

The Treasury

Budget 2016 Information Release

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| | | |
|-------------|--|--------------|
| [1] | to prevent prejudice to the security or defence of New Zealand or the international relations of the government | 6(a) |
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| [33] | to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials | 9(2)(f)(iv) |
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| [38] | to enable the Crown to negotiate without disadvantage or prejudice | 9(2)(j) |
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| [s18(c)(i)] | that the making available of the information requested would be contrary to the provisions of a specified enactment | |
| [40] | Not in scope | |

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) and section 18 of the Official Information Act.

Reference: T2016/374

DH-23-0

Date: 7 March 2016

To: Minister of Finance (Hon Bill English)

Deadline: 11:30 a.m., Tuesday 8 March 2016

Aide Memoire: Briefing for budget meeting with Hon Gerry Brownlee

You are scheduled to meet with Hon Gerry Brownlee at 11:30 a.m. on Tuesday 8 March to discuss the New Zealand Defence Force (NZDF) and the Ministry of Defence (MoD). We understand that you are interested in getting comfort that the agencies can demonstrate that they understand their core business, baseline spending, efficiency and effectiveness. This meeting may also discuss the costs underpinning the 2016 Defence White Paper (DWP) and this year's Defence Midpoint Rebalancing Review (DMRR) budget bid.

Overview of Defence

| Actual expenses 2014/15 | NZDF | MoD |
|--------------------------------|-----------------|----------------|
| Personnel expense | \$902 million | \$7.4 million |
| Other operating expenses | \$623 million | \$3.8 million |
| Depreciation | \$365 million | \$0.4 million |
| Capital Charge | \$435 million | \$0.3 million |
| Total Operating costs | \$2,325 million | \$11.9 million |
| FTEs | 11,714 | 90 |
| Assets | \$5,936 million | \$5.4 million |

Following on from the 2010 Defence White Paper, the DMRR in 2013 involved an in-depth look at the capability necessary to deliver the White Paper, NZDF's cost structure and relative priorities. As a result of the DMRR the funding requirements out to 2030 were indicatively agreed by Cabinet.

DMRR resulted in average year on year increases to NZDF's operating baseline of a little over \$100 million per year [33]

DMRR also set out \$16.9 billion in capital funding to 2030. Major acquisitions signalled in DMRR included:

- Dive tender, [33, 37]
- Maritime Sustainment Capability, [33, 37] (replacement tanker)
- Future Air Mobility Capability, [33, 37]
- Network Enabled Army, [33, 37]
- Future Air Surveillance Capability, [33, 37]
- 3rd Offshore patrol Vessel, [33, 37]
- Frigate replacements, [33, 37]

Under DMRR NZDF also plans to spend \$1.7 billion to 2030 to regenerate its estate.

Core business and efficiency

Through the DMRR process the NZDF was transparent on options for the future make-up and cost of the Defence Force. We have seen the NZDF continue to gain a much better understanding of its costs since then. It has also reviewed and made practical changes to its output measures. Notwithstanding this, it still has work to do to improve its understanding of some cost drivers. In particular, it is undertaking work toward better understanding its workforce cost pressures.

An efficiency requirement was built into the DMRR (an average of approximately \$43 million per annum) and NZDF considers this inbuilt fiscal tension provides the necessary incentives to ensure it continues to operate an efficient level. You may wish to ask for specific examples of how NZDF has achieved efficiencies.

Defence White Paper 2016

We expect that the NZDF will provide a presentation on the cost implications of the White Paper.

Our assessment is that the NZDF costings are underpinned by a good financial model.

There are three components of the increase in costs through to 2030 associated with the White Paper:

- an update to the economic assumptions that underpin the DMRR (e.g. exchange rate, inflation assumptions)
- a “recosting” of DMRR, and
- changes to the specialist military equipment required to deliver the White Paper.

Treasury has worked with Defence on the update to the underlying economic assumptions and supports the DMRR funding track being updated to reflect these. The implications of updating the economic assumptions are:

| | To June 2020 | To June 2025 | To June 2030 |
|---|--------------|--------------|--------------|
| Cumulative increase in DMRR capital costs from update in economic assumptions (\$m) | 26 | 519 | 1,690 |

The main driver of the increase in costs through to 2025 and 2030 is a change in the foreign exchange assumptions for the proposed replacement surveillance and transport aircraft [33, 37] and purchase of frigates [33, 37] respectively.

We propose that officials report back to Joint Ministers on an enduring mechanism for updating changes to the economic assumptions underlying the DMRR.

We are still working with Defence to fully understand the changes associated with the “DMRR Force Structure re-costed”. You may wish to explore this further at the meeting.

NZDF preferred option in the DWP recommends greater capital spending [33] to 2030. The additional spending will deliver:

- more Future Air Surveillance Capability (FASC)
- less Future Air Mobility Capability [33]
- more Cyber protection capability
- disinvestment in Inshore Patrol Vessels
- an Off-shore Patrol Vessel capable of operating in our southern oceans (i.e. Ice strengthened)
- a Littoral Operation Support Capability (LOSC) in lieu of a dive tender.

DWP risk

NZDF has signalled a commitment to staying within the fiscal constraints set by DMRR within the next four years. We have the view that fiscal risks remain beyond 2020 and we will continue to work with Defence to fully understand the fiscal implications of the White Paper and develop an option within the DMRR envelope.

NZDF has been transparent about its challenges and has either started to address them or signalled an intention to do so in various reporting artefacts, including Four Year Plans, Investor Confidence Rating and Long Term Investment Plan. This resulted in Defence generally receiving above average ratings from central agencies for these products.

Defence's DMRR budget bid

The Vote team supports NZDF's budget bid as it is aligned with DMRR.

Talking Points

This meeting is an opportunity to discuss how the agencies run their businesses and how they are managing their budgets. You may wish to get an understanding of the following:

- underpinning DMRR was a change over time in the composition of the NZDF's personnel structure, you may wish to get an update on NZDF's thinking on this
- the major components of the re-costing of DMRR
- how agencies are continuing their drive for efficiency and how efficiency is being measured
- given the cost pressures outlined through the White Paper process, the implications of living within the DMRR funding through to 2030.

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