

The Treasury

Budget 2020 Information Release

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Treasury Report: Meeting with Minister of Defence 10 February 2020

Date:	30 January 2020	Report No:	T2020/179
		File Number:	SH-14-1-1-0

Action sought

	Action sought	Deadline
Hon Grant Robertson Minister of Finance	Note the contents of this report before your meeting with Treasury on baseline reviews. Note the proposed feedback due 4 February on the capability Cabinet papers.	4pm Monday 3 February 2020

Contact for telephone discussion (if required)

Name	Position		Telephone	1st Contact
Lucy Connell	Senior Analyst, Justice, Security and Government Services	[39]	N/A (mob)	✓
Colin Hall	Manager, Justice, Security and Government Services		[23]	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Meeting with Minister of Defence 10 February 2020

Executive Summary

You are meeting with the Minister of Defence on 10 February to discuss the findings of the Baseline Review.

The Minister may also use this opportunity to discuss:

- the three defence investments which are seeking new funding through Budget 2020 and due to be considered by Cabinet on 13 February
- the other initiatives he has submitted through Budget 2020, and/or
- next steps on the Estate First Principles Review.

The Baseline Review has considered the Defence cost pressure initiatives. The Review highlights increasing NZDF personnel costs as a key driver of current cost pressures, and recommends that NZDF develop and implement a [33]

Three of the Baseline Review funding

[33]

Of the Budget 2020 Defence new initiative funding requests, Treasury has recommended scaled funding for:

- capital funding of [33] (compared to [33] requested)[33] with [33] depreciation reserves allocated to offset the capital cost
- operating funding of \$10.180 million for the Security Capability Project to [33] sought), and
- operating funding of \$169 million (compared to [33] sought), to be set aside as a tagged contingency, to assist with implementation of refreshing critical enablers and infrastructure projects where the capital costs are being funded through depreciation reserves. This includes the operating costs associated with [33]

Treasury has not supported funding being allocated to:

- [33]
- [33]
- [33]
- the Ministry of Defence [33]) as we do not consider it meets Budget priorities.

Although these recommendations may increase pressure on the between-Budget contingency and/or Budget 2021, we consider they better align with the Government's wider priorities and place more responsibility on Defence to consider further prioritisation of its investment plan in line with the Government's fiscal constraints.

Recommended Action

We recommend that you:

- a **note** the Budget initiatives submitted by the Minister of Defence for consideration amount to ^[33] operating and ^[33] capital funding inclusive of both cost pressures and new initiatives across Votes Defence, Defence Force and Veterans
- b **note** that, of the proposed NZDF funding paths recommended by the Baseline Review, ^[33]
- c **note** the proposed feedback on the three capability Cabinet papers due 4 February
- d **note** the Treasury recommends only providing ^[33]
- e **note** that the implication of Defence providing a significant contribution to the ^[33] is that it will need to delay or deprioritise a number of other proposed investments
- f **note** that the Treasury recommends not funding the ^[33]
- g **note** that the Treasury recommends a small Tagged Operating Contingency is provided through Budget 2020 to ensure Defence can use remaining depreciation to advance critical capabilities and infrastructure projects this year, and
- h ^[33]

Colin Hall
Manager, Justice, Security & Government Services

Hon Grant Robertson
Minister of Finance

Treasury Report: Meeting with the Minister of Defence 10 February

Purpose of Report

1. This report provides background information for your meeting with the Minister of Defence on 10 February on the Baseline Review report. It also provides information on three other issues that the Minister may raise at the meeting:
 - proposed feedback on three Defence investment Cabinet papers
 - other initiatives submitted through Budget 2020, and
 - the Defence Estate First Principles Review process.

Analysis

2. The Baseline Review identified four funding options.
 - **Option A – Comprehensive Package** (^[33] **over four years**): Would allow NZDF to implement the policy settings articulated in the DCP 2019 with minor risk to output delivery, as well as increased use of current capabilities, prepare for the introduction of new capabilities, and meet compliance and transformation requirements with a minor level of risk. Significant efficiencies would need to be achieved in personnel structure and the use of contractors.
 - **Option B – Increasing Activity and Capability** (^[33] **over four years**): Focuses on increasing NZDF's activity levels and preparing for the introduction of new capabilities. New and returning capabilities should be able to be utilised as planned. ^[1]
 - **Option C – Sustaining Capabilities and Infrastructure** (^[33] **over four years**): Focuses on maintaining current capability and introducing new capabilities in the medium term. ^[1]

One year of funding for remuneration increases is provided, ^[33]
 - **Option D – Base Funding** (^[33] **over four years**): Provides limited funding for new FTE growth, scaled funding for maintenance repair and overhaul activities, operating capabilities, remuneration increases for one year. ^[33]

One year of remuneration funding is provided, ^[33]

[1]

3. The Vote team's assessment of the funding options for NZDF has focused on the three key issues identified within the Baseline Review report:
 - returning military outputs back to expected levels at deliver Government policy priorities
 - ensuring foundational enablers such as ICT and estate infrastructure are sufficiently funded to address ^[1] and
 - creating a strong incentive for Defence to address its unsustainable personnel cost growth (growth in civilian FTEs, increasing seniority, growing use of consultants and contractors).
4. Addressing personnel costs is critical to achieving a more sustainable NZDF cost structure. The Baseline Review recommends NZDF ^[33] to address this issue. We agree there is an urgent need for Defence to provide Ministers with a robust ^[33] It should address capability and capacity needs across the system, while also balancing the risks of attrition with fiscal implications to the Crown. It should also set out for ministers the drivers and appropriate strategies for staff retention.
5. ^[33]
6. We also concur with the Baseline Review's view about the need for Defence to develop an overarching enterprise view of ICT requirements, ^[1]
7. ^[33]
8. ^[1]
9. ^[33]

Personnel

10. The cost pressure options still include a significant remuneration uplift for the forecast period, despite average salaries already being higher than the DMRR forecast. This excludes the current allowance and accommodation assistance provisions, which appear generous.

11. The Defence Act 1990 states that in regard to conditions of service the Chief of Defence Force shall have regard to the need to achieve and maintain fair relativity with the levels of remuneration received elsewhere; and that remuneration needs to be fair to both members of the Armed Forces and the taxpayer, as well as the need to recruit and retain competent persons.
12. While overall retention has improved, senior attrition rates are stubbornly low. It is also unclear what increased value-for-money has been delivered through the current top-heavy workforce structure. The report also states that despite junior ranks receiving the largest pay rises over the past five years, this has not had the impact of improving their attrition rates relative to senior managers.
13. [33]

[33]

Foundational enablers – estate, ICT

14. The Baseline Review concluded that the 2013 Defence Mid-point Rebalancing Review (DMRR) underestimated some key drivers of cost, such as ICT. Maintenance, repair and overhaul (MRO) activities have also increased significantly due to aging assets and price increases from suppliers. The provision made for estate regeneration significantly underestimated the cost of a 'fit for purpose' modern estate, and costs have further increased due to underestimated maintenance and/or replacement costs. The DMRR plan to regenerate the estate was overly optimistic and underestimated the difficulty of delivering the \$1.7 billion capital works programme.
15. While the Defence White Paper 2016 (DWP), Defence Capability Plan 2019 (DCP), and the Defence Estate Regeneration Plan 2019 (DERP) all sought to update these costs and provide Ministers with a more realistic plan for regenerating these foundational enablers, it will remain a challenge to ensure that these projects are given due priority compared to plans for new military capabilities.
16. The Baseline Review notes that there has been a significant increase in FTEs within NZDF's Estate and Infrastructure Branch – excluding significant additional contractors and consultants. Despite this increase in resource, key estate projects have not been progressed in line with the Regeneration Programme. One factor may be the prioritisation of military equipment investment over other parts of the estate – for example infrastructure projects at Base Ohakea to accommodate the new P-8 aircraft being prioritised – at the expense of other estate projects.
17. [1]

New spending initiatives in Budget 2020

18. The Minister has submitted [33] for consideration across his three defence portfolios, [33]

- the military capability initiative requests capital funding of [33] for three major priority projects, with around [33] of depreciation reserves funding a further 60 other military equipment projects
 - operating funding of [33] across the forecast period is being sought – primarily for the depreciation and capital charge implications, but also for other increases in operating costs associated with the proposed investments, and
 - [33]
19. The Cabinet papers and associated business cases for the three priority investments have been referred to you for consultation, ahead of Cabinet Committee consideration on 13 February. The fiscal impact of the funding track recommended through the Baseline Review further reinforces the Vote team assessment that only the critical capability replacement of [33] should receive capital injections this Budget.
20. We have also recommended a scaled tagged operating contingency to allow Defence to utilise the remaining accumulated depreciation funding to progress other projects. Our view, in light of the Baseline Review report, is that there is a need for the critical foundational enablers of ICT and the estate to be prioritised over the introduction of new capabilities – for example, if the ICT infrastructure is not funded and implemented, Defence will not be able to implement [1]. Many of these projects will require Cabinet approval prior to any funding being spent.

Future Air Mobility Capability (FAMC)

21. We agree that the replacement of the aging Hercules fleet is the key defence investment priority. We consider that [33] aircraft would provide sufficient availability and capability to meet policy priorities compared to the current fleet, particularly with the [33]. We are not convinced that the funding requested fully takes into account the cost savings provided from [33], and the general uplift in condition of a new fleet.
22. [33]
23. As you discussed with the Minister of Defence in November 2019, Treasury also recommends that a much larger portion of Defence's depreciation reserves is allocated to this priority project. Defence is proposing a contribution from depreciation reserves of [33]. We consider this is significantly short of what should be allocated to the project given its priority. We recommend that [33] of accumulated depreciation should be used to fund the replacement Hercules, leaving \$635 million to be funded through the Budget 2020 capital allowance. We have also recommended a scaled amount of operating funding be provided for FAMC, [33]
24. [1]

[33]

Estate First Principles (Footprint) Review

31. We have ongoing concerns that the Review is:

[33,34]

[34]

[33]

[33,34]

36. We may wish to seek an update on the Review from the Minister of Defence and reiterate your earlier views that any options put to ministers will require robust analysis given the fiscal implications.

Vote Veterans Initiatives

37. Hon Ron Mark is also the Minister for Veterans, and may wish to discuss the [33]

Next Steps

40. You will be meeting with officials from the Baseline Review team and the Vote team on 3 February 2020 to discuss the findings of the Review and recommendations.
41. Attached is a table outlining all the Budget initiatives submitted by the Minister of Defence. You may wish to discuss this and the Vote team recommendations at the 3 February meeting.
42. Feedback on the three investment Cabinet papers is due 4 February. You may wish to raise the following points in your feedback on the papers, or in your subsequent meeting with the Minister of Defence.
 - You have considered the evidence and consider [33] Hercules aircraft sufficient to deliver Government priorities within Budget constraints compared with the current aging fleet, particularly [33]
 - The proposed Defence spend of accumulated depreciation over the forecast period is [33], yet only [33] has been allocated to the Future Air Mobility Capability investment. You expect that more depreciation is allocated to the proposed Hercules procurement, [1]
 - [33]
 -
 -

[33]

