

**Vote: Defence Force**

**Baseline Alignment Proposal**

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Submitted by:

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## **Section 1: Alignment to Government Priorities**

### **Key messages**

The activities of the NZDF are aligned with Government strategic direction. The NZDF faces cost pressure in a number of areas. The single biggest cost driver in the next two years is unfunded depreciation resulting from legacy decisions which is crowding out available funding for other operating. Despite the challenges faced within the fiscally constrained environment, the NZDF will manage the delivery of required outputs against priorities within its amended appropriations for 2010/11.

### **Scope of this Proposal**

This proposal has been produced at a time when the Secretary of Defence is finalising his Defence Assessment and initiating a Value for Money (VfM) Review. The Defence Assessment and the VfM Review will inform a Defence White Paper likely to be produced around September 2010. The White Paper will seek to align defence policy, capability and funding over the coming years.

Accordingly, this proposal is focussed mainly on 2010/11. The proposal has been developed to ensure the NZDF will be best positioned to implement a range of potential outcomes from the White Paper.

### **Government's Strategic Direction**

New Zealand is a nation with a small population and open borders. It relies heavily on international trade and the protection of its natural resources for generating wealth. National security is a prerequisite for achieving a safe, stable and prosperous society. The Cabinet Strategy Committee noted on 15 February 2010 the contribution made by the NZDF in pursuit of national security tasks. Whether acting in leading or supporting roles, the NZDF is an important component of New Zealand's approach to achievement of the following national security outcomes:

- A secure border and approaches to New Zealand.
- A rules-based international order primarily based on the principle of national sovereignty.
- A network of strong international partnerships.
- A sound global economy under-pinned by the freedoms of commerce and navigation.
- An enhanced international reputation.

These national security outcomes are enduring as they reflect New Zealand's geography, our values, and our aspirations in the international community.

## **Priorities**

On 10 December 2009, I outlined the following overarching priorities for the Defence portfolio:

- Completing the Defence White Paper.
- Ensuring the NZDF remains effective and responsive.
- Consolidating the ANZAC relationship.
- Commencing a sound and balanced acquisition strategy.
- Initiating new resource management methods.

Further guidance will result from the completion of the White Paper.

The Chief of Defence Force has confirmed his key operational priorities for 2010/11 as follows:

- Completion of current military operations and associated preparedness activities.
- Delivering on efficiency and effectiveness initiatives.
- Development and introduction of the future force.

Resources will be allocated within the 2010/11 amended baseline in line with these priorities.

## **Delivering Against Priorities**

The NZDF will contribute to these defence priorities and the Government's strategic direction in the following ways:

- Leading and contributing to international deployments as mandated by Cabinet.
- Keeping the NZDF prepared to conduct the next task Cabinet may require the NZDF to contribute to. This may include combat operations, counter terrorism operations, security and stability operations, disaster relief, evacuations, maritime resource protection tasks, border surveillance & protection tasks or a combination of the above.
- Maintaining defence relations through for example:
  - Partnering regional security assistance and combined exercises and readiness training with Australia,
  - Defence diplomacy, regional engagement and combined exercises and training in the Asia-Pacific region to ensure interoperability, including meeting

our obligations as a member of the Five Power Defence Arrangements (FPDA),

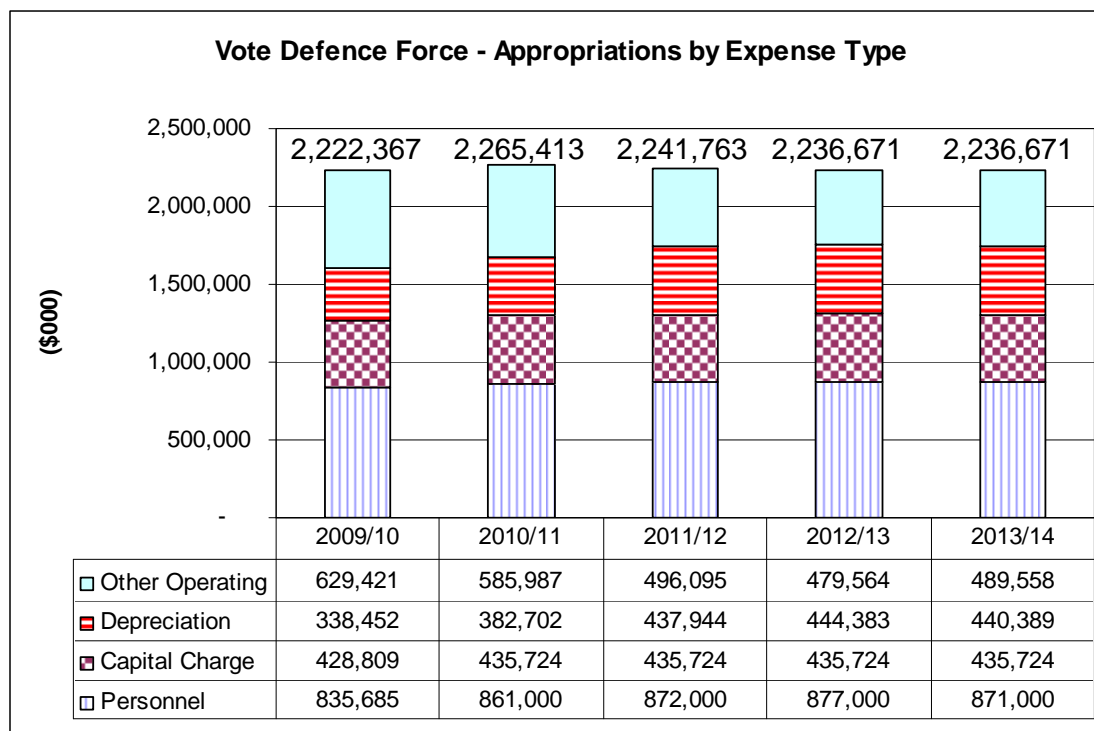
- Supporting young people through the New Zealand Cadet Forces and the Government's 09/10 initiatives - *Opportunities for Young People* and *Fresh Start for Young People*, via the Limited Service Volunteer Scheme, Service Academies in high schools and Military-Style Activity Camps, and the provision of innovative and high-quality education and training.
- Contributing to a more competitive and innovative economy through, for example:
  - Promoting a healthy New Zealand defence industry,
  - Protection of natural resources,
  - Keeping lines of trade open, and
  - The provision of additional skills to New Zealanders via the Reserve Forces, as well as the professional training and personal development of regular force and civilian personnel that inevitably return to the labour market.

### **Fiscal Challenge**

The Vote Defence Force resource plans up to 2009/10 had been aligned with the increase in operating and capital funding provided by the Defence Funding Package. One of the objectives of the Defence Funding Package had been to meet the additional costs of operating and paying the depreciation expenses of new equipment purchased by the last Government. The cancellation of the Defence Funding Package has left a substantial gap in the NZDF baseline. The gap has been partly narrowed by a further \$35m appropriation to help meet additional depreciation charges.

The \$35m increase in appropriation, coupled with reprioritisation decisions, will enable the NZDF to produce a balanced budget for 2010/11. The resource plan for 2011/12, however, forecasts an operating deficit of circa \$90m in 2011/12; increasing in the out-years. This underlying deficit will need to be resolved no later than Budget 2011.

Figure 1 below illustrates the fiscal challenge faced by the NZDF in 2010/11 and beyond. The execution of past acquisition and other policy decisions means that unfunded depreciation, increasing by circa \$100m over the next two years, is crowding out funding for other operating (and intended personnel growth). The increased costs associated with those legacy commitments are largely unavoidable. The situation is complicated by other cost drivers as discussed below. Overall, based on the amended appropriation, funding available for other operating will be circa \$45m less in 2010/11, and circa \$133m less in 2011/12, than was available in 2009/10.



*Figure 1: Unfunded depreciation crowds out available funding for other operating.*

The five main cost drivers to be addressed in 2010/11 and beyond are outlined below.

- **Depreciation.** Funding injections under the Defence Funding Package were intended to cover the increased costs associated with implementation of the Defence Sustainability Initiatives and the Defence Long Term Development Plan. With the termination of Defence Funding Package, the 2010/11 pre-commitment of \$108.1m (including a depreciation component for 2010/11) will be replaced with a scaled adjustment of \$35m to partially offset rising depreciation costs.
- **New Capability Operating Costs.** Pre-committed funding, under the Defence Funding Package, to cover the inevitable increases in operating costs associated with significant capability enhancements has been ceased.
- **Operationally Deployed Forces.** The current operational tempo is not expected to decline significantly during 2010/11 and beyond. If this assumption is correct, it will prove necessary to reset baseline funding for the Operationally Deployed Forces output beyond 2010/11. If this assumption does not hold, then by inference NZDF should be planning around a lower deployment tempo than has been delivered on in recent years.

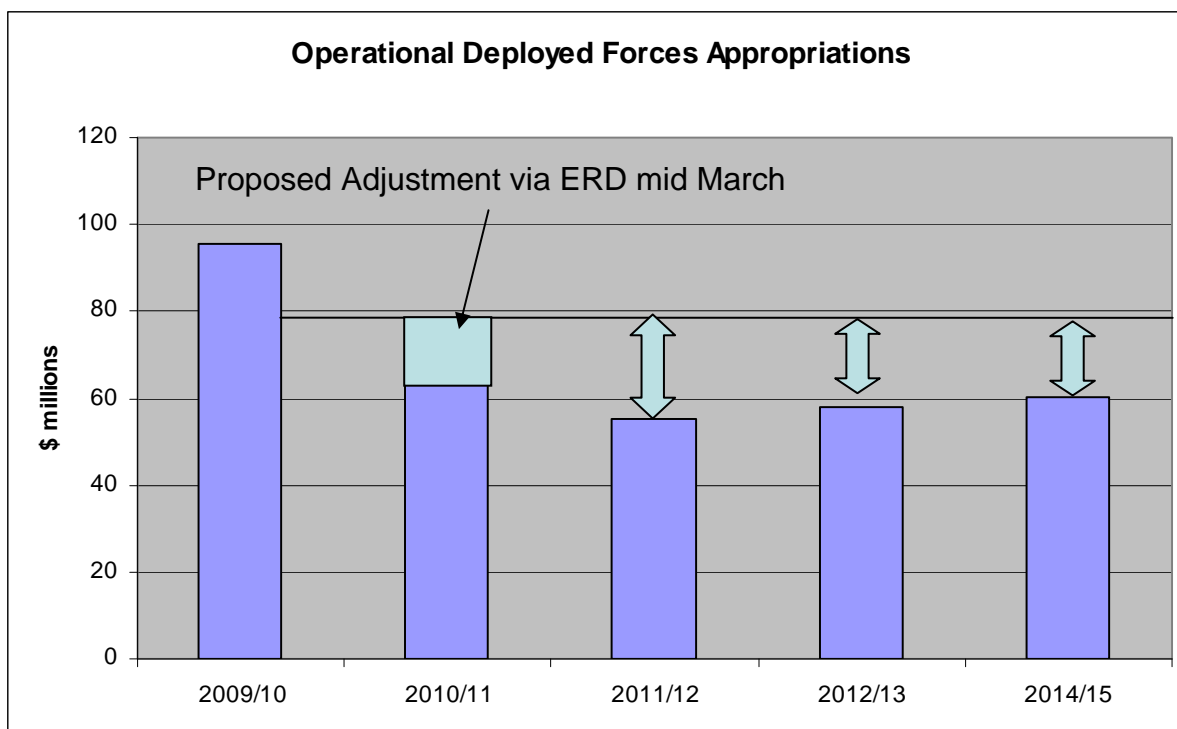


Figure 2: Current Operationally Deployed Forces baseline, indicative level required to sustain current level of deployment tempo, and the gaps.

- Short term personnel pressures.** The current economic situation has resulted in attrition rates falling significantly. With the commensurate lowering of recruitment of 'lower cost' personnel, the average rate of remuneration per person is currently increasing. While expected to be a temporary situation, the increased average cost per person is unavoidable. A superannuation holiday also ceases in 2010/11 increasing personnel costs in 2010/11 and outyears.
- Inflation.** Inflationary pressures applicable to military activities compounds the pressure created by other cost drivers. Foreign exchange fluctuations, and the cost of energy, can also contribute to cost pressures on the NZDF.

## Section 2: Reprioritisation

### Key Messages

The NZDF has carried out an internal reprioritisation activity to ensure alignment with Government's strategic direction and priorities for the Defence portfolio.

Reprioritisation decisions have been taken to ensure the NZDF will produce the necessary outputs within the amended baseline for 2010/11, and contingency planning is underway for 2011/12. There are risks to future capability and sustainment of operations resulting from this reprioritisation. The White Paper seeks to provide greater clarity around New Zealand's future defence requirements, creating improved linkages between policy, capability, force structure, resource

allocation and the risks the Government chooses to carry. Any potential gap between the current Vote Defence Force baseline for 2011/12 and the eventual resource plan associated with the Defence White Paper will need to be addressed by Budget 2011.

### **Managing 2010/11**

The following steps are being taken to ensure the necessary outputs can be delivered in 2010/11 within the amended baseline. It is acknowledged that the Value for Money Review and the White Paper will provide updated strategic guidance for the NZDF, but that the guidance will not be available in time for preparation of 2010/11 budgets. The resultant changes from the decisions taken are discussed below:

- The activities of the NZDF have been reprioritised. Resource allocation decisions are being aligned with those priorities.
- A revised Defence Capital Acquisition Plan has been developed. This involves deferment and/or cancellation of a substantial number of both major and minor non-committed capital projects. In essence, the capital plan has been reduced to minimum levels in the short-term so as to be affordable with a limited capital injection. Bids for capital injection were submitted in February 2010.
- Residual gaps in funding resulting from increased costs for depreciation, deployed operations, operating new capability, personnel and inflation will be absorbed within baselines. Resource allocation is being informed by the reprioritisation activity.
- Non-essential operational, preparedness and support activities will be reduced or curtailed in line with revised priorities.
- The Defence Transformation Programme will continue with a view to improving efficiency and effectiveness of support activities.
- All personnel growth plans have been cancelled. The NZDF total strength has been capped at November 2009 levels.
- The personnel budget has been capped with the exception of increases in the average rate of remuneration and the ceasing of the current superannuation holiday.
- Non-essential maintenance has been further deferred.
- Contingency planning has commenced to address residual issues.

## **Risk**

It is acknowledged that risk increases as a result of the cumulative decisions taken, including in respect of the size and sustainability of NZDF's deployable forces; especially if the global outlook deteriorates. Without appropriate mitigation, the ability of the NZDF to contribute to achievement of national security outcomes would inevitably diminish. The risks have been documented and will be managed within the Value for Money Review and the Defence Review 2009. Resolution of the underlying cost drivers that are creating large deficits for 2011/12 and beyond is essential prior to implementing any new initiatives resulting from the White Paper.

In the meantime, the remedy for 2010/11 is intended to ensure that military capability is maintained to the maximum possible extent, thereby preserving the NZDF's ability to generate the military response options required of it by Government.

### **Sustaining Current Operations (pending Cabinet decision)**

Maintaining current operational deployments remains a fundamental output for the NZDF. A proposal to increase the Operationally Deployed Forces (OE 16) appropriation in 2010/11 is currently before Cabinet. A decision is expected mid March. The proposed adjustment would ensure the current level of approved OE 16 Operationally Deployed Forces missions can be maintained through 2010/11.

### **Capability Management (Initiative 1)**

The main capability priority over the next 12 months is the delivery and operational release of the Project PROTECTOR fleet to the Royal New Zealand Navy, including the 'Get Well' programme for HMNZS CANTERBURY. Other high priorities include Defence Transformation Programme enablers such as the Human Resources Management Information Systems project, the upgrade of the P3K Orion and C130H Hercules aircraft, and the introduction into service of the new NH90 and A109 helicopters. The \$35 million increase in appropriation for 2010/11 and out-years, to partially offset rising depreciation costs associated with these procurements, is included as Initiative 1 in Section 3 - Summary of Financial Movements.

### **Expense Transfer (Initiative 2)**

A number of planned operating activities in 2009/10 are now not possible to complete until 2010/11. These predominantly involve delays to the scheduled introduction into service of new and upgraded capital equipment, but also a number of operating projects that have been impacted by personnel being diverted to higher priority activities. As a result, this proposal includes an expense transfer of \$10m from 2009/10 to 2010/11. This is shown as Initiative 2 in Section 3 - Summary of Financial Movements.



## Value for Money Review

The Government has commissioned an external Value for Money Review of the NZDF. The review is driven by this Government's commitment to improving value for money in the state sector, and by the substantial gap between current Vote Defence Force funding baselines and projected defence costs. This gap was identified before the Defence Assessment began, and has been confirmed by the Assessment.

The key objective of the Value for Money Review is to give Ministers greater assurance of, and options for improving, the NZDF's efficiency, cost effectiveness and sustainability. The Value for Money Review and the Defence Assessment will lead to the Defence White Paper in September 2010. The White Paper will inform Budget 2011 decisions.

## Section 3: Summary of Financial Movements

The summary of financial movements is shown at Figure 3 below.

### Baseline Alignment Proposal - Financial Summary Report

Vote:	Defence Force	2009/10	2010/11	2011/12	2012/13	2013/14
		(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Baseline (2009/10 FBU)		2,232,367	2,220,413	2,206,763	2,201,671	2,201,671
Share Allocation		0	35,000	35,000	35,000	35,000
Centralised Saving		0	0	0	0	0
Reprioritisation						
Expense Transfer		-10,000	10,000	0	0	0
Total Reprioritisation		-10,000	10,000	0	0	0
Transfers Outside Vote						
Total Transfers Outside Vote		0	0	0	0	0
<b>Total Changes</b>		<b>-10,000</b>	<b>45,000</b>	<b>35,000</b>	<b>35,000</b>	<b>35,000</b>
<b>Total Proposed Baseline</b>		<b>2,222,367</b>	<b>2,265,413</b>	<b>2,241,763</b>	<b>2,236,671</b>	<b>2,236,671</b>

Figure 3: Summary of financial movements