

DEFENCE INDUSTRY COMPANION STUDY

“Examining options for economic improvement in the sector”

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The Inshore Patrol Vessels under construction in Whangarei.

Preface

1. In conjunction with the Defence Review, three companion studies were commissioned (with their own terms of reference) into the following areas:
 - Voluntary National Service;
 - Youth Programmes; and
 - Defence Industry.
2. This report focuses on defence industry, in particular *‘examining options for economic improvement in the sector’*. This study has been approached from three perspectives:
 - looking at ways to optimise New Zealand’s defence spending (both capital and operating) in the domestic economy;
 - examining the potential to develop New Zealand’s ‘defence industry’ export capability, particularly with Australia as well as the international market; and
 - examining the potential to improve economic activity from defence spending.
3. Overall, we see there being significant potential to lift New Zealand’s performance in the above areas. Consultation and engagement with domestic and international defence industry has been widespread. Submissions received as part of the Defence Review public consultation process have also informed the preparation of this report.
4. We are in a position to provide a response to the questions put to us as part of the terms of reference (available online at www.defence.govt.nz). In doing so, we will be highlighting issues which we consider relevant to a discussion on defence industry policy within the New Zealand context.
5. This report also makes a set of recommendations for the Government’s consideration around developing and implementing a defence industry policy tailored to New Zealand’s requirements.

Defence White Paper

6. We see the Defence White Paper (including the complementary companion studies) with its outlook to the 2025-30 period as ultimately being about the role defence plays in the delivery of **peace and security** to New Zealand and our near region (i.e. the South Pacific). We see the private sector as having an key role in supporting the delivery of this core national security outcome.

Economic conditions

7. Simultaneous to the development of the Defence White Paper, New Zealand has had to respond to the challenges of a domestic recession and global economic downturn. The Government has prioritised economic growth as the key to delivering jobs, incomes and living standards to the country. A study into defence industry is therefore timely and complements the work undertaken as part of the Defence White Paper process.

Scope of the New Zealand defence industry ‘sector’

8. We have defined ‘defence industry’ as any industry engaged or potentially engaged wholly or partly in support of the New Zealand Defence Force (NZDF) or involved in defence export activity¹. This is a broader description of the sector than would normally be found in larger western countries (i.e. US, UK, France or Germany). The broader description as used here is appropriate given our context of a relatively small country and industrial sector.
9. The New Zealand Defence Industry Association (NZDIA) is the preeminent industry body which has around 67 corporate members and growing. The NZDIA hosts the annual Defence Industry Forum which is a key regional defence industry event. The NZDIA has an active executive and is developing an industry plan to improve its engagement with key stakeholders.
10. Complementing, but separate to the NZDIA, is the Defence Industry Committee New Zealand (DICNZ). The DICNZ was formed in 1994 to improve communication between Defence and New Zealand industry. The Committee reports directly to the Minister of Defence and has a wide brief to provide advice to the Minister on defence and industry related issues. DICNZ membership consists of eight industry members appointed by the Minister of Defence, representatives from New Zealand Trade and Enterprise, the New Zealand Defence Force and the Ministry of Defence.
11. In addition the Manawatu region which hosts Linton Military Camp and RNZAF Base Ohakea and is in relatively close proximity to Waiouru and Trentham military facilities, has an active Defence ‘Hub’ of around 90 members.

What Government policies relating to Defence related industries currently exist?

12. Both the MoD and the NZDF operate within Government procurement policy and is based on the following principles (outlined in Table 1).

¹ This definition was used in “Government procurement policy – a study of effects on the defence industry” produced by the New Zealand Institute of Economic Research (February 2005). We also include parts of the science and technology community within this description.

Table 1.

Government procurement principles	
<ul style="list-style-type: none"> • Best value for money over whole-of-life. • Open and effective competition. • Full and fair opportunity for domestic (New Zealand) suppliers. • Recognition of our bilateral obligations to Australia (CER), Singapore (CEP), Chile and Brunei and our trade policy interests in open and transparent Government procurement markets. 	<ul style="list-style-type: none"> • Improving business capabilities, including e-commerce capability. • Offsets (in the sense of measures used to encourage local development by requiring domestic content) will not be imposed, sought or considered as a factor in the qualification, selection, evaluation or award of the contract. Commercially viable offsets that are freely offered may be accepted.

Local Industry Involvement

13. As outlined on the MoD’s website, any programme involving local industry is voluntary, must be commercially sustainable and not increase the price of the project. However, respondents are encouraged to examine opportunities with the potential to reduce the cost of the procurement and through life cost of the ownership of the equipment purchased.

Domestic (New Zealand) Opportunities

14. The Government’s procurement policy does not however, allow the MoD or the NZDF to use its purchasing as a direct lever for industry or regional development, for example, through domestic price preference or mandatory offsets (requirements on Government buyers to obtain commitments from overseas buyers to assist domestic industry).

What Defence related industries currently operate with New Zealand or overseas with substantial New Zealand ownership?

15. Largely New Zealand based companies which provide goods and services to MoD and NZDF (and internationally) include key industry players such as Safe Air Limited (a subsidiary of Air New Zealand), Babcock Fitzroy, and Lockheed Martin, through to a range of Small and Medium sized Enterprises (SME’s) mainly across the engineering, information technology, simulation, aviation, marine, communication, ordnance, training, project and facilities management sectors.

16. Contrary to the uninformed stereotypes attached to this sector, industry members are focussed on providing support, construction, facilities maintenance and infrastructure to the NZDF.

Table 2.

Leading New Zealand “Defence” Companies

<ul style="list-style-type: none"> • Babcock Fitzroy • Air New Zealand including subsidiary Safe Air Limited • Lockheed Martin • Yakka Apparel Solutions • PAE 	<ul style="list-style-type: none"> • MACE Engineering • MAROPS • Global Hydraulics • Ordnance Developments Limited • Pacific Aerospace Limited • GHD
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Overseas investment

17. Affirming the health of the New Zealand defence sector have been moves by defence multinationals to establish a presence in New Zealand, including Thales (2007) and Lockheed Martin (2010).

18. In March 2010 Lockheed Martin was awarded an initial 10-year contract as part of Project Alexander (SA1977) valued at more than \$100 million by the NZDF to provide the Army with warehousing and repair services. The contract allows for syndication with other New Zealand agencies particularly New Zealand Police. The agreement includes the maintenance, repair, and overhaul of the organization's equipment and supply chain services ranging from soldier store acquisition, such as tent and weapons, to warehouse sustainment.

19. Such investments should have positive spin offs not only for the NZDF (through the delivery of more cost effective and improved goods and services), but also for the wider economy through employment opportunities, investment and training.

20. Our view would be that New Zealand companies and defence multinationals would look to work collaboratively to deliver products which are of benefit to the NZDF, and which can be exported. Other benefits include the 'capability reach back' provided by these multi-nationals.

21. Additionally, increased collaboration between SMEs and defence multinationals could boost international competitiveness by exposing SME's to new technologies, new processes and world best practice, along with the opportunity to be involved in global supply chain activities.

22. We are aware that for most suppliers, while Defence is an important client, it is not necessarily the sole client. Most suppliers to Defence provide their products and services to a range of customers. We do, however, recognise that undertaking work for Defence does provide an increased measure of reputational capability, important for when companies seek to break into the export market.

What is the estimated total value of New Zealand defence related industry in terms of domestic supply, import and export?

23. Aggregated as a total annual figure, New Zealand defence spending is not insignificant. The Ministry of Defence (MoD) and NZDF is conservatively

estimated to spend at least NZ\$700 million annually² on capital **and** operating goods and services. Viewed over a ten year period, the total defence spend is significant by any standard.

Table 3.

Key areas of defence expenditure (in recent years)	
Capital Acquisition	Support and Operating Expenditure
<ul style="list-style-type: none"> • Medium Utility Helicopter • Training Light Utility Helicopter • P-3K Orion Upgrade • C-130 Life Extension • Project Protector • Light Operational Vehicles • Light Armoured Vehicles • Night Vision Equipment 	<ul style="list-style-type: none"> • Maritime Maintenance and Support • Aviation Maintenance and Support • Information Technology Services and Software Development • Vehicle Fleet Maintenance and Support • Infrastructure and Site Management Services • Civil Engineering Services • Specialised Military Training Systems • Apparel/Clothing Suppliers

24. Most of the MoD's capital acquisition (and therefore project expenditure) has taken place offshore. By contrast, the NZDF's operating expenditure is largely spent domestically. In the future, as part of the Government's recently introduced Capital Asset Management (CAM) regime, which requires a greater investigation of whole-of-life costs as part of Government procurement, we expect that opportunities for local suppliers will become identified earlier in the procurement process and allow for increased scope for involvement in capital projects. The CAM process will require time to bed in before results can be evaluated.

Which countries currently buy or sell defence products and services from or to New Zealand?

Table 4.

Key suppliers of defence goods and services to New Zealand	
<ul style="list-style-type: none"> • Australia • United Kingdom • North America 	<ul style="list-style-type: none"> • Europe (particularly France and Italy) • East Asia (primarily Singapore)

² 2010 figures (based on the accumulative totals of MoD and NZDF capital expenditure and the NZDF's operating spend).

Exports

25. While a number of New Zealand companies are active agents or exporters in the defence sector, to date, records of the value of defence/dual use exports have not been recorded by relevant Government agencies, nor industry bodies. With that said, we are aware that a number of New Zealand companies are very active in the international market particularly Air New Zealand/Safe Air, Ordnance Developments Limited and Pacific Aerospace Limited as outlined below.

Case Study: Pacific Aerospace Limited and L-3 Communications



26. Pacific Aerospace Limited a Hamilton based aviation company has partnered with defence multinational L-3 Communications to offer its versatile P-750 XTOL platform, designed and manufactured in New Zealand in the global defence and civilian markets.

27. This partnership is a prime example of what can be achieved by local industry.

28. Like other SME's, Pacific Aerospace is keen increase their share in the international market, and also seeking to leverage off work undertaken with the NZDF.

Utilisation of Defence Attaché's (DA's) and Government agencies

29. We note efforts by DA's to assist companies in the promotion of their products internationally. Our DA's are well connected and regarded by their international interlocutors and we should look to leverage off this positive reputation in a way which benefits our economy. We see scope to more effectively utilise DA's in concert with New Zealand Trade and Enterprise and the Ministry of Foreign Affairs and Trade to assist in the promotion and support of the defence industry sector in a more coordinated and pro active way.

Identified Issues

What impediments to the growth of defence related industry in New Zealand currently exist?

30. As outlined below. Overall feedback and perceptions from industry underpinned by submissions received as part of the public consultation process can be aggregated into the following points:

Government Procurement processes

- Those interviewed were largely critical of Government procurement policy. As they stand, and in our view, these processes are ill suited to the defence sector. Procurement processes have sometimes been lengthy, resource intensive and burdensome for industry to engage in.
- There is no established common understanding within MoD and NZDF and wider Government agencies of what constitutes “Through Life Support” and “Total Cost of Ownership”.

Relationships

- Closer relationships, based on improved communication, between MoD and NZDF, and industry would be mutually beneficial. The limited size of our defence and industry sectors compels closer cooperation between the two to maintain the sustainability of their respective capabilities.
- Taking a longer term view of contracting, thereby increasing the value of through-life-support would assist industry in investing. This could mean a move from contract/supplier relationship to a ‘partnership’ relationship.
- Overall there is a lack of an integrated approach between defence, wider government agencies and industry to promote domestic suppliers to defence. In our view, increased utilisation of existing Government services such as Industry Capability Network would be useful.

Intellectual Property (IP) challenges

- We have been encouraged by the efforts of the Defence Technology Agency (DTA) to develop IP for the NZDF and commercialise the products with an industry partner. For example DTA engagement with Bluewater Systems, Marops and Skycam amongst others provides a guide to ongoing collaboration. Where appropriate, more IP which was developed for the NZDF should be commercialised.

Industry Participation Plans

31. Looking across the Tasman, a common tool to assist in ensuring public spending is invested in the local economy is through the use of Industry Participation Plans (IPPs).
32. These are required by Australian Federal, and most State and Territory Governments for publically funded infrastructure and resource-based projects valued above a certain level. These threshold levels vary from \$1 million to \$5 million, depending on the jurisdiction. IPPs seek to:
- Boost local employment and business growth by maximising opportunities for local SMEs;
 - Improve international competitiveness by exposing SME's to new technologies, new processes and world best practice; and
 - Provide additional opportunities for SME's to be involved in global supply chain activities and exports.
33. The potential benefits of IPPs are compelling. Industry Capability Network (ICN) commissioned Business and Economic Research Limited (BERL) to calculate the benefits to New Zealand (as a whole) of spent project/major purchasing money with local companies rather than offshore ones. The latest report was completed February 2009 and uses 2007/08 statistical data and the 2008 tax changes, it shows that for every \$1m of import replacement or local spend NZ benefits by:

- 10.4 jobs created or retained.
- \$108,457 of tax revenue.
- \$207,762 of increased purchasing power.
- \$128,685 saving of government welfare payments.

34. The model that Australian states use could be customised effectively for New Zealand. The adoption of IPP's would need to operate within Government procurement guidelines and be consistent with our international trade obligations.

Benefits of IPPs

35. An example of the effective usage of IPPs in Australia include:

- **ANZAC Ship Project:** required industry participation and set local content targets. Some New Zealand companies are still servicing this contract (i.e. Mace Engineering) nearly 18 years on from project start up.
- **Light Armoured Vehicle (LAV) turrets:**



the Australian Government required local content as part of the second Phase of Project ASLAV, which saw GMD establishing their global turret fabrication facility in Adelaide. Around 500 LAV turrets (and follow on orders) have been produced in Adelaide (including 105 for the NZDF). By contrast New Zealand did not require a local industry content as part of its LAV purchase.

IPPs resource cost

36. The inclusion of IPPs would be made mandatory as part of a response to a tender or proposal issued by the MoD or NZDF. IPP templates would need to be made available to industry.
37. The adoption of IPPs in itself would not have a financial implication, but support and monitoring through the NZT&E's ICN programme would have a staffing resource implication, as this activity would be additional to work currently undertaken within the ICN.

Associated Issues

Scientific & Technological

38. We consider defence industry, with its focus on technology and innovation, to include parts of the scientific research community. Increased engagement between the Defence Technology Agency (DTA), Crown Research Institutes, tertiary institutions and industry to work together as outlined below provides a guide for future collaboration:
 - Commercialisation of DTA developed IP in the area of unmanned aerial vehicles and secure communication equipment in collaboration with New Zealand firms has been successful.
 - DTA works closely with tertiary institutions, underlined by an MOU between Defence and Massey University provide a guide to future collaboration. This offers extensive opportunity for development .
39. The report by the Crown Research Institute Taskforce provides a basis to take science and technology initiatives forward.

Commercialisation, outsourcing and Public Private Partnerships (PPPs)

40. Over the past ten to fifteen years, the NZDF has embarked upon a process of increased commercialisation and outsourcing. Parts of NZDF installations have been opened up to commercial operators who lease the facilities³, whilst the NZDF maintains ownership and in some cases shares profits.
41. The Defence White Paper calls for greater savings and efficiencies in the areas of Human Resources, Infrastructure and IT management, and the

³ For example: Babcocks Fitzroy operate out of the dockyard at HMNZS Philomel, Lockheed Martin are located at Trentham Army Camp, Safe Air Ltd operate from RNZAF Base Woodbourne.

defence estate. The NZDF already relies on a high degree of outsourcing to support its day to day operations. Functions previously provided in house are now provided by contractors as follows:

Main areas of NZDF outsourcing	
<ul style="list-style-type: none"> • Facility management and support • On site security services 	<ul style="list-style-type: none"> • Training. • Platform Maintenance and Support

42. The NZDF has also stepped up its cooperation with other state agencies for cost effective solutions, examples include:

- Joint Army and District Health Board cooperation to purchase medical and dental stores to enhance buyer capacity; and
- the new NZDF rations contract being developed in conjunction with the Department of Corrections and being offered to wider agencies.

43. In our view, outsourcing and commercialisation within the NZDF will continue to increase as the NZDF redistributes its resources towards the frontline. Investigation of PPP opportunities by the MoD and the NZDF are also mandated by Government. These activities are not without their challenges, however, provided an appropriate governance structure is developed, the right incentives are put in place and parties work from the position of a partnership arrangement they can be mutually beneficial.

Australia / New Zealand – Closer Economic and Defence Relations

To what extent are the intentions or structures within CER and CDR, relating to Defence industry, being achieved?

44. The companion study has examined the Closer Economic Relations (CER) and Closer Defence Relations (CDR) and their intentions and structures relating to defence industry. This is in line with concepts of Trans-Tasman cooperation as outlined in the **Prime Ministerial** joint statement of 20 August 2009 and reflected in the spirit of **Defence Ministerial** joint statement of 30 September 2009.



45. Feedback from industry indicates that while some companies have been successful in gaining contracts as part of the ANZAC frigate project and Project Protector, many other NZ companies, for a variety of reasons, have not had the opportunity to play more of a role in the trans-Tasman defence market. With the release of Australia's defining defence white

paper in 2009 there is an opportunity for the New Zealand industry to play a key role alongside Australian industry in assisting in delivering of those objectives.

46. In our experience, successful economic cooperation (such as CER) rests on **institutionalisation**. We are therefore considering ways in which Australia and New Zealand defence industry can work more closely together. Our initial thinking includes the following:

- The inclusion of a defence industry related protocol into the CDR framework to institutionalise defence industry cooperation.
- Appointment of an leading Australian to the DICNZ.
- We would also anticipate a reciprocal appointment to the Australian equivalent.
- Potential secondment opportunities between officials who work on defence industry strategy and engagement.
- Regular Australia/New Zealand defence industry consultations, undertaken within the CDR framework. This could mean reports on defence/industry cooperation being provided to Defence Ministers at their annual meeting.
- Additional joint defence related trade missions.



Repairs carried out on a P-3 Orion at Safe Air Ltd

Findings and Recommendations

What measures should be implemented to assist the growth of New Zealand's defence – related industry?

47. We put forward the following recommendations for the Government's consideration.

48. We recommend the Government, through, adopt the below principles as the underlying basis for a defence industry policy which meets New Zealand's requirements.

- **Recognise** that New Zealand industry has a fundamental contribution to make to the development, support, training and operation of the NZDF's capabilities and the outputs Defence provides to Government;
- **Improve** Government procurement to:
 - Increase dialogue between industry and Defence, to ensure more cost effective capability solutions for Defence
 - Ensure industry/commercial representation on Defence capability and procurement management boards
- **Encourage** innovation in the defence sector to involve New Zealand companies more in Defence business, particularly through increased consideration of PPPs / joint ventures to achieve Defence's outputs to Government;
- **Support** New Zealand industry in developing its export capability particularly into Australia, and industry's ability to engage in international industry more generally; and
- **Commit** to increased collaboration between Defence and Industry, underpinned by improved communication flows.

49. Below are practical measures which deliver the outcomes desired from the above principles:

Defence Industry Engagement Unit

50. The formation of a dedicated unit within the MoD i.e. a Defence Industry and Engagement Unit (DIEU) to be a point of contact for industry and government agencies on industry related issues. DIEU would increase the engagement between defence and industry. The DIEU would be staffed by personnel within MoD and NZDF who already work on defence industry related issues. The DIEU would:

- develop and implement on a strategic framework for defence/industry engagement;
- with industry, Defence (particularly Defence Attaché's) and wider government agencies identify, prioritise and support export opportunities in the defence sector in a coordinated and proactive manner;

- update industry on developments on key defence capability projects and the potential for industry involvement;
- with ICN provide advice on IPPs; and
- provide advice on export clearances for industry which are led by MFAT.

Industry Participation Plans

51. Adoption of IPPs for appropriate capital projects and significant support activities undertaken by Defence. NZTE's ICN would assist in the development and implementation of IPPs in conjunction with Defence. The inclusion of IPPs would be made mandatory as part of a response to a tender or proposal from the MoD or NZDF.

Defence and Industry Development Course

52. Establishment of a Defence and Industry Development Course (DIDC) involving mid level management from defence, industry and the scientific and technological community to share views, discuss issues of mutual interest and increase the level of engagement between defence and industry.

53. DIDC could be based around the annual Defence Industry Forum and be hosted at defence facilities in Wellington. A programme could include briefings from senior defence officials, presentations from industry, site visits, and collaborative case studies.

Enhancement of the Defence Industry Committee New Zealand (DICNZ)

54. We recommend the enhancement of the DICNZ to be a more strategic and influential body i.e. an Executive Board nominally chaired at Ministerial rank. DICNZ would then have the ability to ensure that the proposed defence industry policy framework is being implemented and adhered to.

55. Appointment of an Australian as a member of the DICNZ (which reports to the Minister of Defence) to act as an advocate for New Zealand industry in Australia and provide advice to DICNZ. We would also anticipate a reciprocal appointment to the Australian equivalent.

Australia

56. We recommend the consideration of the following initiatives with regard to broadening and deepening trans-Tasman engagement:

- The inclusion of a defence industry related protocol into the CDR framework to institutionalise defence industry cooperation.
- Potential secondment opportunities between defence personnel who work on defence industry strategy and engagement;
- Additional joint defence related trade missions; and

- Regular Australia/New Zealand defence industry consultations, undertaken within the CDR framework. This could mean reports on defence/industry cooperation being provided to Defence Ministers at their annual meeting.

Procurement

57. We found industry, in general, to be critical of Government procurement policy as it relates to long term specialised defence purchasing and relatively small enterprises. Cost and uncertainty make entrance into the sector difficult. The new Capital Asset Management (CAM) regime may be of assistance. Looking however to the development of the New Zealand Defence Industry for the long term within an ANZAC framework, the Study Team recommends for long term development, support and maintenance, the establishment of a separate Defence procurement system.

Summary

58. Aside from the recommendation in paragraph 57, our other recommendations do not cut across existing policy settings. They look to enhance current arrangements without imposing additional resource costs, and develop an essential Defence Industry base for the long term that will enhance specialised industry and employment and increase national income without imposing undue resource costs.

<p>Hon Hugh Templeton Chair: Study Team</p>	<p>Mr Neal Garnett Member: Study Team</p>
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Glossary

BERL	Business and Economic Research Limited
CDR	Closer Defence Relations
CER	Closer Economic Relations
DA's	Defence Attaché's
DIA	Defence Industry Association
DICNZ	Defence Industry Council New Zealand
DIDC	Defence and Industry Development Course
DIEU	Defence Industry and Export Unit
DTA	Defence Technology Agency
ICN	Industry Capability Network
ICP	Industry Cooperation Programmes
IP	Intellectual Property
IPPs	Industry Participation Plans
LAV	Light Armoured Vehicle
MoD	Ministry of Defence
MOU	Memorandum of Understanding
NZDF	New Zealand Defence Force
NZT&E	New Zealand Trade and Enterprise
SME's	Small and Medium sized Enterprises



Minister of Defence, Hon Wayne Mapp presents Richard Thompson of W.M. Brown the Special Recognition Award.

