

## HON PEENI HENARE, MINISTER OF DEFENCE

### Defence: Depreciation Shortfall Funding

February 2022

This publication provides papers associated with Cabinet's November 2021 decision on making baseline adjustments as a pre-commitment through Budget 2022 to relieve depreciation-related operating baseline pressure arising from sustainment capital investments made, or planned to be made, during the 2020/21 – 2022/23 financial years.

The pack comprises the following documents:

- November 2021 Cabinet Government Administration and Expenditure Review Committee Minute of Decision *Defence: Depreciation Shortfall Funding* [GOV-21-MIN-0050]; and
- The associated Cabinet Paper *Defence: Depreciation Shortfall Funding* [GOV-21-SUB-0050].

This pack has been released on the New Zealand Defence Force website, available at: [www.nzdf.mil.nz/nzdf/search-our-libraries/documents/?document-type=Official+information&sort=relevance](http://www.nzdf.mil.nz/nzdf/search-our-libraries/documents/?document-type=Official+information&sort=relevance).

Certain information has been withheld in accordance with:

- section 6(a) of the OIA: *would prejudice the security or defence of New Zealand or the international relations of the Government of New Zealand;*
- section 9(2)(b)(ii) of the OIA: *would be likely unreasonably to prejudice the commercial position of the person who supplied or who is the subject of the information;* and
- section 9(2)(f)(iv) of the OIA, *to: maintain the constitutional conventions for the time being which protect the confidentiality of advice tendered by Ministers of the Crown and officials;*
- section 9(2)(g)(i) of the OIA, *to: maintain the effective conduct of public affairs through the free and frank expression of opinions by or between or to Ministers of the Crown or members of an organisation or officers and employees of any public service agency or organisation in the course of their duty;* and
- section 9(2)(j) of the OIA, *to: enable a Minister of the Crown or any department or organisation holding the information to carry on, without prejudice or disadvantage, negotiations (including commercial and industrial negotiations).*

In addition, Annex A is withheld in full in accordance with sections 9(2)(f)(iv) and 9(2)(j) of the OIA; and Annex B is withheld in full in accordance with sections 6(a), 9(2)(f)(iv) and 9(2)(g)(i) of the OIA.



# Cabinet Government Administration and Expenditure Review Committee

## Minute of Decision

*This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.*

### Defence: Depreciation Shortfall Funding

**Portfolio**                      **Defence**

On 25 November 2021, the Cabinet Government Administration and Expenditure Review Committee:

- 1        **noted** that the Vote Defence Force funding increase at Budget 2020, reflecting the outcome of the 2019 Defence Baseline Review, <sup>s.9(2)(g)(i)</sup>
- 2        **noted** that additional funding is needed <sup>s.9(2)(f)(iv)</sup>
- 3        **noted** that any further reprioritisation of existing operating baseline to meet depreciation requirements <sup>s.6(a)</sup>
- 4        **noted** that the recommended sustainment investments to be approved during the 2021/22 financial year are the minimum necessary to maintain NZDF readiness for government-directed tasks;
- 5        **noted** that it is important to maintain the recommended sustainment investments to ensure the viability of New Zealand suppliers and workforces;

- 6 **approved** the following changes to appropriations for the depreciation expense to enable critical capability sustainment investments to proceed, with a corresponding impact on the operating balance and/or net Crown Debt:

Vote Defence Force Minister of Defence	NZ \$M – increase/(decrease)				
	2021/22	2022/23	2023/24	2024/25	2025/26 & Outyears
Departmental Output Expenses: Air Force Capabilities Prepared for Joint Operations and Other Tasks (funded by revenue Crown) Army Capabilities Prepared for Joint Operations and Other Tasks (funded by revenue Crown) Navy Capabilities Prepared for Joint Operations and Other Tasks (funded by revenue Crown)	s.9(2)(f)(iv)				
<b>Total Operating</b>					

- 7 **agreed** that the changes for Vote Defence Force appropriations for 2021/22 above be included in the 2021/22 Supplementary Estimates, and that, in the interim, the increases be met from Imprest Supply;
- 8 **agreed** that the expenses incurred under paragraph 6 be charged s.9(2)(f)(iv)

Rebecca Davies  
Committee Secretary

**Present:**

Hon Grant Robertson (Chair)  
Hon Dr Megan Woods  
Hon Chris Hipkins (Deputy Chair)  
Hon Stuart Nash  
Hon Kris Faafoi  
Hon Peeni Henare  
Hon Jan Tinetti  
Hon Michael Wood  
Hon Kiri Allan  
Hon Meka Whaitiri  
Dr Deborah Russell, MP

**Officials present from:**

Office of the Prime Minister  
Officials Committee for GOV

Office of the Minister of Defence

Chair, Government Administration and Expenditure Review Committee

## **DEFENCE: DEPRECIATION FUNDING SHORTFALL**

### **Proposal**

1. This paper seeks operating baseline funding for the New Zealand Defence Force of **s.9(2)(f)(iv)** over the period to FY2025/26, to fund the depreciation cost of near term capital investments for sustainment activities to maintain ships, aircraft and other essential operational capabilities.
2. This will ensure that the NZDF continues to have the capabilities available to maintain essential operational readiness for disaster relief, regional support and to respond to unforeseen emergencies.

### **Relation to Government Priorities**

3. This paper reflects funding requirements that collectively allow the NZDF to sustain current capabilities and keep them prepared for operations, both at home, in the Pacific, and further afield. It supports Government's priorities (CAB-20-MIN-0525 refers) as described below.
4. Objective 1: Keep New Zealanders Safe from COVID-19. The NZDF is taking a major role in New Zealand's COVID-19 response. This includes support to Pacific Island nations, supporting the human, social and economic interdependency between them and New Zealand.
5. The ability of the NZDF to manage and sustain its responsiveness is dependent on keeping its range of capabilities serviceable. It ensures that the NZDF can respond to concurrent security and border protection tasks, other Government-directed tasks including Op PROTECT<sup>1</sup>, and maintain readiness for emerging and short-notice emergency tasks. This supports the wellbeing of New Zealanders and people in the Pacific.
6. Objective 2: Accelerating the Recovery. The ongoing major maintenance and sustainment activities underpinning capabilities have a high domestic focus. Whilst many components for major equipment have to come from overseas, the major servicing of platforms is undertaken in New Zealand by a combination of NZDF personnel and New Zealand-based companies, such as Babcock in Auckland, Airbus in Blenheim, and BECA and Lockheed Martin New Zealand, who operate across the country.

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<sup>1</sup> Op PROTECT is the name of the combined NZDF operations in support of the all of Government response to COVID-19

7. Objective 3: *Laying the Foundations for the Future*. Ensuring that personnel have the equipment they need and that the equipment is kept in good condition is key to the NZDF's ability to deliver on Government priorities into the future.
8. The investments addressed by this paper also align with our Defence priorities of People, Infrastructure and the Pacific.

### **Executive Summary**

9. Each year, the NZDF manages a range of capital investment activities that provide for the major maintenance and long term sustainment of capabilities. These investments incur ongoing depreciation costs.
10. Budgets 2020 and 2021 s.9(2)(f)(iv)
11. The New Zealand Defence Force has managed the funding shortfall in the short-term, committing to a minimal number of capital spends as an interim measure, to prevent immediate output failure, ensure stewardship of high-value assets, and to meet ongoing contractual obligations to New Zealand suppliers. These projects will generate \$57 million steady state depreciation expense that will be provided to as a cost pressure bid through the Budget 2022 process. Although this cost pressure is not sought through this paper, it is indicative of the wider depreciation cost challenge.
12. Essential sustainment investments that can be approved from May 2022 onwards s.9(2)(f)(iv)
13. The immediate problem is essential sustainment investments that need to be approved between now and May 2022. This is to keep key capabilities available to undertake operations, and to maintain the domestic supplier and industry base that delivers these sustainment activities.
14. I have asked the NZDF to identify those investments that are essential to maintain capabilities in the short term. My recommended solution is an interim baseline adjustment that will cover the ongoing depreciation costs of the s.9(2)(f)(iv) of key capital investment activities that must be approved in order to maintain capability, particularly over the 'peak demand' summer/autumn periods this year and next year. The cost of this proposal is s.9(2)(f)(iv) over the period to FY2025/26.

### **What is the Problem?**

15. The NZDF spends significant capital every year on the repair and routine maintenance of major assets to keep them operational and protect their capital value; the ongoing replacement of small equipment; and the sustainment of infrastructure and Information Technology assets. Whilst the exact nature of each

expenditure item changes from year to year, they are effectively a non-discretionary annual cost of maintaining and supporting the asset base<sup>2</sup>.

16. This expenditure ensures critical equipment and major platforms (ships, aircraft and vehicles) are available to train and to deliver operations when called upon by Government. These operations may consist of resource and border protection and emergency response activities within New Zealand, assisting our Pacific neighbours facing the same challenges, and contributing to global obligations alongside our partners.
17. If sustainment capital investments are not made on an ongoing basis, it leads to operational output failure. Assets may become unusable through either failure of major components or because they do not meet minimum worthiness and certification requirements (similar to that required for any civilian transport operator). All platforms require regular sustainment, but the need is even more acute with our older platforms still in service. It also ensures our personnel, especially those charged with immediate response, are equipped with what they need to undertake what can be very hazardous operations.
18. Once sustainment capital spending has been approved, depreciation is a significant annual expense incurred, averaging \$40M, which cannot be deferred, avoided or waived.
19. Until 2019, any increases in depreciation costs have been covered retrospectively through an increase in baseline funding sought through the annual Budget process as a cost pressure initiative. The Defence Mid-Point Rebalancing Review 2013 (DMRR) set up this funding mechanism in line with the indicative Vote Defence Force funding track approved by Cabinet.
20. This depreciation funding mechanism has now changed to be aligned with all other agencies whereby operating funding is required to be identified to cover the depreciation expenses before the capital investment goes ahead.
21. The 2019 Baseline Review of Defence did not consider the funding requirements of the Defence Capability Plan 2019 which included the capital sustainment and maintenance of existing assets. [s.9\(2\)\(g\)\(i\)](#)
22. The NZDF has prioritised or halted any further investment approvals. The NZDF has acted to ensure that key capabilities remain available in the short term by approving investment in their sustainment. These include HMNZS Canterbury, HMNZS Manawanui, one B757 aircraft, one Seasprite helicopter and one C-130 Hercules.

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<sup>2</sup> The NZDF maintains an overall asset base with a value of \$8.0B.

23. Beyond these, all sustainment investments planned for FY2021/22 that are not already committed [s.6\(a\), s.9\(2\)\(f\)\(iv\)](#)

### Distribution of NZDF Baseline Funding

24. The NZDF has a current baseline of \$3.1 billion (90% fixed, 10% marginal/variable). A breakdown is shown here:

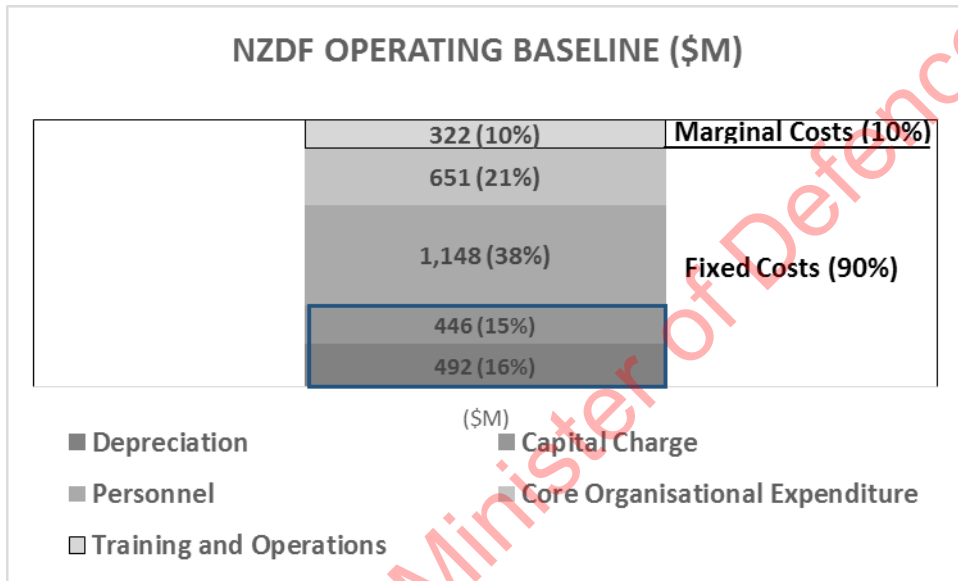


Chart 1: NZDF Operating Baseline

25. Depreciation and Capital Charge (31%). \$938 million is required for depreciation and capital charge. These costs of capital investment cannot be deferred, avoided or waived.

26. Personnel (38%). The workforce investment required is \$1,148 million. Following the Baseline Review, the NZDF is currently working on a Workforce Strategy in which I will bring to Cabinet in due course. This shows that although the NZDF now has a sustainable workforce strategy [s.6\(a\), s.9\(2\)\(f\)\(iv\)](#)

27. Core Organisational Expenditure (21%). \$651 million is required in the following key areas; [s.6\(a\), s.9\(2\)\(j\)](#)

These costs are relatively fixed in the short to medium term. The level of investment is efficient with only two prioritisation options available

<sup>3</sup> These costs include unique expenses for NZDF including the Youth Development Unit, Defence Technology Agency and Veterans' Affairs as well as those elements consistent with operating a 14,000 strong workforce.

(travel and contractors) and these costs have been reduced following the Baseline Review.

28. There are also a number of emerging cost pressures including inflationary pressure on the estate, ICT, logistics and engineering as well as <sup>s.6(a), s.9(2)(f)(iv)</sup>
29. Training and Operations (10%). If a funding uplift is unavailable, savings would need to be found within the remaining \$322 million operating component of the NZDF's baseline. These are the marginal costs of direct training and operating aircraft, ships, vehicles and other military equipment. These costs are variable, based on the utilisation of these assets and activities carried out. Funding the additional depreciation cost wholly within baseline would need to come from a reduction in sea days, flying hours or training activities.
30. This is consistent with the Baseline Review that found "NZDF's capabilities have large fixed costs and marginal operating costs in general make up less than 10% of the total capability expenditure. Relatively small increases in operating funding should result in higher utilisation and increased efficiency of expenditure". The converse is also true: absorbing additional depreciation costs will have a disproportionately large impact on outputs across the NZDF.
31. Therefore the NZDF cannot afford within its existing baseline the additional operating costs that arise from the capital investments detailed in Annex A. Any further reprioritisation of existing operating baseline to meet depreciation requirements would reduce the level of training and operational activity of NZDF platforms and people. The NZDF needs new depreciation funding to be agreed by Cabinet so that these capital investments can go ahead.

## Budget 2022

32. <sup>s.9(2)(f)(iv)</sup>

33. <sup>s.9(2)(f)(iv)</sup>

## The short term solution

34. The NZDF has carefully analysed the proposed FY2021/22 capital investments that are suspended to determine those that can be deferred with only limited negative consequences until Budget 2022 is determined.

35. <sup>s.6(a)</sup>

It is proposed that Cabinet approve a baseline adjustment



to fund the depreciation impact of funded capital investments totalling s.9(2)(f)(iv) and allow work to be commenced.

36. Annex A identifies the investments and Annex B provides a more comprehensive description of each activity.
37. Each of the activities has been prioritised because of the immediacy of the need. In particular, they affect assets that are either on immediate call and/or are most likely to be required during the upcoming summer seasons, with the attendant high probability of natural disasters (such as bushfires), adverse weather events in the Pacific (especially cyclones) and the seasonal requirements for servicing the Antarctic and other remote locations.
38. The ships *Canterbury*, *Manawanui* and *Aotearoa* have unique capabilities, and ensuring their availability provides assurance to Government. Maintaining the frigates adds depth to the maritime response capability, as well as essential training as the force is regenerated. The Naval Patrol Force vessels also provide agency support and response options within New Zealand waters and into the Pacific.
39. Summer sees extensive tasking for the air transport fleet to service Antarctica and maintain immediate readiness for Pacific emergencies. The helicopters are also an important part of our disaster response capability, which is why they are prioritised along with the ships that can support aviation.
40. The other compelling reason for undertaking the above investment activities is to sustain our domestic industrial base and manage capacity. New Zealand has limited means to undertake major sustainment activities, and the providers depend on the regular scheduled workflow to maintain critical mass in their workforce. For this reason, the NZDF has a range of regular contracts with essential providers. Failure to meet schedules can result in penalty payments, and to prevent this, I consider it prudent that the NZDF is able to honour its contracts.
41. s.6(a), s.9(2)(b)(iii)

42. As Annex A shows, the NZDF has been judicious in recommending these investments. They have only recommended those that are essential to ensure that we have the capabilities on which we rely, especially during the summer/autumn

seasons. For the ships' maintenance, it reflects only the core activities necessary to maintain the vessels which will be managed across the fleet as work progresses, with other work deferred. This will also ensure that Babcock has sufficient demand to keep the existing skilled workforce employed during this financial year, and not risk exceeding their capacity in future years. <sup>s.9(2)(f)(iv)</sup>

## The Cost

43. The table below shows the total capital cost of the recommended investments, and the annual impact on the operating baseline. The capital cost is all met from accumulated depreciation reserves. The request for baseline assistance is only for the operating cost impact.

Investment Area	Capital Commitment (\$M)	Unfunded depreciation expense (\$M)				
		2021/22	2022/23	2023/24	2024/25	2025/26 and outyears
Aotearoa	s.9(2)(f)(iv), s.9(2)(j)					
Canterbury						
Frigates						
Littoral Warfare						
Patrol Vessels						
B757						
C-130						
NH-90						
Seasprite						
Special Forces Equipment						
ICT and other Infrastructure						
<b>TOTAL</b>						

Table 1: Forecast depreciation expense arising from FY2021/22 capital investments

## Other Implications

44. There are no legislative, gender, disability, climate change, or human rights implications resulting from this proposal.

## Consultation

45. This paper has been prepared by the New Zealand Defence Force. The Ministry of Defence and Treasury have been consulted. DPMC has been informed.

## Communications

46. No communications are planned.

## Proactive Release

47. This paper will be proactively released in accordance with Government policy.

## Recommendations

The Minister of Defence recommends that the Committee:

1. **note** that the Vote Defence Force funding increase at Budget 2020, reflecting the outcome of the 2019 Defence Baseline Review, <sup>s.9(2)(g)(i)</sup>
2. **note** that the indicative funding requirements for steady state <sup>s.9(2)(f)(iv)</sup>
3. **note** that any further reprioritisation of existing operating baseline to meet depreciation requirements would reduce the level of training and operational activity of NZDF platforms and people;
4. **note** the recommended sustainment investments to be approved during FY2021/22 are the minimum necessary to maintain NZDF readiness for Government-directed tasks;
5. **note** the importance of maintaining the recommended sustainment investments for the viability of New Zealand suppliers and workforces;
6. **approve** the following changes to appropriations for the depreciation expense to enable critical capability sustainment investments to proceed, with a corresponding impact on the operating balance and/or net Crown Debt:

Vote Defence Force Minister of Defence	NZ \$M – increase/(decrease)				
	2021/22	2022/23	2023/24	2024/25	2025/26 & Outyears
Departmental Output Expenses:	s.9(2)(f)(iv)				
Air Force Capabilities Prepared for Joint Operations and Other Tasks (funded by revenue Crown)					
Army Capabilities Prepared for Joint Operations and Other Tasks (funded by revenue Crown)					
Navy Capabilities Prepared for Joint Operations and Other Tasks (funded by revenue Crown)					
<b>Total Operating</b>					

7. **agree** that the proposed changes for Vote Defence Force appropriations for 2021/22 above be included in the 2021/22 Supplementary Estimates, and that, in the interim, the increases be met from Imprest Supply; and

8. **agree** that the expenses incurred under recommendation 6 be charged s.9(2)(f)(iv)

Authorised for lodgement

Hon Peeni Henare  
**MINISTER OF DEFENCE**