

3 February 2009

Minister of Defence

On 17 December 2008 the Cabinet Business Committee directed chief executives to review the expenditure within their Votes and report their conclusions to their Minister by 5 February 2009 [CBC Min 08 32/6 refers]. This report responds to that direction. We are reporting jointly because the work of our two organisations is closely interconnected and the approach we are inviting you to endorse affects both Vote: Defence Force and Vote: Defence.

Specifically, the Cabinet Business Committee required us to identify:

- savings that can be freed up for Budget 2009;
- programmes that are inconsistent with this government's priorities and should be discontinued;
- programmes that may be inconsistent with this government's priorities and should be looked into;
- programmes and expenditure that are not efficient or effective;
- areas where performance information is insufficient to make a judgement about efficiency and effectiveness, and actions agencies should take to make improvements by the next review period.

We have approached this task having regard to two realities – (1) the current economic situation and the imperatives for restraint in government expenditure and (2) the recent history and current status of the Defence Votes.

The Government's intention to commission a defence assessment and publish a white paper during calendar 2009 (known as *Review 09*) provides an ideal mechanism to examine broadly the value-for-money of defence expenditure. The assessment will enable all defence expenditure to be critically examined and should result in a balanced mix of policy, capabilities, operational tempo and funding that accords with the Government's fiscal priorities.

In the short term our ability to find savings in our Votes is constrained by the momentum that has built up in Defence through capital investment, rebuilding personnel numbers, organisational reform and the operational tempo. The existence and inescapability of these funding pressures has obliged us to formulate our advice around how the present situation can best be managed. However, there are a number of things that the NZDF and the Ministry can and will do to restrain expenditure during 2009/10. These are detailed below.

Vote Defence Force

Between 1990 and 2002/3, Vote Defence Force declined in both nominal and real terms. The investment in defence was insufficient to maintain the NZDF's capabilities. Personnel numbers therefore declined and the condition and capabilities of the NZDF's military equipment and infrastructure degraded.

Since 2002, the NZDF has been implementing a programme known as the *Defence Long-Term Development Plan* (LTDP) to restore and develop its capabilities and infrastructure. The LTDP has involved, among other things, a **significant capital programme** to replace or substantially upgrade most major weapons platforms and communications systems. This has two major consequences for Defence:

- The Crown is contractually committed to the acquisition or upgrade of several major items of critical equipment (the balance of the Protector vessels; all Air Force platforms except the King Air trainer);
- The new or upgraded acquisitions will incur additional operating expenditure, by way of both depreciation and the direct costs of using them.

In respect of **rebuilding personnel**, the NZDF has been pursuing a priority programme to rebuild its numbers through improved recruitment and retention. One aspect of this personnel programme has been a new remuneration package: this will also incur additional costs.

In terms of organisational reform, the **Defence Sustainability Initiative** (DSI), initiated in 2005, required the NZDF rebuild its organisational capability while implementing a programme to improve efficiency and effectiveness. During 2005/06 and 2006/07, the two most significant initiatives were the establishment of the Joint Logistics and Support Organisation (JLSO) and a major organisational restructuring and management capability development of HQNZDF. Both exercises involved substantial change. Since 2007 the NZDF has been undertaking the **Defence Transformation Programme** (DTP), the primary objectives of which are to realise efficiencies and align expenditure with strategic priorities. This programme was initiated by means of an internal "baseline review" in 2007, led by an independent Treasury secondee and focused on support and overhead functions.

The baseline review identified prospects for useful savings in:

- ◆ Education and training;
- ◆ Computer and information systems (CIS);
- ◆ The Defence estate;
- ◆ Logistics; and
- ◆ Human resources

The DTP is ongoing and has as its objectives both short term results and longer term change. It is currently being undertaken in three streams:

- ◆ Logistics;
- ◆ Human resources (including education and training); and
- ◆ HQ activities, excluding shared services.

Each stream is being led by a Service chief. A robust governance structure has been put in place, and management of the work streams and the consequential organisational and process changes is being undertaken by a mix of NZDF and contracted experts. Once the organisational and process changes have largely been achieved, responsibility is passed to line management to continue as “business-as-usual”.

The cost analysis that was undertaken through the baseline review is refined and updated periodically to identify areas for further work and to confirm the success of completed initiatives in reducing indirect costs.

To date, the DTP has achieved savings of \$34 million in 2007/8 and \$18 million in 2008/09. Additional forecast savings over the next three years are \$34 million in 2009/10; \$59 million in 2010/11 and \$85 million in 2011/12.

Like any other government organisation, the NZDF must achieve an appropriate balance of effort between delivering government-required outputs and undertaking internal organisational change. The management resources committed to, and the organisational changes associated with, the DTP are already quite substantial. They effectively represent the limit to which the NZDF could go without incurring operational risks through a diversion of resources from output delivery to organisational change. In addition, if further restructuring initiatives were to be adopted, they would be likely to result in a loss of focus on the three main areas already identified, which are currently considered to be the most promising.

What the NZDF will do

To restrain expenditure during 2009/10 the NZDF will:

- ◆ manage its capital programme without the remaining pre-committed capital contribution of approximately \$210 million, *[information deleted in order to maintain the current constitutional conventions protecting confidentiality of advice tendered by Ministers and officials];*
- ◆ not provide any general adjustments in remuneration in 2009/10. Any increases will be limited to those directly related to performance under existing arrangements;
- ◆ continue vigorously to pursue its programme of efficiencies under the DTP;
- ◆ *[information deleted in order to maintain the current constitutional conventions protecting confidentiality of advice tendered by Ministers and officials];*
- ◆ cover any approved increments in Vote Defence in 2008/09 and 2009/10 by way of fiscally-neutral transfers between Vote Defence Force and Vote Defence;

- ◆ cover \$20 million of an additional requirement of \$25 million in 2008/09 for output expense *Operationally Deployed Forces* by way of a fiscally-neutral transfer from a surplus in other output expenses.
- ◆ cover \$20 million of an additional requirement of approximately \$34 million in 2009/10 for output expense *Operationally Deployed Forces* by way of a fiscally-neutral transfer from a surplus of other output expenses carried forward from 2008/09 to 2009/10.

Vote Defence

The Ministry's appropriation has been static in recent years. Output requirements have remained unchanged so inflationary cost pressures have been successfully absorbed to date.

Of the Ministry's three statutory functions, in respect of two of them - policy advice on defence and security matters, and evaluation of the NZDF and of procurement, the Crown has the ability to determine the amount of output it wishes to purchase. The situation is different with respect to Acquisition, where the size of the function is geared to the current and prospective programme of defence acquisitions. Furthermore, the capability of the Acquisition function has been criticised from a number of quarters.

What the Ministry will do

To manage current and expected expenditure pressures, the Ministry:

- ◆ has stopped the recruitment of policy and evaluation analysts;
- ◆ will tightly control discretionary expenditure (travel, hospitality, consultancies); and
- ◆ has cancelled some other expenditure.

In addition, the Ministry is expecting to cover the costs of the white paper as far as possible within its existing budget. Any shortfall will be met by a fiscally-neutral transfer from Vote: Defence Force.

Budget bids

Vote Defence and Vote Defence Force are submitting a total of eight bids for Budget 2009: seven for the NZDF and one for the Ministry. Four relate to immediate pressures on Defence spending in 2009/2010 and have been categorised as emergency bids; one relates to the Ministry's procurement capability; and three are technical. This section summarises these bids in the context of the line-by-line review.

Vote Defence Force initiatives are as follows:

1. Annual operating increases from 2009/10 of \$85.718M for the next stage of the Defence Funding Package (DFP)

This increment is intended to provide for the Budget 2009 element of an earlier approval (CAB Min (05) 5/2 Refers) to restore military and organisational capability. Without this increment the NZDF will have difficulty meeting the costs of capability developing initiatives already in train.

2. Appropriation increases for the Operationally Deployed Forces of \$25M for 2008/09 and \$32M in 2009/10. This proposal will also be considered within a separate Cabinet submission

This bid should be read together with bid (3) below. The appropriations for operationally deployed forces are currently insufficient to cover the forecast costs. This bid and bid (3) below seek increased appropriations for *Operationally Deployed Forces* during 2008/09 and 2009/10 that will meet the difference between forecast costs and the amounts currently appropriated. Without this funding, current operational deployments would need to be scaled back or discontinued.

The DTP savings and other areas of reduced expenditure have resulted in a forecast operating surplus of approximately \$70 million for 2008/09 in output expenses other than *Operationally Deployed Forces*. It is proposed that \$20 million of this operating surplus be applied towards an increase in *Operationally Deployed Forces* for 2008/09. It is further proposed that the balance of approximately \$50 million be carried forward to 2009/10 and, of this \$50 million, \$20 million be applied towards an increase in *Operationally Deployed Forces* for 2009/10. This means that:

- ◆ the required increase in Output Expense *Operationally Deployed Forces* of \$25 million for 2008/09 would be funded by a fiscally-neutral transfer of \$20 million from the forecast surplus and new money of \$5 million; and
- ◆ the required increase in Output Expense *Operationally Deployed Forces* of \$32 million for 2008/09 will be funded by a fiscally-neutral transfer of \$20 million from the proposed carry-forward of the forecast surplus for 2008/09 and new money of \$12 million.

3. Baseline savings of \$40M to contribute to the Operationally Deployed Forces costs during 2008/09 and 2009/10

See the explanation for (2) above. It is proposed to transfer part of the forecast surplus towards the increased appropriations for Operationally Deployed Forces detailed in (2) above.

4. *[information deleted in order to maintain the current constitutional conventions protecting confidentiality of advice tendered by Ministers and officials*

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5. *[information deleted in order to maintain the current constitutional conventions protecting confidentiality of advice tendered by Ministers and officials*

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6. A technical change associated with a review of tax treatment

This technical change aims to recover costs that will result from an Inland Revenue Department (IRD) review of tax treatment for the non operational allowances paid to NZDF personnel serving overseas.

7. A technical accounting treatment to appropriate costs included in the New Zealand Defence Force Statement of Financial Position;

This technical item seeks a specific appropriation without any requirement for corresponding funding.

Three of the above initiatives – the 2009/10 increment for the Defence Funding Package, *[deleted – confidentiality of advice]*, and the supplementary appropriation for operationally deployed forces - are classed as “Emergency Pressure”.

The bids for supplementary appropriations for *Operationally Deployed Forces* have been prepared in conjunction with the savings initiative. Formal recognition of the transfer of these savings will be necessary to avoid the 2008/09 and 2009/10 appropriations for *Operationally Deployed Forces* appropriations being exceeded.

The Vote Defence initiative is:

8. An increase to output expense *Management of Equipment Procurement* of \$400,000 per annum

This increase would fund additional staff for the Acquisitions Division strengthen its capability and to mitigate the fiscal risks associated with current and upcoming acquisition projects.

The recent review by Mr John Coles of the safety and functionality of the MRV CANTERBURY suggested the there could be deficiencies in the capability of the Ministry’s acquisition division. This was confirmed by a subsequent analysis undertaken within the Ministry, which estimated that the deficiencies in Acquisition Division capability translated into a shortfall of approximately 5 FTEs for the period 2010-

2015. This shortfall, if continued, would incur significant fiscal risks, but these could be mitigated by strengthening the Division somewhat and rescheduling the start dates of projects. With careful prioritisation of projects the analysis estimated that only two additional project managers would be needed.

Consequences

If the \$85.718M pre-committed increase in Vote Defence Force for 2009/10 did not proceed, the consequences would be significant. The exact nature of those consequences would depend on the particular funding decisions taken and Ministers' directions about which activities and developments should be curtailed. The NZDF will be able to provide explicit advice on these issues.

[information deleted in order to maintain the current constitutional conventions protecting confidentiality of advice tendered by Ministers and officials] However, depending on other decisions and circumstances, some or all of that contribution might be funded from depreciation.

To date the practice has been to increase Vote Defence Force to cover the financial effects of asset revaluations. The capital that derives from the increased depreciation that results from upwards revaluations may allow the *[deleted – confidentiality of advice]*].

Other requirements

We did not identify any:

- ◆ programmes that are inconsistent with this government's priorities and should be discontinued;
- ◆ programmes that may be inconsistent with this government's priorities and should be looked into;
- ◆ programmes and expenditure that are not efficient or effective.

Summary and Conclusions

The pending work on the defence assessment and white paper during calendar 2009 will provide an ideal mechanism to examine broadly the efficiency, effectiveness and value-for-money of defence expenditure. In the meantime, we believe we can support the Government's objectives for fiscal restraint during 2009/10 by limiting Defence expenditure to the minimum increases necessary to meet unavoidable cost increases for outputs and operational deployments, and to cover risk. As detailed in this report, we have identified and will implement a number of opportunities for restricting expenditure.

In his letter to you dated 17 December, the Minister of Finance indicated that he believed that the existing pre-commitment of an increase in operating expenditure should remain (subject to discussion in the budget bilateral) but that the pre-commitment of a capital contribution should be withdrawn. In substance, we believe that we can implement that approach.

In addition, we believe that *[deleted – confidentiality of advice*

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Budget bid for this sum has been made because, although it is possible, it is not certain that the work can be funded from accumulated depreciation.

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Secretary of Defence

J. Mateparae
Lieutenant-General
Chief of Defence Force