controls, Magna, Faurecia, Visteon, Delphi and Denso. Some suppliers are direct spinoffs, products of earlier restructuring by vehicle assemblers.

Increasing significance of intellectual capital

The micro-electronic revolution is now having a profound influence on the way in which the industry develops products. We're doing more on the computer than before. We are doing it more accurately, more quickly, and in some cases, we're doing what we couldn't do at all before. In many cases intellectual property is a substantial portion of the cost and price of the system supplied to the assembler.

Supply chain integration

E-commerce is making possible hitherto impossible levels of integration between firms. Thus suppliers of components and sub-assemblies are able to work with complete and seamless integration. This enhances the 'outsourcing' opportunities open to assemblers. This process has been underway in this country, and elsewhere, for some time. For example, Ford outsourced its plastics plant at Broadmeadows. More recently, it has outsourced its seat manufacture to Air International.

Outsourcing of design and finance

The logical conclusion of all these trends is that the major vehicle producers will come to see themselves as stylers of vehicles and managers of 'platforms'. They will manage the marketing of those

platforms and much of their role will be in managing the brands they own and managing contractual relationships with tier one systems integrators. Much of the assemblers' design, development and production responsibilities are in the process of being shifted to tier one systems integrators. Even assembly is already being outsourced on a substantial scale, particularly in Europe.

It is less clear that pushing the *financing* of component production and tooling onto suppliers makes real long term commercial and technical sense even in very large markets, as the largest firms generally enjoy the lowest cost of capital and the vehicle manufacturers are the largest firms. This pattern of financing is certainly being imposed upon the industry from above. One can imagine plausible reasons why the capital market might induce such a corporate strategy, even if it was not in the long-term interest of shareholders. It is in the short-term interest of the shareholders, at least those of the most commercially powerful firms, the vehicle producers. By forcing their suppliers to bear the financial burden and risk of the tooling and other capital investment to produce components, vehicle assemblers can keep liabilities off their balance sheets and improve their short-term returns.

3. Problems for Australia

As the global industry transforms itself, platforms are rationalised and the merged entities selling vehicles come to see themselves as the custodians and managers of global vehicle brands and design, how should Australia respond? The fact is that despite our progress over the last two decades, this model faces Australia with very substantial challenges. Competitiveness in the manufacture of vehicles will depend on the competitiveness of component suppliers. And components will not be competitively produced without the development of Tier One suppliers in Australia supported by competitive tier two and three suppliers.

The equity capital for each of these firms can be supplied either by Australians or foreigners, though in each case, Australian operations will need to have access to global technology through either equity linkage and/or licence and other technology sharing arrangements.

The availability of capital looms as a substantial problem. Even for foreign-owned firms, this is probably a major problem if local subsidiaries are to escape the 'branch office' mentality. So far a few – like Robert Bosch Australia – have done so. Many others have not. For Australian firms, a window of opportunity exists to transform 'tier one' status in Australia into a platform to supply the Australian and global markets, and, at the same time, leveraging the productivity of their Australian assets and capabilities over a much larger volume base.

In large developed markets pushing the funding of tooling onto component suppliers is not necessarily a major problem as 'tier one' suppliers are generally sufficiently large to access the capital markets at only a small relative disadvantage to vehicle assemblers. However, the same approach creates major problems for Australian-owned component suppliers. For instance, the market capitalisation of Air International, a major Australian 'tier 1' supplier of interior parts, is around three to four hundred million Australian dollars, with its parent Futuris just over \$1 billion on current share market valuations. Pacifica, owner of PBR, has a market capitalisation of around half this. The contrast with their customers could hardly be more marked. Ford, General Motors, Toyota and Mitsubishi are each amongst the largest firms in the world.

Likewise global tier one suppliers are of a size which dwarfs Australian component suppliers. Delphi, the tier one supplier spun off from General Motors has a market capitalisation of over US\$ 8 billion,¹ and generates revenue in excess of the whole of the Australian industry.

In addition to being located in a small, mature and slowly growing market, the Australian component sector still has not thrown off the shackles it acquired in the years of protection. Despite substantial rationalisation, the sector supplying the vehicle assemblers remains far more fragmented than necessary or appropriate. This has been actively encouraged by the major assemblers because it enhances their control over suppliers. This has two related results. Firstly it undermines the capacity of the Australian industry to move towards a contemporary industry structure. It is difficult enough attracting capital to the industry given the size of our market. But a failure to make the best of the volume base we have condemns us to marginalisation in the revolution that is sweeping the global industry, assuring that where we are not already, we retain our status as a 'backwater'.

Secondly, and as a result, many component suppliers will continue to lead the kind of 'hand to mouth' existence which has characterised the industry for many years. Although one would expect the market to sort this out, the risk is that it will do so by gradual attrition rather than by the 'creative destruction' which is necessary for real renewal and vibrancy for the industry. In the meantime, the global industry will be reinventing itself and Australia will find itself with a 'branch office' role to play – if that.

Note in this context, that assistance to the industry from ACIS can be a double-edged sword. It has certainly been critical to the efforts being made by Australian firms like PBR and Air International and foreign firms such as Robert Bosch Australia to making the investments necessary to

¹ http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=DPH&script=900

give Australian firms a role in the global industry. At the same time, it helps more timid players, with few aspirations or capacity to expand, to play a 'spoiling role' in supplying the industry, and in so doing fragmenting production. To some extent the same might be said of vehicle manufacturers. The assemblers in Australia all need to have a strategy that will see the Australian automotive industry playing a critical role and making an optimal contribution to their global strategy.

'Tier One' systems integration and much component supply to the Australian industry have 'natural monopoly' characteristics in Australia

With a few possible exceptions, a firm cannot become a tier one supplier unless it can convince its customers – the vehicle assemblers – that it:

- Has the depth and breadth of resources required in at least the following areas.
 - Intellectual capital – design and engineering capability
 - Access to financial capital and capacity to bear project risk
 - Access to competitive suppliers

The tier one supplier must also be able to guarantee security of supply.

Given the volume of Australian production, it is clearly essential for car producers to share Tier 1 suppliers if competitive volumes are to be generated, and adequate capital and expertise is to be attracted.

Put another way, given the huge and still growing financial demands on component suppliers for investment that is essentially fixed and product specific, the supply of a range of components in Australia has substantial 'natural monopoly' characteristics. This contains a range of challenges both for business and for policy makers. But the way around the natural monopoly question in business has always been through long term co-operation between businesses in the supply chain by one of a range of expedients including

- Long term contracts
- Price arbitration
- Equity sharing
- Sharing of capital investment costs.

The Australian industry is unique amongst developed countries because all other developed country markets either are, or are part of massive consumer markets. Thus even with the very dramatic rationalisation that is taking place, there is room in Europe, in the United States and in Japan for more than one producer of virtually every commodity. But one does not have that choice if the Australian industry is to be competitive. It is rather like Orica in Botany deciding that it wants ethane from the

Cooper Basin but wants to retain the luxury of bargaining with two companies for supply. It would be a nice idea if two pipelines could be afforded, but they cannot.

The Australian automotive industry, however, remains dominated by corporate purchasing cultures which have been forged in vastly larger markets than our own – markets that can afford, and indeed reward, the 'divide and compete' model. Given the size of the global parents of Australia's vehicle assemblers, such uncompetitive practice can survive for many years despite the fact that it is less efficient. The reluctance of the vehicle assemblers to help facilitate, or indeed force much greater component supplier rationalisation is understandable. But we in Australia must not subsidise that corporate desire with taxpayers' money.

4. Some examples

This section outlines some areas in which tier one rationalisation is imperative. The following sections then turn to the policy environment that could bring it about. The broad views expressed here were canvassed with senior industry executives in the process of conducting a Task Force into the South Australian automotive manufacturing industry in 2001. The CEO's of all four vehicle producers indicated their strong agreement with the sort of industry structure being described.

The following areas of tier one supply have been examined on a *prima facie* basis, using engineering prefeasibility studies and indicative costings.

Seating and interior trim

Air International is establishing itself as the dominant supplier of seating systems in Australia. It has recently established or purchased seating assembly facilities in both Victoria and South Australia either within the precincts of a vehicle manufacturer's assembly plant (Ford at Broadmeadows) or adjacent to the vehicle manufacturers assembly plant (GMH at Elizabeth).

Air International will expand production into interior trim systems servicing other car companies. Its dominance has already substantially improved the economics of seating supply and further sharing of supply would improve things still further – in some cases taking advantage of the opportunity to use non-visible componentry common to several vehicles. It now needs to capture the Toyota and Mitsubishi business. There is only room for one Seat maker in Australia.

Ride Control

Dana Corporation has established to supply Holden with front and rear suspension systems and is negotiating to provide an even more

extensive service for other vehicle producers. In the study undertaken by the South Australian Task Force, there was an indicative saving of some 40% in purchasing front and rear suspension as modular systems.

Toolmaking

Tooling is the core technology of manufacturing. It is highly capital intensive and a bellwether for the future health of the industry. This is because, for an industry to be capable of reaching beyond the 'branch office' mentality in manufacturing, it must have a vigorous tooling sector supporting manufacturing investment. It is also a matter on which the vehicle producers could co-operate without making any great concessions to their own autonomy. On the other hand, it is one of the first things that can be sacrificed where the vehicle producers – or even a substantial number of them – become doubtful of their long-term viability and commitment to manufacture here in Australia.

Even where they appear to have a medium to long term commitment – for instance Toyota – in some ways it is easier for firms to rely on their parent company for much of the tooling (or components requiring heavy tooling cost). Reliance on overseas designs, or modifications thereof, relieves the local subsidiary of much of the necessity for local tooling. At the same time, however, a properly capitalised and located 'tier one' tooling supplier to the local industry would generate additional benefits for local manufacturers in the form of lower cost and greater speed of delivery.

Holden closed their large toolroom in the late 1980s and retain a die maintenance capability, which is still able to build new dies, albeit to a limited extent. Toyota has a maintenance capability, while Ford has the most extensive and modern facility among the local car producers.

MMAL has a very competent toolroom, but with dated equipment. Holden has strongly supported the idea of an international tooling supplier establishing as a first tier integrator of tooling.

Toolmaking is a most capital-intensive operation and the demands of each automotive producer are linked to their own product cycles, giving rise to unsustainable peaks and troughs in shop loadings. It would therefore be eminently sensible for MMAL, Ford and Holden to rationalise their respective facilities into one operation under the management of a tooling system supplier who would take turnkey responsibility for tooling systems, and provide a die maintenance service under contractual arrangements.

In this area, as in others – particularly stamping and engines – there remains the need to consider company concerns about confidentiality and product differentiation. This is discussed in a separate section at the end of this part of the submission.

Rear wheel drive transmission

The only transmission manufacturer in Australia is in Albury-Wodonga. Commencing as a Borg Warner Plant, it was purchased by BTR and has just been purchased by ION. This facility supplies Ford and export markets in Korea export market as well as Maserati. Australia is the one country in the world that has retained rear wheel drive (RWD) as a volume product offering. There are substantial risks in this position. Nevertheless, given Australia's tiny share of the world market, it also represents a substantial opportunity. Rear wheel drive is typically associated with top of the line vehicles and prestigious marques – such as the larger BMW and Mercedes.

Thus Australia is a very logical base from which to specialise in the engineering and build of niche RWD products. The move into sports utility vehicles by some of our vehicle builders will add strength to such a strategy.

This particular example illustrates several important principles that will be taken up in the next section. The capabilities of the purchaser of this facility are critical. A purchaser with little technical capability will be unlikely to develop the facility in the long term best interests of the industry and the country.

Sheetmetal Stampings

Like tooling, Sheetmetal stamping is a capital-intensive operation where effective asset utilisation is critical. The following table summarises current capacity utilisation for each of the car companies.

**Sheetmetal Stamping Capacity and Utilisation
(normal 2 shift arrangements)**

Company	Capacity (car sets/day)	Utilisation
Holden	480	565
Ford	600	400
MMAL	300	185
Toyota	450	480

Source: Automotive Task Force, Interim Report to the Premier, Prepared for the Cabinet of the South Australian Government, August 2000

The table illustrates how much excess capacity is available to Ford and MMAL whilst Holden and Toyota both struggle with capacity shortfalls which are met by partial 3rd shift and weekend work at points of constraint.

There is clearly a role for a sheet metal system integrator who can meet the shortfall and take up the slack, in overall Australian capacity. There

are such facilities operating elsewhere in the world – for instance Mayflower Corp in the US (currently turning over \$1B a year in sheetmetal system supply) and Comau S.p.A. who go as far as building a complete body for Ford in South America.

A particular commodity – the body side stamping – also provides an excellent example of the potential benefits of the kind of approach being proposed. Thus in other markets body sides are often pressed in one piece generating gains in weight, unit cost, labour cost and strength. However body side panels require a transfer press line with a header press of some 2,000 tonnes. This requires investment of \$80 million or over. No Australian OEM has the volume to justify this investment and so Australian cars are built with body sides pressed in several (usually two) pieces, which are then joined during body assembly.

Engines

Engine manufacture is also a very capital-intensive activity for both casting and machining, with global operations requiring minimum economic scales of 300 – 400,000 units p.a. – i.e. about the current total Australian vehicle build.

The choices available to Australia are to move immediately into the production of aluminium engines, or to make do with existing facilities until a more strategic move into aluminium engine production can take place. The pieces of the jigsaw puzzle are as follows.

Holden and Ford have developed their own 6-cylinder iron block engines over the last few decades to a point at which they are near the end of their lives. Toyota build a 4-cylinder engine using a grey iron cylinder block produced by Holden but their 6-cylinder engine has been fully imported. There is an accelerating global trend away from cast iron cylinder blocks towards aluminium engine build. However MMAL have a 6-cylinder V6 engine which, though it is manufactured from an iron block, nevertheless performs in all respects at levels which are comparable with aluminium block engines.

This scenario raises clear strategic issues for Australia – issues of precisely the kind referred to in the terms of reference where reference is made to investment decisions being “made on the basis of [Australian subsidiaries’] global operations (rather than simply in the interest of maximising returns on their Australian operations)”.

Today the need remains for integration of the industry’s aluminium engine-casting capacity. It is critical that this issue is addressed in the context of Ford’s and Toyota’s sourcing decisions.

As we now know, after considerable time and effort examining the attraction of sourcing its next engine from the MMAL facility in Lonsdale, Holden decided instead to build its own local engine at Fisherman’s Bend in Melbourne. Holden was awarded a world scale ‘module’ of

production of a new generation of GM engines. In this sense, the priorities of the parent company predominated over the interests of the industry. I offer some further comments on this in the subsequent section.

Ford is now seeking to decide on its own course with a power train whose origins date back to the 1960s. The various engines have characteristics that would suggest a basis for at least a common casting facility. Engines are very strongly connected to corporate identity.

The issue of corporate control

Much of this is commonsense. What is proposed would involve no greater difficulty – for instance in the provision of confidential design information – than occurs routinely in relations with tier one suppliers both in Australia and elsewhere. But elsewhere economic scale can be achieved without the discomfort to corporate cultures which can be produced by the idea of ‘sharing facilities’ and single sources of supply. Even given this, the idea has the ‘in principle’ support of many in the industry and we should use what arms of policy we have to ensure that every step has been taken to bring it about.

5. Some illustrations of our failure to grasp opportunities

Two recent corporate decisions illustrate the problems with the current situation. Holden decided to proceed with a major investment to build a new generation 6-cylinder engine at Fisherman’s Bend

Holden will now has an engine that requires casting technology that is not immediately economic to replicate in Australia. Accordingly the Port Melbourne engine plant will be supplied with castings from Mexico at substantial cost. Most engines will then be transported to Adelaide at further cost.

And sadly, the bidding war between South Australia and Victoria actually perpetuated a foreign corporate culture that stands as a major threat to the global viability of our industry.

ION’s recent purchase of BTR provides another illustration. ION is unlikely to have the technical backing necessary to develop the transmission produced by BTR making it more difficult for the facility’s output to meet the future needs of the industry. An opportunity remains to supply the whole of Australia’s rear wheel drive market – which with exports could well amount to 300,000 units within (say) a five year period. This, together with direct exports could underwrite long term viability.

6. *The relevance of industrial relations issues*

Two decades ago, Australia had an extremely poor industrial relations climate. It was a relic of our 'lucky country' days. We have come a long way since then. There is much greater understanding that workers and employers both require a prosperous industry in order to prosper themselves. Days lost to strikes have fallen markedly as well.

Yet the truth is that automotive manufacturing involves integrated management of such logistic complexity that it is impossible to excel without excellent industrial relations. And we are a long way from excellence in our industrial relations. Demarcation issues continue to dog the industry – particularly amongst the assemblers, few of which are able to achieve single union sites. And we have only recently witnessed the extent to which a breakdown in harmony in one relatively small producer has crippled the industry.

In my experience, we can expect a substantial proportion of lost production from the Walker dispute never to be recovered due to lost sales and unpreparedness of the workforce to work overtime and on weekends. With very high fixed costs and a low profit margin on sales, such an impact can have a huge impact on industry profitability. In fact the Walker dispute was not the only dispute to threaten crippling the industry, even this year! Earlier in the year, we had the spectacle of the dispute at BHP's Springfield facility. There has also been a round of wage negotiations, each one of which has held out the spectre of crippling either the whole or substantial parts of the industry.

As a manager in manufacturing, I have generally regarded strikes as a worthwhile 'safety valve' – a last resort by which workers can signal their dissatisfaction with management. But the sheer arbitrariness of a strike at one small site crippling a multi-billion dollar industry, and an employer of thousands of people, who might not otherwise be employed, leads me to conclude that this is a major problem that must be addressed.

We have already outlawed 'secondary' boycotts. The effect of a strike in a small component supplier in the automotive industry is far more effective in spreading 'collateral damage' than any secondary boycott. In addition S170MW of the Workplace Relations Act allows the AIRC to terminate a period of protected industrial action where it "is being taken to support or advance claims . . . is threatening . . . to cause significant damage to the Australian economy or an important part of it". In fact we are moving towards tightly constraining the right to strike in these circumstances. This is appropriate where the vast majority of the victims of the strike simply have no involvement in the dispute. I would urge the Commission to deliberate on this matter. Perhaps we need to take the next step in recognising that, where the principal effects of a strike are to damage the interests of many more people and firms than those

involved in the strike, that over any reasonable time frame, permitting such strikes is in no one's interest.

Apart from affecting the industry's output, profitability and thus ultimately its viability, the risk of strikes raises two additional critical strategic issues. Firstly, our industrial relations environment is a major obstacle to supplier rationalisation. For as long as there is the possibility that a supplier may be crippled by industrial action, there remains the incentive to 'divide and conquer' – the incentive assemblers have to split their supply orders. Secondly, the prospect of strikes within supplier firms disadvantages most those firms with the greatest commitment to Australian design and development. This is because firms producing replicas of vehicles manufactured elsewhere can have specific parts flown in to maintain production. Had the Walker dispute dragged on, some assemblers may have been able to fly in the relevant parts. This would not have been possible for firms such as Holden and Ford with substantial and unique Australian design.

7. Policy in the recent past

How then should Australian policy respond to these forces? We note in this context the terms of reference mention of the significance of scale economies and their central reference to the Government's desire to have "an internationally competitive and globally integrated automotive manufacturing sector".

Before setting out the direction for the future, it is useful to characterise where we have been. The periods of policy making we have passed through since the 1970s may be broadly divided into four periods.

Riding on the Holden's back

From the 1950s to the mid 1970s, policy exacerbated the natural fragmentation which was occurring in the market as consumer tastes grew more luxurious and various. Thus via a range of mechanisms – most notably the local content plans – the industry was encouraged to 'cover the field' of automotive manufacture both in terms of the components and the vehicle types and brands it supplied.

Picking losers and ideological trench warfare

The failure of this strategy was exposed with the structural changes of the mid 1970s – the oil and wages shocks and the global recession of the mid 1970s saw demand for Australian vehicles collapse, both in Australia and in export markets. Our response was higher protection. This actively harmed export production and the chase to manufacture smaller cars turned out to be a dead end. We were uncompetitive from the outset in the most price-sensitive part of the market competing against production runs of half a million and more per annum. At the

same time the debate between free traders and protectionists did not lead to any constructive middle ground.

Transitioning towards lower assistance and more export orientation

This period began with the implementation of export facilitation in 1979 and was entrenched by the Button Plan in 1984. It was further entrenched with the imprimatur of the Industry Commission's 1990 acceptance of the case for positive assistance to allow the industry to focus as rapidly as possible on its strengths and to liquidate its weaknesses. There was broad agreement between all, that assistance levels should come down, and that some assistance should be provided to export to enable our most efficient automotive producers to thrive at the expense of the least competitive producers.

Forward looking assistance

The current regime involves a tariff pause until 2004 together with the ACIS scheme, which replaced export facilitation and the duty free allowance. It has been a major success. Despite very substantial increases in import penetration in an ever more diverse market, Australian production has held up thanks to substantial and still growing vehicle and component exports and substantial investment in skills and in physical capacity. Nevertheless there are some signs that investment in the industry remains tentative, with the forecasts automotive producers provide Ausindustry indicating falling investment by component producers from a high in 2001, and sharply falling investment from a high of 2004 in the case of vehicle producers. These figures may be unduly pessimistic, but they strongly suggest that the Australian industry is not yet 'out of the woods' – that its future cannot be assumed and that it may be starved of capital in the future.

As helpful as ACIS has been as a transitional measure there remain structural and strategic issues in the automotive industry which this submission argues must be addressed *directly*, rather than as a by-product of an assistance regime which seeks to be 'all things to all men'. Ultimately the industry has the responsibility to address these issues.

However the drivers of the industry – the vehicle manufacturers are all foreign owned, and their commercial culture is not well suited to the particular and peculiar demands of our own market. As the terms of reference point out.

[B]y international standards, Australia is a small, mature and diverse market; for many firms, pursuing growth to achieve scale economy is a major priority. Global integration, including exports, is paramount to the future of the sector. The majority of firms in the sector are subsidiaries of overseas owned corporations, with investment decisions and the identification of potential export markets made on the basis of their

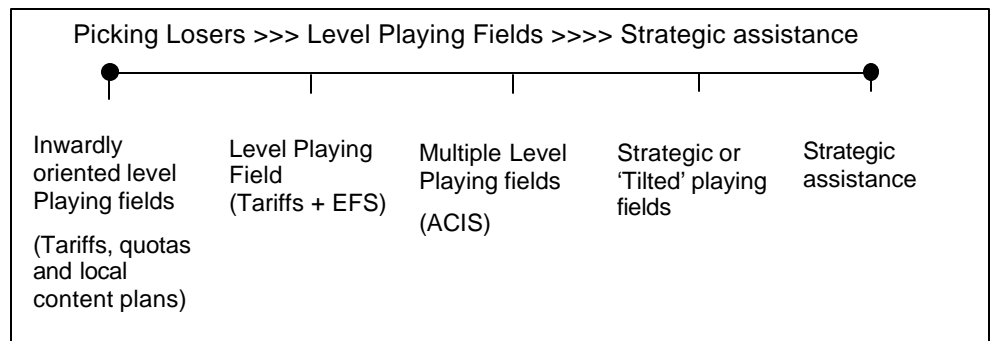
global operations (rather than simply in the interest of maximising returns on their Australian operations).

In these circumstances government agencies can play some role in encouraging greater rationalisation and efficiency. At the very least, for however long industry specific assistance remains, that assistance should not help firms to resist the forces of rationalisation. And where possible it should actively assist the process ahead of other objectives.

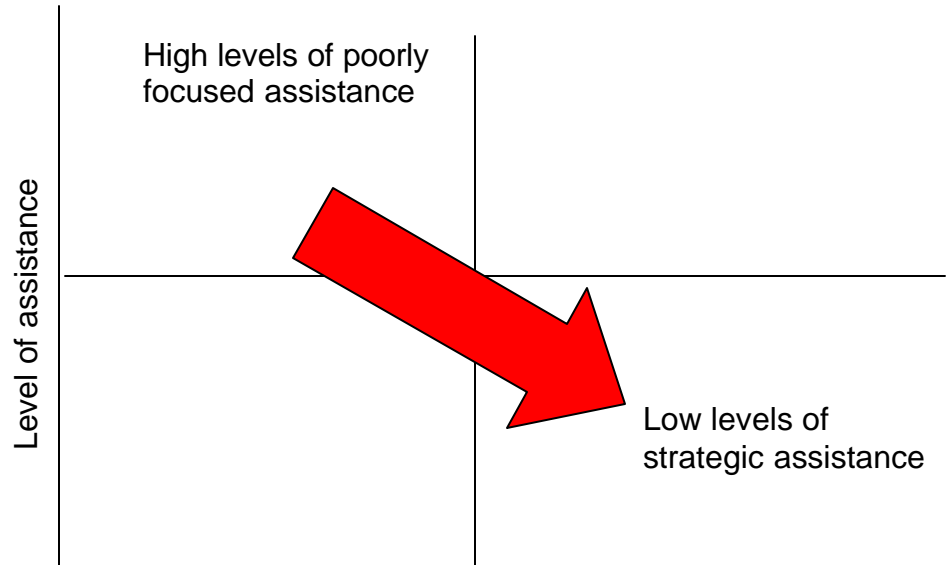
At the same time we now see an evolutionary change in the industry. Assemblers are withdrawing from some of their traditional activities in search of higher short-term returns – outsourcing their manufacturing and their capital requirements to Australia’s manufacturers. The dramatic changes in structure this entails means that we cannot afford for industry assistance to be just ‘more of the same’. We must develop a firm strong base of manufacturing that is sufficiently competitive that it will enable governments of the future to withstand the ‘blackmail’ of the major global players.

8. A strategic Australian policy response

Given this history, the time is now ripe to move beyond an assistance regime which set levels of assistance which were then administered as several ‘level playing fields’ within the industry. This is perhaps best explained using the following diagram. According to the schema set out in this diagram, as policy has moved from ‘riding on the Holden’s back’ to where we are now, it has moved from the left of the diagram to the right.



At the same time the level of assistance has been falling. This aspect of our situation is illustrated by adding another axis to the diagram producing a movement over the last twenty years from the top left of the space to the bottom right of the space.



Picking Losers >>> Level Playing Fields >>>> Strategic assistance

There are many advantages of providing assistance according to simple criteria that are seen to be 'fair' between different players in the industry. Typically such programs involve tariffs or subsidies to output. The apparent fairness of the criteria for assistance has political attractions. It ruffles fewer feathers. Also, where markets are relatively large compared with economies of scale, a 'level playing field' creates an environment in which winners pick themselves by doing best in competition with others in the industry for resources (and assistance). The methods we have used in the past have broadly followed this principle, but at the same time, in an effort to be 'fair' to other industries, we have been reducing the level of assistance to the automotive industry.

The period during which tariffs and export facilitation were both in operation provided the most 'level playing field' within the industry, and was also bringing down the differences between the automotive industry and other industries. Nevertheless, even where economies of scale are not important, there are reasons for believing that assistance can be further optimised. Providing it does not present undue administrative and compliance difficulties, assisting *incremental* changes in desired activity against some base level of performance will be much more cost effective. This is because incremental assistance will exclude much 'base' level of activity that would have occurred in any event without assistance.

This reasoning is strengthened when one considers the following issues:

1. Massive re-investment must take place if Australia is to remain competitive;
2. Australia is a relatively small market

3. Economies of scale are very substantial particularly on that part of the cost curve on which Australian automotive firms operate.
4. The level of assistance is now much lower than it was, capped at 5% of revenue under the present scheme;

This last point is clearly an important consideration. There clearly comes a point where a general non-strategic assistance regime will have a negligible effect on firm behaviour and so will generate all the costs of funding with negligible commensurate benefits. At this point a more strategic use of the same amount of assistance can still have a substantial effect.

The ACIS scheme illustrates this point very clearly. Assistance is capped at 5% of sales revenue – which, if it were paid to the industry as a straight production subsidy, would be unlikely to change its behaviour very much. With modulation now discounting credits by nearly 30%, many firms would be receiving assistance at rates well below 5% of sales. If this assistance were expended as a production subsidy it would have negligible effect.

Yet the scheme will cost over \$2.5 billion over the five years of its life, and this is an amount of money that is clearly capable of making a substantial difference to the industry if used in a strategic way. Already we know the scheme's more strategic elements within the components sector have given rise to substantial projects which would not have taken place without it. We also know that vehicle assemblers have been unsuccessful in securing very substantial export orders, which might have been secured with greater assistance.

The ACIS scheme took the first critical step towards a strategic approach to automotive industry assistance. However, this was coupled with a desire to provide continuity with past schemes – both the export facilitation scheme and the duty free entitlements of vehicle producers. Thus, in addition to whatever benefits might be available from tariffs on imports, each firm receives whatever benefits of ACIS it qualifies for according to its

- Production
- Investment in plant and equipment and/or
- Research and development.

The latter two heads of assistance correlate with investment for the future. However, it is still the case that ACIS credits stand to substantially assist firms which have low profitability, and which have little prospect or intention of being a vibrant part of the industry in ten or twenty years' time. Even where firms have effectively adopted a strategy of 'running down their capital', this may occur over a long period during which it may still be viable for them to take on additional supply contracts. Such contracts would enable them to make additional

marginal investments in plant and equipment and research and development and so continue to receive ACIS credits.

Nevertheless there are some difficulties associated with moving all the way towards 'strategic' assistance. Fully strategic assistance would involve qualitative judgements being made by government agencies about the strategic significance of different projects on a case by case basis as they came forward. It is certainly possible for those entrusted with such decisions on behalf of government to make errors, as indeed it is possible for automotive firms to err, or for policy makers to make errors in designing assistance schemes that do not discriminate in this way. My own view is that, providing such decisions were made at true 'arms length' from government – and indeed from vested interests of particular commercial players in the industry – that the successes would outweigh the failures and that costs would be minimised. But there is no doubt that those who were not awarded assistance would resent the scheme.

A less ambitious step would be to design a scheme that has a clear strategic intent, but operates according to specific strategic rules to which there is policy pre-commitment. One might call this the 'tilted playing field'. Thus, for instance, it would be possible to replace the existing ACIS scheme with a similarly funded scheme targeting *substantial increases* in desired activity. Desired activity would be capacity building in plant and equipment and research and development. But it might also make sense to assist increments in vehicle and component production – provided they were sufficiently substantial to be the result of some major new initiative and/or an indication of progress in moving towards a stronger industry structure.

If this more guarded move towards strategic assistance is taken, it could also be worth having a reserve scheme that could be used as a source of assistance for initiatives of great strategic significance. An obvious example would be the development of new variants of Australian vehicles, with production of sufficient levels to give confidence that there was scope for Australia to capture a production mandate for some niche product on the world market. An expansion of the Holden Monaro project provides a case in point or the production in adequate numbers of a new generation fuel efficient hybrid car. So too would be the rationalisation of the supplier sector in some area.

9. Making restructuring happen

It is not intended to suggest a 'blueprint' in this section, but rather to suggest an illustrative approach to facilitating industry rationalisation. It would be possible to establish a Working Group under the aegis of the Federated Chamber of Automotive Industries (FCAI), headed by an expert but independent Executive Chairman, with an independent

Project Director and support staff. Industry Operatives would be drawn from senior ranks within the car companies.

The body could be known as The National Automotive Strategic (NAS) Group. It would operate under the governance of a Steering Committee chaired by the Federal Industry Minister, and comprising the Executive Chairman, the four OEM CEO's, the Director of FAPM and the Industry Ministers of the automotive States (Victoria and South Australia).

A review to determine the continuation of the NAS Group would be undertaken by the Steering Committee after two years operation. In the event of consensus on this matter not being reached within the Committee, then the Federal Minister would determine the matter.

Methodology

Whilst the methodology by which of the Group pursues its objectives would be established within the Group as it became operational, the following broad outline is set out as a framework within which the work program would be developed. It is envisaged that the activities of the Group would fall under two broad headings:

1. Establishing a more sustainable structure for capabilities that already exist in Australia. (This could well include the introduction of new global Tier 1 companies to provide an umbrella for existing companies to operate as Tier 2's and 3's).
2. Developing strategies for the establishment in Australia of those capabilities which do not currently exist, but which are, or will be required by vehicle designs.

Strategies would obviously be developed within the existing Federal and State Government policy frameworks. In addressing both 1 and 2 above, the Group would:

- Consider the process capabilities required (both existing and not yet established);
- Consider the options for setting up such capabilities in a sustainable manner;
- Rank the various options in terms of
 - Acceptability to OEMs based on global procurement policies, and the potential to create a local presence from multiple sources through strategic partnerships, licensing arrangements, etc.
 - The aspirations of various supplier companies and means of achieving best fit between those of the vendors and their OEM customers.

- Develop strategies to enjoin other organisations having a direct interest in changed sourcing patterns.

The Group would then co-ordinate, and to the extent required by the parties, participate in negotiations to establish supply chain arrangements, and equity and corporate relationships where necessary.

This proposal does not seek to solve the problems of the industry, nor to prepare it for the future. It recognises the implications of the relative insignificance of the Australian industry in the global scheme of things, and proposes an operational forum in which it can bring its collective resources to bear and maximise its limited scale, in securing sources of supply which have long term sustainability.

It is estimated that as a result of the "Tiering Strategy" now starting to occur in the Australian Automotive Industry, that a transfer of required investment of around \$3 billion will move from the OEM's to the supplier industry during the next five to ten years. The existing supplier base does not have the financial capacity to accommodate this change further illustrating the need for rationalisation and restructuring.

10. A possible model

I have argued in Section 8 that we need a more strategic approach to policy, and outlined in the previous section an institutional body that could play a catalytic and facilitative role in bringing about the kind of change desired. I want to suggest a possible model that brings together these two approaches by specifying further the kind of policy option floated in Section 8, and proposing a resulting role in administering discretionary aspects of the assistance program for the NAS Group.

Let us assume for the sake of illustration that the automotive states – Victoria and South Australia – spend on an annualised basis \$40 million and \$20 million respectively in subsidies and special deals in 'bidding' for automotive investment for their states. ACIS has current funding of nearly \$570 million per annum. This gives us over \$600 million spent by government each year – a substantial amount of money. Just citing these numbers illustrates the amount of effort to which Australian policy makers have gone to help the industry. At the same time, it shows how adept we have been at shooting ourselves in the foot. For at the same time as we plough the community's resources into the (mostly foreign owned) firms in the industry, we fail to insist that the investment is made wisely. As a result we subsidise a range of individual investment decisions which fail to build the most competitive industry of which we are capable.

Public funds should not be spent on automotive investment without greater confidence that the investment structure to which it is contributing is not just in the interests of the firms undertaking it, but also in the interests of Australia.

In order to maximise the chances of this being the case, any budgetary assistance received by the industry (from either State or Federal Governments) should be received from an integrated national program focussed on strategic capacity building in the industry. In order that this not be too great a departure from the success of ACIS, the integrated program should resemble the ACIS scheme in certain respects. For instance, it could assist investment in plant and equipment and in R&D by some specified amount (with a bias in favour of R&D investment).

I believe what I have called ACIS II below should be further optimised in the following ways.

1. ACIS II should be national and integrated. That is, some contribution would be expected from the motor manufacturing states (Victoria and South Australia). This should be commensurate with the level of special investment assistance they have provided over the last five years, or with the relative size of the industry in their state, or with the degree of assistance firms in their states receive. The final formula would no doubt be a matter for political negotiation between Federal and State Governments.

If State Governments:

- were unwilling to contribute automotive firms located in their state; or
- offered new special investment incentives to the industry outside of ACIS II.²

firms in those states would be ineligible to receive ACIS II credits.

2. ACIS benefits would only go to firms that can meet some hurdle set so as to focus assistance on those firms that have a track record of strong growth. Accordingly, ACIS credits would be available to firms that have increased Australian sales, and physical and R&D investment each by more than 5% per annum on a 5-year-rolling-average basis. Further, they would be targeted at increases in investment, so that firms increasing their investment faster would receive more assistance.
3. If the firm were a newcomer it would have no track record to operate as a benchmark. Here if the newcomer were providing the industry with some enhanced or new capability as a new tier one integrator or tier two or three supplier (as assessed by NAS) it would be

² I have in mind that as part of gaining eligibility for ACIS under the scheme they would sign up to some 'code of conduct' which would specify what was and what was not acceptable behaviour in assisting new investment in the industry. There are a range of facilitative services that state governments can offer which should not be regarded as outside the spirit of the arrangements.

eligible for credits. However, if its entry simply rendered an already small market more crowded, it would only receive assistance once it had established itself and was able to demonstrate sustained growth over the medium term.

It may also be appropriate to direct some tranche of the assistance scheme to assist specific rationalisation projects assessed as necessary or desirable by NAS. The states would have involvement in the NAS group. They would purchase this at the cost of signing onto a code of conduct that would tightly constrain their ability to offer additional incentives for automotive investment in their own state.