

Reference: 20150079

20 May 2015



Thank you for your Official Information Act request, received on 10 March 2015. You requested the following:

*“a copy of all Treasury written advice (including presentations) provided by the Treasury to the Government from 1 January 1999 to 8 May 2001 about:*

- (a) The A4k Skyhawk Air Combat Force capability.*
- (b) The F16 acquisition.*

*I also request a copy of all Treasury internal policy studies (1 January 1999 to 8 May 2001) about the RNZAF Air Combat Force contributions to:*

- (a) Air combat contributions to the Defence of Australia and ADF training;*
- (b) FPDA and IADS;*
- (c) Support for combat, peace-making and peacekeeping operations.”*

Following communication with a Treasury official, you limited your request to:

*“Any formal Treasury advice to Ministers over the period 1 January 1999 to 8 May 2001 that relates to the possible reduction or disbanding of all or part of NZ’s Air Combat Force capability. It may exclude any documents that do not make substantial assertions about the ongoing need or viability of NZ’s Air Combat Force i.e. exclude technical or administrative advice.”*

As agreed with you, we have omitted any documentation duplicated in the information pack provided to you by the Ministry of Defence in their response to you.

On 10 April we extended the time limit for deciding on your request by an additional 30 working days.

## Information Being Released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	7 May 1999	Treasury Report: Upcoming Defence Issues for Consideration and Treasury's General Concerns over Defence Fiscal Risks	Release in part
2.	23 June 1999	Treasury Report: F-16 Acquisition	Release in full
3.	12 July 1999	Cabinet Strategy Committee Paper: Lease of F16 Aircraft and Purchase of Supporting Equipment and Regeneration Services	Release in part
4.	10 December 1999	Treasury Report: F-16s	Release in part
5.	29 February 2000	Treasury Report: Financial Impact of a Decision to Exit the F-16 Deal	Release in part
6.	20 April 2000	Treasury Report: Defence Issues: Meeting with Treasury Officials	Release relevant information
7.	19 May 2000	Treasury Report: Aide Memoire for Meeting with Ministers on Defence Review	Release in full

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- section 6(a) – to protect the security or defence of New Zealand or the international relations of the Government of New Zealand,
- section 6(b)(i) – to protect the entrusting of information to the Government of New Zealand on a basis of confidence by the Government of any other country or any agency of such a Government,
- section 6(b)(ii) – to protect the entrusting of information to the Government of New Zealand on a basis of confidence by any international organisation, and
- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people.

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This fully covers the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Fiona Whiteridge  
**Manager, Justice & Security**

# Information Being Released

## OIA 20150079

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RELEASED UNDER THE  
OFFICIAL INFORMATION ACT

**TREASURY REPORT COVER SHEET**

**Report No:** T99C/940

**Date:** 7 May 1999

**Security Classification:** Confidential

**Subject:** **Upcoming Defence Issues for Consideration and Treasury's General Concerns Over Defence Fiscal Risks**

	Action Sought	Deadline
<b>Treasurer</b>	Read and refer copy of the report to the Minister of Defence	Cabinet, 10am Monday 10 May 1999
<b>Minister of Finance</b>	Read and advise the Treasurer of any views	Cabinet, 10am Monday 10 May 1999
<b>Associate Minister of Finance (Dr Hon Lockwood Smith)</b>	Note	Cabinet, 10am Monday 10 May 1999
<b>Associate Minister of Finance (Hon Tuariki John Delamere)</b>	Note	Cabinet, 10am Monday 10 May 1999

**Contact for Telephone Discussion (if required):**

Name	Position	Telephone		Suggested First Contact
		Direct Line	After Hours	
Bryan Wilson	Manager, Government Services and Defence	471-5272	Withheld under s9(2)(a)	✓
John Wilson	Director, External and Government	471-5936		

GD/9/3/1A  
T99C/940

CONFIDENTIAL

7 May 1999

Treasurer  
Minister of Finance

cc: Associate Minister of Finance (Dr Hon Lockwood Smith)  
Associate Minister of Finance (Hon Tuariki John Delamere)

**UPCOMING DEFENCE ISSUES FOR CONSIDERATION AND TREASURY'S  
GENERAL CONCERNS OVER DEFENCE FISCAL RISKS**

**Executive Summary**

1. This report briefs Treasury Ministers on specific Defence issues to be considered in the first three days of next week, along with raising significant concerns that Treasury has over fiscal risks associated with the New Zealand Defence Force (NZDF).

*Not relevant to request*



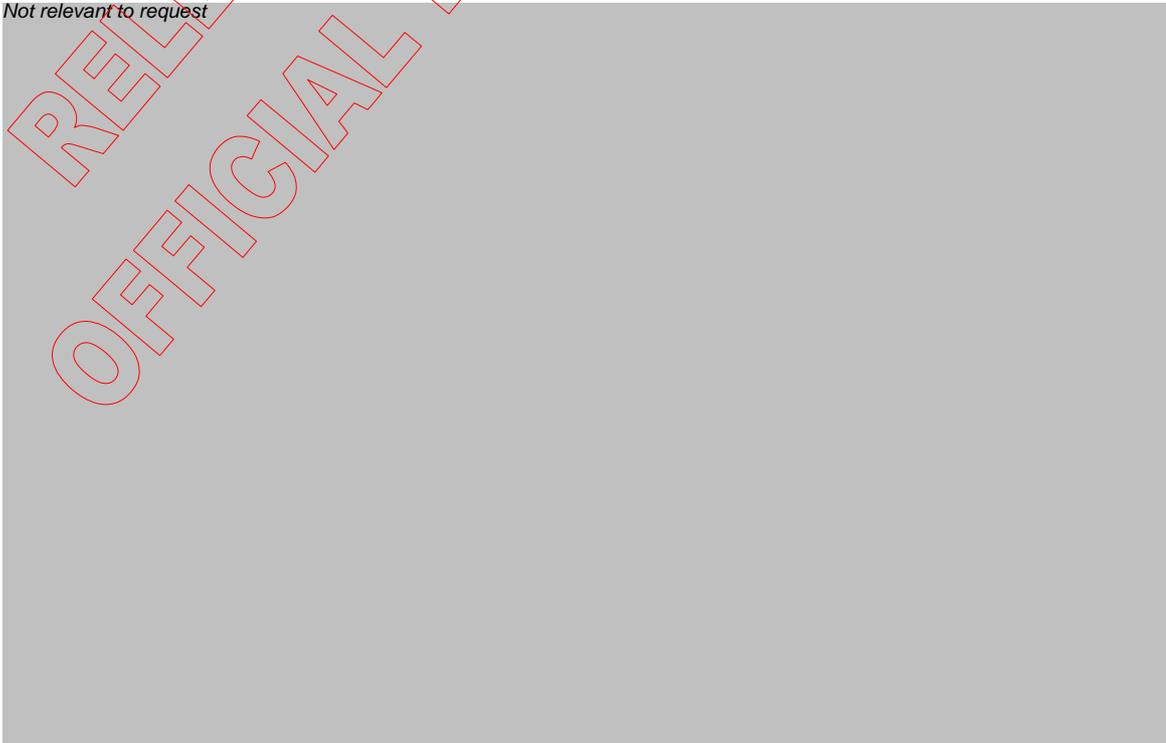
- e A paper providing an update on the status of NZDF capital procurement projects managed by the Ministry of Defence.

3. The issues above are indicative of a wider set of general concerns that Treasury now has over the NZDF's ability to manage within their operating budget and capital plan. The NZDF is consistently reporting their inability to absorb any additional costs without cutting outputs or compromising overall operating capability. Treasury is aware of some of the general pressures on the NZDF's baselines, however we lack specific details on the extent of this problem at this time.

4. It is also becoming apparent to Treasury that the NZDF's capital plan is becoming increasingly unsustainable. There are several factors contributing to this including inflation, adverse changes in foreign exchange rates, changes in the scope of projects and overly optimistic initial assessments of project costs. Indications are that the Government's blueprint for NZDF capability development may no longer be achievable without further large capital injections.

5. Treasury believes that the problems highlighted in this report are significant enough to warrant the Government giving serious consideration to a review of Defence policy and funding. The capability development objectives set out in the Defence Assessment 1997 now appear to be unachievable without sizeable additional capital injections from the Crown, and many of the assumptions factored into the 1997 assessment are no longer valid.

*Not relevant to request*



Not relevant to request

7. Briefing notes and suggested recommendations, for these meetings are included at the Annexes to this report. A separate annex has been prepared for each of these three days next week.

#### **Treasury's General Concerns Over NZDF Fiscal Risks**

8. The issues above are indicative of a wider set of general concerns that Treasury now has over the NZDF's ability to manage within their operating and capital financial constraints. These concerns centre around:

- a The pressures that the NZDF report to be facing on their operating baselines, combined with an apparent lack of centralised transparency and control over NZDF expenditure.
- b Our impression, shared in part by the NZDF, that the NZDF's capital plan is unsustainable. This is resulting in an inability to implement what is in effect the Government's approved blueprint for NZDF capability development.

9. The combination of problems being faced in both these areas has highlighted to us that many of the assumptions on which the Defence Assessment 1997 was based are no longer valid. We do not believe these issues can be resolved without a review of Defence policy and funding.

Not relevant to request

Page 4 not relevant to request

***Pressures on the Capital Plan***

14. As part of the Defence Assessment 1997 a major review was undertaken of the NZDF's capabilities. This review resulted in the NZDF capital plan being redrafted. However barely a year later, in November 1998, this capital plan had to be redrafted again, primarily due to:

- a an overall escalation in estimated project costs;
- b the government needing to make some major defence capability decisions which required affordability to be demonstrated; and
- c the New Zealand dollar had significantly devalued against the currencies of our major defence equipment suppliers.

*Not relevant to request*



16. There are also risks around the cost of the F-16 lease escalating. This risk is mainly due to complexities of the United States Government Foreign Military Sales (FMS) system, Withheld under s6(a) and s6(b)

An increase in the overall scope of the project, due to previously unforeseen equipment support requirements, also appears likely to increase the overall cost of this project.

17. Other general pressures contributing to the NZDF's capital plan becoming unaffordable include:

*Not relevant to request*



Not relevant to request

18. From the combination of specific and general factors discussed above Treasury believe the NZDF's capital plan is likely to have a funding shortfall of about \$300 million if all priority one projects go ahead. This figure requires detailed review, however gives some idea as to the extent of the affordability problem.

### **Conclusion**

19. It is clear to Treasury that not all NZDF 'priority one' projects can be afforded within the government's current funding envelope. Although a reprioritisation of projects may be possible it is highly unlikely that this will result in an affordable plan that allows all current policy objectives to be achieved. In our view a review of Defence policy and funding is required.

### **Recommendations**

20. We recommend that you:

- a **note** that briefing notes, discussion points and recommendations for your meetings on Defence issues next week are included at the annexes to this report;
- b **note** that Treasury believes that the problems highlighted in this report are significant enough to warrant the Government giving serious consideration to a review of Defence policy and funding; and

c **refer** a copy of this report to the Minister of Defence.

Bryan Wilson  
for Secretary to the Treasury

Minister of Defence

Referred: Yes/No

Rt Hon W F Birch  
Treasurer

Hon Bill English  
Minister of Finance

*Page 8 not relevant to request*

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Not relevant to request



Withheld under s6(a)



Not relevant to request



Not relevant to request

**3. Treasury recommends that you:**

***Paper One: Political Situation***

a Support all recommendations.

***Paper Two: NZDF Contingency Equipment Enhancements***

a Support recommendations:

“a.” (commencement of equipment enhancements).

“d.” (capital charge and depreciation for any capital purchases would be met by the NZDF).

Not relevant to request

“g.” (any operating or capital contributions would count against the government’s fiscal limits).

b Do not support recommendations:

“b” (approval of new, Crown funded, operating appropriations).

“c” (approval of new, Crown funded, capital contributions).

“h” (inviting Minister of Finance to approve incurring of expenses in excess of appropriation due to b and c above).

Pages 11-18 not relevant to request

LD/12/15

**COPY**

**TREASURY REPORT COVER SHEET**

Report No: T99C/1314

Date: 23 June 1999

Security Classification: In Confidence

Subject: F-16 Acquisition

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	Action Sought	Deadline
Treasurer	Discuss with the Minister of Defence	ASAP
Minister of Finance	Discuss with the Minister of Defence	ASAP
Associate Minister of Finance (Dr Hon Lockwood Smith)	None	N/A
Associate Minister of Finance (Hon Tuariki John Delamere)	None	N/A

Contact for Telephone Discussion (if required):

Name	Position	Telephone		Suggested First Contact
		Direct Line	After Hours	
Bryan Wilson	Manager, Defence and Government Services	471 5272		✓
John Wilson	Director, External and Government	471 5963		

24 JUN 1999



# THE TREASURY

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GD/8/2/15  
T99C/1314

IN CONFIDENCE

23 June 1999

Treasurer  
Minister of Finance

cc: Associate Minister of Finance (Dr Hon Lockwood Smith)  
Associate Minister of Finance (Hon Tuāriki John Delamere)

## F-16 ACQUISITION

1. We have a number of generic concerns with both:
  - the attached report, dated 1 June 1999, from the Minister of Defence regarding the F-16 acquisition; and
  - a paper (currently in draft form) that the Minister of Defence intends to submit to Cabinet Strategy Committee (STR) on 30 June 1999 seeking approval-to-commit to the acquisition (lease) of the F-16 aircraft and the purchase of supporting equipment and regeneration services.
2. Not all the costs associated with the F-16 project have been included in these documents. For example, costs for the Ohakea runway and the mid-life upgrade of the F-16s have been omitted. In our view, all the costs associated with the F16 project need to be clearly presented and described in the paper, including those already included in the Capital Plan (and 'minor Capital plan').
3. The costs of the support package and regeneration services, as currently stated, have increased (from NZ\$204 million to NZ\$238 million, GST exclusive), largely due to the inclusion of additional items (for example, the simulator) that Defence officials did not identify earlier in the process.
4. Further details on the proposed disposal process of the A4 Skyhawks (along with the timing of key milestones) also need to be clearly stated. In particular, details on how the process would be sped up once a decision is made on the F-16s.

5. The Minister of Defence aims to get his paper to STR on 30 June 1999. However, it is unlikely that we will be able to arrive at an agreed paper before then, given our concerns (outlined above) and the need for the Minister of Defence to consult and meet with you prior to the paper going to STR. Therefore, in order to get an agreed paper, we recommend that you invite the Minister of Defence to take the paper to STR on **14 July 1999**.

6. We expect to receive a revised copy of the paper from Defence shortly and will brief you again prior to the paper going to STR.

### Recommendations

7. We recommend that you:

- a **discuss** the contents of this note with the Minister of Defence; and ✓
- b **invite** the Minister of Defence to submit an agreed paper on the 'Lease of the F 16 aircraft and purchase of the supporting equipment and regeneration service' to Cabinet Strategy Committee on **14 July 1999**. ✓



Bryan Wilson  
for Secretary to the Treasury

Hon Bill English  
Treasurer



Rt Hon Sir William Birch  
Minister of Finance

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**CABINET STRATEGY  
COMMITTEE**

ACTION COPY,

**STR (99) 154**

12 July 1999

Copy No: 3

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*This paper is the property of the New Zealand Government. As it includes material for Cabinet or Cabinet Committee purposes it must be handled with particular care, and in accordance with any security classification or other endorsement assigned to it. The information in it may be released only by persons having proper authority to do so, and strictly in terms of that authority.*

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**LEASE OF F16 AIRCRAFT AND PURCHASE OF SUPPORTING EQUIPMENT AND  
REGENERATION SERVICES**

**LATE PAPER:** This paper was received after the Cabinet deadline.

Not relevant to request



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Not relevant to request

**Treasury recommendations**

- q note that:
  - i acquiring the F-16s replaces and increases New Zealand's current Air Combat capability;

- ii the capital costs associated with this increased capability are at least NZ\$700 million (assuming that the future Government purchases these aircraft at the conclusion of the second five year lease), comprising the:
  - A lease of the aircraft for ten years (NZ\$125 million);
  - B purchase of supporting equipment and regeneration services (the "start-up package"), including the engine hush-house (NZ\$246 million);
  - C purchase of equipment to allow the aircraft to be deployed into hostile situations and a structural integrity maintenance system (NZ\$42 million);
  - D outright purchase of the aircraft after ten years (NZ\$287 million);
- iii there will also be increased operating costs of approximately:
  - A <sup>additional</sup> NZ\$2.8 million per annum once the planes are operational; and
  - B NZ\$30 million per annum depreciation expenses once the aircraft are delivered.
- iv note that the net impact of these operating expenses requires further consideration, and that NZDF can absorb a large portion of these costs but they may also require some additional funding;
- r note that the figures referred to in paragraph (q) are GST exclusive and are based on an exchange rate of NZ\$1 = US\$0.52;
- s note that the current offer from the US Government for the F-16s still appears to be the "least cost option" for the New Zealand Government to acquire this increase Air Combat capability (compared to the cost it would face if it were to acquire this capability later as initially planned).

Brian Hallinan  
for Secretary of the Cabinet



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## Minister of Defence

**URGENT: PASS QUICKLY**

12 July 1999

Chair  
Cabinet Strategy Committee

### **REQUEST FOR INCLUSION OF LATE PAPER**

I request that the Defence paper "*Lease of F16 aircraft and purchase of supporting equipments and regeneration services*" be included in the Cabinet Strategy Committee meeting on Wednesday 14 July 1999 as a late agenda item.

The paper is late due to the requirement for exhaustive inter-departmental consultation (Treasury, the Controller and Auditor General and Crown Law Office) in order to reach an agreed position on the treatment of the lease arrangement in respect of it qualifying as a finance or operating lease and how this impacts on the NZDF Balance Sheet.

Yours sincerely

Hon Max Bradford  
**Minister of Defence**

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Office of the Minister of Defence

Chair  
Cabinet Strategy Committee

**LEASE OF F-16 AIRCRAFT AND PURCHASE OF SUPPORTING EQUIPMENTS AND  
REGENERATION SERVICES**



Not relevant to request

Pages 1-8 not relevant to request

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Not relevant to request

**Treasury Comment**

54. Acquiring the F-16s replaces and increases New Zealand's current Air Combat capability. The Capital costs associated with this increased capability are at least NZ\$700 million, (assuming that the future Government purchases these aircraft at the conclusion of the second five year lease) comprising the :

- lease of the aircraft for ten years (NZ\$125 million);
- purchase of supporting equipment and regeneration services, including the engine hush-house (NZ\$246 million);
- purchase of equipment to allow the aircraft to be deployed into hostile situations and a structural integrity maintenance system (NZ\$42 million); and
- outright purchase of the aircraft after ten years (NZ\$287 million).

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55. There will also be increased operating costs of approximately:

- NZ\$2.8 million per annum once the planes are operational; and
- NZ\$30 million per annum in depreciation expenses once the aircraft are delivered. However, the net impact of these operating expenses requires further work. NZDF can absorb a large portion of these costs but they may also require some additional funding.

All the figures are GST exclusive and are based on an exchange rate of NZ\$1=US\$0.52.

56. The paper states that the costs of the supporting equipment and regeneration services have increased from NZ\$204 million to NZ\$238 million. The increase has largely been due to US Officials errors and omissions during the FMS system and also partly due to the inclusion of additional items (for example, the simulator, estimated at NZ\$10 million). We understand that these latter costs would have been identified earlier had a normal acquisition process been in place.

57. In addition, an engine 'hush house' (estimated at NZ\$8 million) is also required. This cost needs to be recognised and included as part of the F-16 Project costs and not 'dealt with as a separate item in the Capital Plan' as currently proposed in the paper.

58. Acquiring this capability will almost certainly require additional equipment, including ECM pods and self protection equipment if the aircraft are to be deployed into hostile situations (such as in a coalition force in Kosovo). In addition, a structural integrity maintenance system is likely to be required. The estimated cost of this additional equipment is NZ\$42 million and this is not currently included in the Capital Plan.

59. Notwithstanding this, the current offer from the United States Government for the F-16s, still appears to be the 'least cost option' for the NZ Government to acquire this capability (compared to the cost it would face if it were to acquire this capability later, as initially planned).

Page 11 not relevant to request

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**Treasury recommends :**

p. **NOTE** that :

- i) acquiring the F-16s replaces and increases New Zealand's current Air Combat capability; and
- ii) the capital costs associated with this increased capability are at least NZ\$700 million, (assuming that the future Government purchases these aircraft at the conclusion of the second five year lease), comprising the:
  - lease of the aircraft for ten years (NZ\$125 million);
  - purchase of supporting equipment and regeneration services, including the engine hush-house (NZ\$246 million);
  - purchase of equipment to allow the aircraft to be deployed into hostile situations and a structural integrity maintenance system (NZ\$42 million);
  - outright purchase of the aircraft after ten years (NZ\$287 million); and
- iii) there will also be increased operating costs of approximately:
  - NZ\$2.8 million per annum once the planes are operational; and

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- NZ\$30 million per annum in depreciation expenses once the aircraft are delivered. However, the net impact of these operating expenses requires further work. NZDF can absorb a large portion of these costs but they may also require some additional funding;
- q. **NOTE** that all the figures are GST exclusive and are based on an exchange rate of NZ\$1=US\$0.52;
- r. **NOTE** that the current offer from the United States Government for the F-16s still appears to be the 'least cost option' for the NZ Government to acquire this capability (compared to the cost it would face if it were to acquire this capability later as initially planned).



Hon Max Bradford  
Minister of Defence

9 / 7 / 1999

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**Treasury Report: F-16s**

<b>Date:</b>	10 December 1999	<b>Treasury Priority:</b>	<b>High</b>
<b>Security Level:</b>	Confidential	<b>Report No:</b>	T99/3

**Action Sought**

	<b>Action Sought</b>	<b>Deadline</b>
Treasurer/Minister of Finance	Support proposals to review F16 lease	At Cabinet on Monday 13 December

**Contact for Telephone Discussion (if required)**

<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>
John Whitehead	Branch Manager	471 5295 (wk) <small>Withheld under s9(2)(a)</small>	✓
Bryan Wilson	Manager	471 5272 (wk)	

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9 December 1999

GD/8/2/15

## **Treasury Report: F-16s**

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### **Executive Summary**

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A review of the F-16 acquisition will allow wider Defence policy issues to be identified, with the potential to lead into a more comprehensive Defence Review allowing these wider policy issues to be tested.

Treasury is not in position to advise on whether NZ should divest its air combat capability – a wider review is required to do this. However, we note that some preliminary work does suggest that a more specialised Defence force has increased benefits over a broad approach to Defence.

### **Recommended Action**

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**Agree** to support proposals to review the current arrangement to lease 28 F-16s from the United States Government.

John Whitehead  
for Secretary to the Treasury

**Hon Dr Michael Cullen**  
Treasurer  
Minister of Finance

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## Treasury Report: F-16s

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### Purpose of Report

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1. This report briefs you on the F-16 issues that may be raised at next Monday's Cabinet meeting.
2. We understand that the Prime Minister is likely to brief Cabinet on plans for a review of the lease arrangement for 28 F-16 aircraft from the US Government. A terms of reference and budget for a review is currently being drafted by Mr Derek Quigley (and officials) focusing on the implications of any decision to cancel, suspend or continue the F-16 arrangement. This work would form the basis of a paper to the Cabinet meeting of 20 December 1999 formally recommending the review. If agreed, the review is expected to report to Cabinet by mid-February 2000.
3. Three annexes are also attached to this report outlining the:
  - costs and cash-flows of the F-16 lease arrangement,
  - fiscal risks and budget issues for Defence; and
  - an outline of the nature of the Defence votes.

### Analysis

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4. A review of the F-16 arrangement raises questions about the current air combat capability and about the future of the Air Force within the New Zealand Defence Force (NZDF). It may also open up opportunities to benchmark other areas of the defence business.
5. While there would be logic in resolving the general air combat capability issues first through a wider review, timing considerations favour an earlier and more rapid review of the F-16 lease arrangement. However, this review will allow the larger defence issues to be identified. For example:
  - affordability – current Defence Policy is **unaffordable** within current baselines (including the additional funding 'envelope' of \$500 million over ten years, signalled in the 1997 Defence Assessment – DA97). To maintain current policy, NZDF require capital injections estimated by NZDF to be \$1.084 billion (for highest priority projects only<sup>1</sup>) – **twice** the amount of capital injections signalled in the DA97 for ALL priorities (refer Annex 2); and
  - the need to establish clear defence objectives and links to defence outputs – doing this will assist Government move towards deciding on a more suitable

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<sup>1</sup> Which included replacement of the air combat force.

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defence force for New Zealand (an important issue for a future defence policy review).

In our view it is important that Ministers are aware of these wider Defence issues and that they are aware that air combat capability question is a component of a much larger defence affordability problem (Refer Annex 2).

At the time of the initial F-16 proposal last year, Treasury agreed with the NZDF and the Ministry of Defence (MoD) that the current F-16 arrangement was likely to be the least cost option for Government to maintain its air combat capability, given the current policy that this capability was to be maintained.

Treasury is not in a position to have a view on whether New Zealand should divest this air combat capability - a wider defence policy review would be required to test the merits of this option. However, we note that:

- the latest strategic review of defence policy (the Foreign Affairs Defence and Trade Select Committee Report – “Defence Beyond 2000”) ranked air combat as the least important capability;
- some very recent work<sup>2</sup> suggests that NZ (and potentially Australia) are likely to benefit from increased defence specialisation; and
- beyond some transitional costs, there would be considerable savings from divesting this capability; generated from the resulting redundant infrastructure (rationalisation of the Aermachhi jet trainers, airbases and support, personnel reductions and force elements (the A4s/F-16s).

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<sup>2</sup> A draft report commissioned by the Treasury. This has not yet received wide circulation or review.

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**ANNEX ONE: F-16 COSTS AND CASHFLOWS**

**Costs (GST exclusive)**

The total cost of the F-16 package is estimated at NZ\$700 million, comprising two consecutive five-year leases and the outright purchase of the aircraft.

The cost of the **first five-year** period is approximately \$276 million, comprising \$38 million in lease payments and \$238 million in support package costs.

The cost of the **second five-year** period is approximately \$87 million for the lease payments only.

The remaining costs of approximately \$337 million, are yet to be approved by Government:

- purchase of ECM pods to allow the aircraft to be deployed into hostile situations, and a structural integrity maintenance system (NZ\$42 million);
- engine hush-house (NZ\$8 million); and
- outright purchase of the aircraft after ten years (NZ\$287 million).

**Payments**

To date, New Zealand has paid approximately \$34 million. The next payment of (\$1.5 million) is due on 15 December 1999. Further payments are as follows (rounded):

*Cash payment schedule for 1999/00 (\$NZ millions, ER \$NZ=\$US 0.52)*

	Lease Payments	Support Package Payments	Cumulative total
Initial Deposit	2.5	29	31.5
15 Sep 99	1.5	0	33
15 Dec 99	1.5	0	34.5
15 Mar 00	1.5	19	55
15 Jun 00	1.5	24	80.5

**Legal issues**

*Withheld under s6(b)(i)*

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Withheld under s6(b)(i)

### **Disposal of the A4 Skyhawks**

A process is underway with Ernst & Young, contracted to the NZRAF, to dispose of the A4s. *Withheld under s6(a)* The MoD estimates a sale price of approximately \$NZ 144 million.

Timing of the disposal is important if the Government is to gain the best possible sale price. Delaying sale until 2007 (when the aircraft are due to be decommissioned) is likely to reduce the obtainable sale price - the aircraft will be less attractive to buyers and the airframes will have aged with greater wear and tear.

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## ANNEX 2: FISCAL RISKS AND 2000/01 BUDGET ISSUES

### *General affordability issues*

Current Defence Policy is **unaffordable** within current baselines (including the additional funding 'envelope' of \$500 million over ten years, signalled in the 1997 Defence Assessment – DA97).

### **The Capital Plan**

Following DA97, NZDF established a ten-year Defence Capital Plan outlining the capital expenditure required to meet current Defence Policy. The plan is divided into five priorities. As at November 1998 it totalled approximately \$4.1 billion comprising:

- Priority one \$3.4 billion (3rd Frigate, F-16 purchase, C130 replacement etc)

*Not relevant to request*



To maintain current policy, NZDF require capital injections estimated by NZDF to be \$1.084 billion (for priority one projects only) – **twice** the amount of capital injections signalled in the DA97 for ALL priorities.

These increases have been driven by military inflation (currently @ 6%), adverse movements in foreign exchange rates (most equipment is purchased in \$US), changes in the scope and timing of projects, and project cost increases. The extent to which these risks can be managed by NZDF/Mod is unclear.

### **2000/01 Budget issues**

**Capital injection for current NZDF commitments** – estimated at \$119 million in 2000/01 and \$18 million in 2001/02. This is a new risk.

**NZDF operating pressures** – driven by increases in fuel and munitions costs. Current estimates are \$30 million.

**East Timor** – \$35 million in 2000/01 to fund the second rotation of NZ's commitment (to 31 March 2001) to East Timor (a downsized force, 60% of a three-company battalion group). The main cost driver is Army (rations, clothing, general consumables).

**Potential source of savings** – Defence is a major area of discretionary spending. Divesting a capability can reap significant savings both from the resulting redundant infrastructure and force elements. A key issue for Ministers will be to decide whether Defence is a priority area for additional spending or a source of potential savings.

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### ANNEX 3: THE NATURE OF THE DEFENCE VOTES

Defence is:

- Expensive (the 7<sup>th</sup> largest government spending priority).
- Appropriated approximately \$1.8 billion (for 1999/2000). This purchases services from the Ministry of Defence (\$265 million – Vote Defence) and from the NZDF (Vote Defence Force, \$1.5 billion for an Army, Navy and Air Force).
- Funded to a directed level of capability (D-LOC). Additional funding is required (and sought by NZDF) to 'work' the force elements up to O-LOC (operational level of capability) for deployment. Actual deployment also requires additional funding. For example, East Timor.
- Highly capital intensive (with block obsolescence risk i.e. this can cause cash-flow and presentational problems if all the assets are replaced at one time).
- An area of high fiscal risk (cost increases, expensive if investment mistakes are made).

**Treasury Report: Financial Impact of a Decision to Exit the F-16 Deal**

<b>Date:</b>	29 February 2000	<b>Treasury Priority:</b>	<b>High</b>
<b>Security Level:</b>	Confidential	<b>Report No:</b>	T2000/334

**Action Sought**

	<b>Action Sought</b>	<b>Deadline</b>
Treasurer/Minister of Finance	Refer a copy of this report to the Prime Minister, Minister of Foreign Affairs and Trade and the Minister of Defence	Before the Prime Minister leaves for Australia

**Contact for Telephone Discussion (if required)**

<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>
Bryan Wilson	Manager, Government Services and Defence	471 5272 (wk)	Withheld under s9(2)(a) ✓
John Wilson	Middle Manager	471 5963 (wk)	

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29 February 2000

GD/8/2/15a

## **Treasury Report: Financial Impact of a Decision to Exit the F-16 Deal**

### **Executive Summary**

#### **Summary**

Cancelling the F-16 deal effective 31 March 2000 could provide an overall financial gain to the Crown in the order of \$6 million. The reason for the gain is that the positive impacts of unwinding the remaining hedging and a refund from the US more than outweigh the estimated costs.

**Table 1: Calculation of refund to NZ**

	<b>\$US million</b>
Amount paid to US by NZ (including 15 March payments)	29.4
Less: US estimate of costs it has incurred	6.7
<b>Estimated refund to NZ</b>	<b>22.7</b>

**Table 2: Gross costs incurred by NZ**

	<b>\$NZ million</b>
Hedged amount paid to US by NZ (including March 15 payments)	55.6
Less: refund from Table 1 above converted to \$NZ (@ XR = 0.488)	46.5
plus: costs incurred by NZ	1.8
<b>Gross cost to NZ</b>	<b>10.9<sup>1</sup></b>

**Table 3: Net cost/benefit incurred by NZ**

	<b>\$NZ million</b>
Benefit of Foreign exchange impacts from unwinding hedging arrangements	17
Less: Gross cost from table 2 above	10.9
<b>Net Benefit</b>	<b>6.1</b>

The overall impact is very sensitive to changes in the value of the NZ dollar. For every one cent change in the USD/NZD exchange rate there would be a corresponding \$6 million change in the financial impact. Thus an increase in the rate from the current 0.488 to 0.498 would reduce the gain to close to zero.

The major assumptions are: cancellation on 31 March 2000, and NZ makes the payments scheduled on 15 March 2000.

While the US estimates contain some risk, we are satisfied that that risk is small and that the estimates are robust.

<sup>1</sup> This is not the sum of the NZ costs and the converted US costs, because the exchange rates used in both cases are different.

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Withheld under s6(a) and s6(b)

### Recommended Action

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- a **note** that the unrecoverable costs from exiting the F-16 lease and associated LOAs are estimated at \$NZ10.9 million (Table 2) and that (subject to negotiation issues) these are unlikely to be subject to large variation;
- b **note** that at the current exchange rate, these costs are more than offset by foreign exchange gains, although the extent of these gains is very sensitive to the exchange rate; and
- c **refer** a copy of this report to the Prime Minister, Minister of Foreign Affairs and Trade and the Minister of Defence.

**Bryan Wilson**

Manager, Government Services and Defence  
for Secretary to the Treasury

Prime Minister  
Minister of Foreign Affairs and Trade  
Minister of Defence

Referred: Yes/no

**Hon Dr Michael Cullen**

Treasurer/Minister of Finance

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## **Treasury Report: Financial Impact of a Decision to Exit the F-16 Deal**

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### **Purpose of Report**

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1. This report summarises the financial impact of a decision to exit the F-16 deal. The impact is calculated as follows. The cost to NZ equals:
  - the amount paid by New Zealand (NZ) to the United States (US);
  - less the refund provided by the US to NZ after subtracting the costs incurred by the US;
  - plus other costs incurred by New Zealand; and
  - plus the impact of unwinding the hedging arrangements.
2. The basis of the costings (both US and NZ) are those costs that cannot be recovered and that have already been incurred (or would be incurred), at the time of exiting the F-16 deal. These are based on (1) the US's best estimate of US costs incurred on NZ's behalf, and (2) actual and estimated costs incurred by the Ministry of Defence.
3. This report covers direct costs of the F-16 deal. It does not include costs associated with any regeneration or improvement in the current A4 Skyhawk capability.

### **Analysis**

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*Withheld under s6(a) and s6(b)*

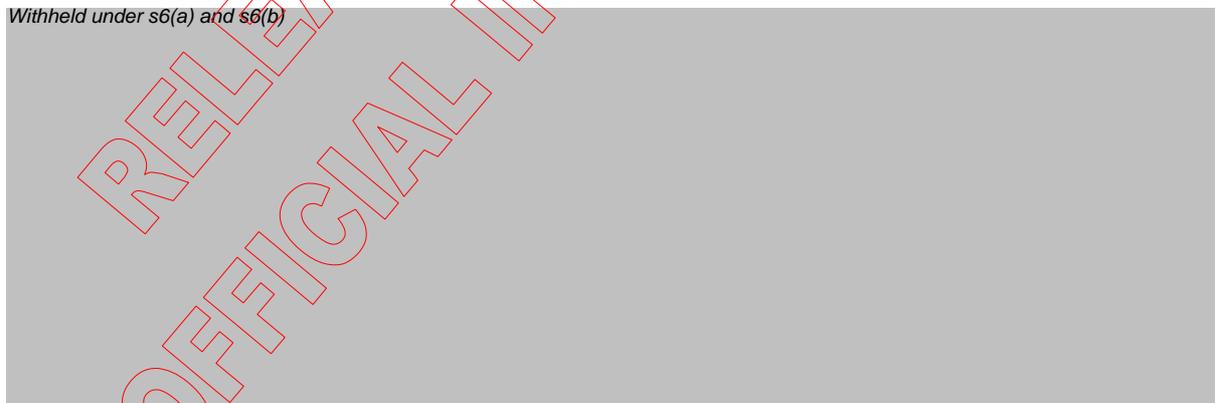


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### Structure of F-16 Arrangement

7. The F-16 deal consists of:
  - a a five year lease for 28 F-16 planes – estimated total cost US \$19.494 million;
  - b a Letter of Offer and Acceptance (LOA) for acquisition of spares and maintenance equipment, the regeneration of 22 planes to safe flying condition, and delivery of the planes to New Zealand – estimated total cost US \$112.607 million;
  - c a separate LOA covering US survey – estimated total cost US \$0.194 million. This has been completed and is in the process of being closed;
  - d a further LOA formally offering the planes to NZ to purchase – estimated total cost (a maximum of) US \$230.720 million<sup>2</sup>. This has not been signed by NZ but remains open; and
  - e Ministry of Defence project management, including a project definition study preceding the deal.
8. There is an informal understanding between US and NZ that there will be a second five year lease agreed to at the end of the first. This is not legally binding as the US Arms Export Control Act (AECA) allows for leases of up to only five years.

Withheld under s6(a) and s6(b)



11. The Lease requires a 180-day notice of cancellation.
12. The LOA includes an administration cost provision to cover overheads, including:
  - the costs of negotiating and establishing any contract; and
  - non-attributable overheads such as the availability of technical/expert support (whether or not used).

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<sup>2</sup> This was intended to represent a maximum figure based on \$US8 million per plane. Costs are likely to be lower than this if allowance for depreciation was built in at the time that a decision to purchase was made.

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13. All ongoing work is being undertaken under (2) and (5) above.

#### Current State of Play of F-16 Arrangement

14. The spares and regeneration LOA is at a very early stage. Only one subcontract is specific to this LOA and the US advised that termination can be accommodated without triggering further contractual costs to New Zealand. Very few orders of equipment have been made. All further action on is on hold.

#### Costs Incurred by US to Date

15. *Withheld under s6(a) and s6(b)*

16. *The Lease* – The US has interpreted the lease as requiring 180 days notice during which rental payments would be required. The US has also interpreted the lease schedule as specifying these rental payments. Assuming a notification to cancel were provided on 31 March 2000, the total cost of the lease would be US \$4,548,600.

17. *LOA Administration Costs* –

*Withheld under s6(a) and s6(b)*

This covers principally US costs in negotiating and arranging the LOA. The cost NZ would face to exit would be US \$1,250,021.

18. *Other LOA Costs* – Specific LOA item costs are estimated to total US \$907,020, and could be subject to (limited) variation.

#### Robustness of US Costs

19. The US was explicit that the costs it has identified are best estimates only and are not final figures. Nevertheless, they indicated that most of the figures were unlikely to change significantly. In particular, the risk around the Lease cost and the Administration Charge is extremely low.

20. *Withheld under s6(a) and s6(b)*

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21. *Withheld under s6(a) and s6(b)*

### Other Costs/Savings Relevant to Cancellation

22. The Ministry of Defence's project definition study leading up to this deal cost NZ \$957,000. This included the site survey LOA. That is being capitalised as part of the project.
23. Costs of the Ministry's project management (including the team at Hill Airforce Base) are about NZ \$600,000 to date. Additional expenditure of about \$300,000 would occur if the project was cancelled in March and some of the team remained to monitor US closure actions. There would also be some costs incurred in bringing the project team back early. These figures are based on estimates and are, therefore, not very robust.
24. The estimate (as at 27 February) of the financial impact of unwinding the remaining hedging for the Ministry of Defence is a benefit of NZ \$17 million. This estimates the amount the Crown gains by cancelling the remaining foreign exchange transactions. The unwind is based on estimates of current market interest rates and exchange rates. The price of the unwind is subject to change until the transactions are completed.
25. The majority of this benefit has come from the depreciation in the NZD/USD exchange rate. When the F-16s were hedged the Crown effectively established a large US \$ asset position at an average exchange rate of 0.5237. This position is now worth substantially more in NZ \$ terms than at the time it was created with the current spot NZD/USD rate being around 0.488. It is however, sensitive to changes in the rate – a one cent change would give rise to a change of about NZ \$5 million.

### Potential Negotiation Issues

26. The Lease contains a clause stating that "the quarterly payments in Schedule A will be adjusted based on actual flying hours used". We explored this with the US. The US indicated that it saw the current rental schedule as specifying a minimum lease payment. Its understanding of the intention behind the clause was that it was there to protect NZ if the US wanted the planes back, during the term of the lease and to protect the US if NZ decided not to renew the lease after the first five year period but had flown more hours than forecast. Both of these contingencies would result in the lease payments increasing.
27. The Ministry of Defence's recollection of the intention behind the clause is not entirely consistent with this. The Ministry understands that a downward adjustment of rental payments was envisaged if fewer than estimated hours were flown. The Ministry has indicated that there was an understood view that this adjustment would occur at the end of the lease. It should be noted that depreciation to date would be

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a factor in determining the purchase price of the aircraft (ie less than \$US 8 million) if NZ decided to proceed to purchase.

28. While the initial discussions did not envisage a cancellation, the Ministry's understanding would be consistent with a lease adjustment at cancellation for zero hours being flown. Such an approach would require the establishment of a figure to compensate reasonably the US for the costs it had actually incurred (e.g., the lost opportunity to sell or lease the planes to another customer).

29. *Withheld under s6(a) and s6(b)*

30.

**Financial Impact of a Cancellation**

31. Three tables show the calculation of the net financial impact resulting from cancelling the F-16 lease and associated LOA. They are:

- Table 1, which calculates the likely refund to NZ;
- Table 2, which calculates the gross cost to NZ; and
- Table 3, which calculates the net cost to NZ (ie offsets the costs incurred against the benefit of unwinding foreign exchange cover).

**Table 1: Calculation of refund to NZ**

	\$US million
Amount paid to US by NZ (including 15 March payments)	29.4
Less: US estimate of costs it has incurred	6.7
<b>Estimated refund to NZ</b>	<b>22.7</b>

**Table 2: Gross costs incurred by NZ**

	\$NZ million
Hedged amount paid to US by NZ (including March 15 payments)	55.6
Less: refund from Table 1 above converted to \$NZ (@ XR = 0.488)	46.5
plus: costs incurred by NZ	1.8
<b>Gross cost to NZ</b>	<b>10.9<sup>3</sup></b>

**Table 3: Net cost/benefit incurred by NZ**

	\$NZ million
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<sup>3</sup> This is not the sum of the NZ costs and the converted US costs, because the exchange rates used in both cases are different.

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Benefit of Foreign exchange impacts from unwinding hedging arrangements	17
Less: Gross cost from table 2 above	10.9
<b>Net Benefit</b>	<b>6.1</b>

32. Both the impact from unwinding the hedging arrangement and the refund to NZ are sensitive to the value of the NZ dollar. For every one cent change in the USD/NZD exchange rate there would be a corresponding \$6 million change in the financial impact. Thus an increase in the rate from the current 0.488 to 0.498 would reduce the gain to close to zero.

### Sensitivity to Time of Decision

#### *Delaying Cancellation*

33. Delaying a cancellation decision is possible without the US incurring much additional expenditure on the LOA. The major impact of a long delay would be serious schedule (and, therefore, some inflation) risk if the project went ahead. There would also be some costs arising from re-establishing a US team if the project were restarted after a long delay.

34. However, indications were that the US would continue to accrue rental for the planes at US \$324,900 per month (paid in quarterly instalments of \$974,700).

#### *Bringing Forward Cancellation*

35. In terms of the scheduled payments, deciding and notifying the US before 15 March would affect only the LOA payment due on 15 March. This would not proceed. On the other hand, lease payments for the notice period (including 15 March) would still be required.

### Process

36. Cancellation would require a formal letter to the Defence Security Assistance Agency from the Ministry of Defence via the NZ Embassy in Washington. The US would act immediately upon receipt of that letter.
37. The US was confident (but not absolutely certain) that a final bill could be provided within six months. Refunds of overpayments would need to await confirmation of all costs (i.e., until September). (Further NZ advances scheduled for post 15 March would be required only in respect of the lease and not for the LOA.)
38. The US indicated that there would be little that NZ would have to do to assist in winding up the deal. It might be useful for some Ministry of Defence presence (e.g., the project manager) to remain at Hill Airforce Base for a limited period to monitor the costs charged to New Zealand. The US indicated that they were comfortable with this. The NZ Embassy would also be involved in case closure.

**Treasury Report: Defence Issues: Meeting with Treasury Officials**

<b>Date:</b>	20 April 2000	<b>Treasury Priority:</b>	<b>High</b>
<b>Security Level:</b>	Confidential	<b>Report No:</b>	T2000/827

**Action Sought**

	<b>Action Sought</b>	<b>Deadline</b>
Treasurer/Minister of Finance	Discuss at your meeting with Treasury officials on Defence issues	4.15pm Wednesday 26 April 2000
Associate Minister of Finance	Note	None

**Contact for Telephone Discussion (if required)**

<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>
Bryan Wilson	Manager, Government Services and Defence	471 5272 (wk)	Withheld under s9(2)(a) ✓
John Whitehead	Branch Manager	471 5295 (wk)	

Confidential

20 April 2000

## **Treasury Report: Defence Issues: Meeting with Treasury Officials**

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We have a meeting with you on Wednesday 26 April 2000 at 4.15pm to discuss:

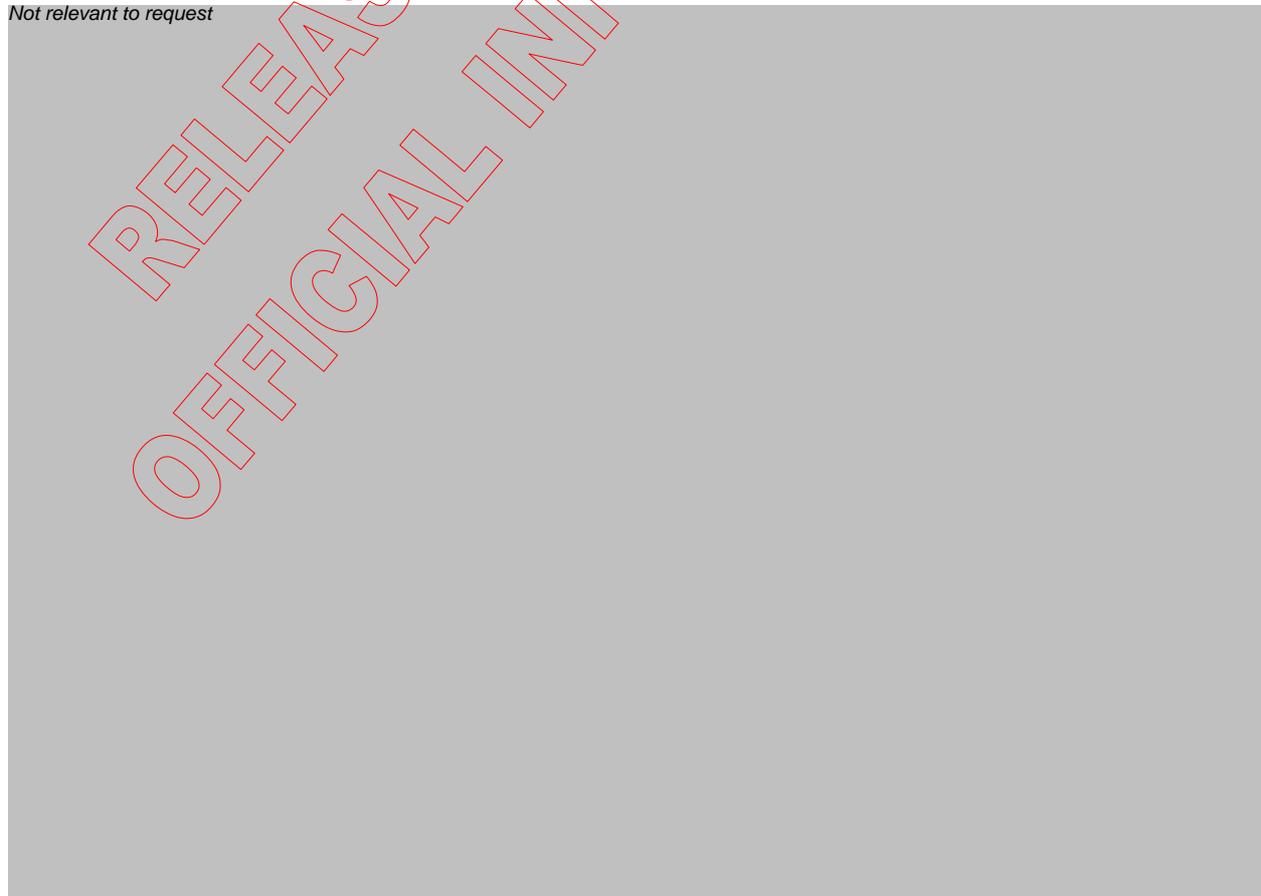
- the New Zealand Defence Force Real Estate Consolidation Strategy (see T2000/801);
- Project Sirius - the letter you asked us to draft is attached for discussion;
- the forthcoming Defence Review process; and
- Treasury's preliminary thinking on the Defence Review outcomes.

This note focuses on the last two discussion points.

### **Defence Review Process**

Many of the problems facing defence today are similar to those faced at the time of the 1997 Defence Assessment i.e. the unaffordability of the Defence Capital Plan and the need for the Government to set priorities in Defence spending.

*Not relevant to request*



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### Treasury's Preliminary Thinking on Defence Issues

In assessing New Zealand's future force structures it is important to consider:

- affordability over the long term;
- forces that can capably handle independent national tasks; and
- forces that can make a meaningful contribution to our security partners.

In addition New Zealand needs to respond and deploy quickly, and be equipped sufficiently for the job i.e. our Defence Force needs **depth**. Depth should enable our forces to be seen as **credible** by our partners.

In our view the past approach of breadth over depth - keeping the widest range of options open at lower levels of credibility and readiness - has not yielded the maximum security credits with our partners. New Zealand has been criticised for spreading resources too thinly. For example, NZ's contribution to Bosnia was seen as professional in approach, but poorly equipped. Keeping New Zealand's military capability up to date is an ongoing and dynamic problem, with increasingly specialised and costly technology fast outstripping our ability to maintain the entire platform.

Therefore the choice in developing a credible force for New Zealand that will overcome NZDF's current fiscal problems, probably means shedding some of the capabilities that we currently have and instead emphasising areas where we have a comparative advantage. At this stage Treasury's thinking is that a Defence Force centred on elements associated with having a very mobile and deployable Army would meet Government's objectives. This offers the most appropriate arrangements for New Zealand's security requirements, and presents the best value for money.

The argument for a shift to a more land force centred Defence Force is as follows:

- it is the Army that provides the bulk of the forces required to meet both the small contingencies and the recent overseas deployments made by New Zealand;
- the type of force elements used by the New Zealand Army tend to be less technology intensive than the Air Force or Navy, so that the risk of being committed to high cost capital replacements is reduced;
- New Zealand land force contributions are valued by our allies as it is more possible to train and equip infantry up to international standard within our fiscal constraints;
- it plays on New Zealand's traditional strengths in well trained, independent and resourceful personnel; and
- while it is not possible to predict future Defence requirements with any great certainty, historically the Army and air transport have been the most frequently deployed.

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For a shift to a force structure along these lines to occur, without increased baselines, does imply some reduction in existing capabilities from the naval combat and/or air combat force elements. The choice the Government would most likely have involves either an early decision to phase out the air combat force, or a decision to downsize the naval combat fleet.

### **Gaining Acceptance From Our Allies**

A re-focused NZDF centred around land-based capabilities however poses a diplomatic challenge to convince our allies that New Zealand is not reducing its overall Defence efforts. A Defence Force with **depth** should be **credible** as it is of far greater utility but traditionally our allies have evaluated our membership fee by:

- inputs - Defence spending as a ratio of Gross Domestic Product;
- process - sustaining the current force structure; and
- the range of potential deployment options New Zealand has available.

Our proposed approach based on achieving **depth** in land forces and air transport focuses on what it has historically done well and gives the Government the ability to front with well-equipped and credible force elements. Marketing this to our partners will require demonstrating that this gives more credible deployment options than a force structure based on a wider spread of increasingly poorly equipped capabilities.

### **Recommended Action**

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We recommend that you **discuss** the contents of this report with Treasury officials.

#### **Bryan Wilson**

Manager, Government Services and Defence  
for Secretary to the Treasury

#### **Hon Dr Michael Cullen**

Treasurer/Minister of Finance

**Treasury Report: Aide Memoire for Meeting with Ministers on Defence Review**

<b>Date:</b>	19 May 2000	<b>Treasury Priority:</b>	<b>High</b>
<b>Security Level:</b>	Confidential	<b>Report No:</b>	T2000/1045

**Action Sought**

	<b>Action Sought</b>	<b>Deadline</b>
Treasurer/Minister of Finance	Read and use at meeting of key Ministers on defence review	Meeting to be arranged
Associate Minister of Finance	Read and use at meeting of key Ministers on defence review	Meeting to be arranged

**Contact for Telephone Discussion (if required)**

<b>Name</b>	<b>Position</b>	<b>Telephone</b>	<b>1st Contact</b>
John Wilson	Director, External and Government	471 5936 (wk)	Withheld under s9(2)(a) ✓
Bryan Wilson	Manager, Government Services and Defence	471 5272 (wk)	

In Confidence

19 May 2000

GD/8/6/1

## Treasury Report: Aide Memoire for Meeting with Ministers on Defence Review

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### Purpose

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1. You agreed to a meeting of relevant Ministers to discuss the forthcoming Defence Review. This note summarises the key issues you may want to discuss at the meeting - the Review process and what the Review should cover including:
  - New Zealand's strategic environment;
  - Government response to the environment;
  - Force element priorities;
  - Re-equipment plan; and
  - Gaining acceptance from our allies.

An Aide Memoire, with discussion points, is attached.

### Analysis

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#### Review Process

2. A sound review process will be essential for ensuring a sustainable outcome from the Defence Review. This will require drawing upon the lessons of the 1997 Defence Assessment, in particular:
  - i* **Clarity of Government requirements** – The clearer and more specific the Government's policy statement is, the easier it will be for the rest of the Review. If Government were sufficiently clear about the nature of the most likely operations New Zealand would deploy to then the basic structure (capabilities and outputs) of Defence Force would follow directly. The Government currently has clear and defined objectives in Defence to upgrade the Army and focus the Defence Force on peacekeeping and peace enforcement roles. The terms of reference for the Review should clearly articulate these objectives.
  - ii* **Rigorous Ministerial involvement** – Ministers need to be closely involved in the Review process to ensure that the Review maintains momentum and delivers the outcome that the Government wants. Past assessments have become bogged down in technical detail but if the Government has clarity of objectives then Treasury believes that highly technical analysis at each stage

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adds little value and is likely to significantly delay completion and implementation of the review.

- iii* **Long term focus** – The Review needs to look ahead at least twenty years. It needs to ensure that Defence's long term planning strategy is focused on delivering the set of capabilities required by Government and not focused on maintaining a "balanced" tri-service force.
- iv* **Credible budget constraint** – The Review process must consider the amount of funding the Government is willing to commit to Defence (instead of to other fiscal priorities). Defence assessments in the past have tended to determine capability without early consideration of cost. Fiscal concerns have been considered as secondary to defence and foreign policy objectives. Understanding fiscal parameters from the beginning of the Review will improve the quality of the outcome. This will require a strong involvement from Finance Ministers.
- v* **Keep the process simple** - The logic of the Review should be kept simple to maintain momentum and should:
- identify threats, risks and the likelihood of them occurring – i.e., a strategic assessment;
  - decide on how New Zealand will respond to those – i.e., set Government defence policy;
  - determine the likely type of engagement that New Zealand will be involved in;
  - identify the type of capability Defence Force should have to best contribute to those engagements; and
  - develop a long-term re-equipment plan and identify any operational or structural implications.

### **What the Review Should Cover**

#### ***New Zealand's Strategic Environment***

3. Strategic Assessment 2000 completed by the External Assessment Bureau concluded:
- New Zealand is not directly threatened by any country;
  - New Zealand is unlikely to be involved in any widespread armed conflict within the next five years; and
  - New Zealand will face a number of challenges over the next five years including problems caused by unstable Government in South Asia and the Pacific and by pressures on the multilateral system.

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### **Government Response**

4. The Government has already informally articulated a response to this strategic environment:
  - New Zealand will contribute to UN peacekeeping/peacemaking requests;
  - New Zealand will respond to local/regional security issues in a cooperative way with Australia and others; and
  - New Zealand will continue a strong relationship with Australia.
5. Based on this context it seems most likely that New Zealand will continue to contribute, as a junior partner, to peacekeeping/peace enforcement deployments such as the current contribution to East Timor.

### **Force Element Priorities**

6. The basic structure required by the Defence Force would be based on the argument for a shift to a more land force centred Defence Force, which is as follows:
  - it is the Army that provides the bulk of the forces required to meet both the small contingencies and the recent overseas deployments made by New Zealand;
  - the type of force elements used by the New Zealand Army tend to be less technology intensive than the Air Force or Navy, so that the risk of being committed to high cost capital replacements is reduced;
  - New Zealand land force contributions are valued by our allies as it is more possible to train and equip infantry up to international standard within our fiscal constraints;
  - it plays on New Zealand's traditional strengths in well trained, independent and resourceful personnel; and
  - while it is not possible to predict future Defence requirements with any great certainty, historically the Army and air transport have been the most frequently deployed.

### **Joint Force**

7. The Defence Force should also look at joint-force structures. A Defence Force based on a force element structure as outlined above suggests that a joint force approach might be desirable. The Canadian and Irish experiences should be looked at much more thoroughly.

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### ***Re-equipment Plan***

8. This lends itself to focus a re-equipment plan on developing the capabilities of:
  - Special Air Service;
  - an Army equipped well enough to make an effective, self sufficient and robust contribution; and
  - air and naval support elements.
9. A prioritised re-equipment plan to achieve the Government's defence policy objectives would therefore be based on:
  - vehicles and weapons for the Army;
  - acquiring a military sealift capability - probably upgrading the Charles Upham. While this may not have been the best purchase initially, it is likely to be the cheapest way ahead for a maritime transport capability;
  - upgrading air transport – Hercules and possibly the current 727; and
  - upgrading rotary wing transport – currently the Iroquois.
10. A shift in force structure along these lines to occur, without increased baselines, does imply that some reduction in existing capabilities is necessary. Capabilities that appear to deliver lower value for money include:
  - maritime surveillance – leaders of coalition operations New Zealand will be involved in are likely to be Australia or the US. These countries will always have a significantly greater ability to provide and manage this capability; and
  - air strike – this is very expensive, widely available around the region, and is less likely to be required in any UN or peacekeeping/peace enforcement operations.

### ***Gaining Acceptance From Our Allies***

11. A re-focused NZDF centred on land-based capabilities poses a diplomatic challenge to convince our allies that New Zealand is not reducing its overall Defence efforts. Traditionally our allies have evaluated our membership fee by:
  - inputs - Defence spending as a ratio of Gross Domestic Product;
  - process - sustaining the current force structure; and
  - the range of potential deployment options New Zealand has available.

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12. Our proposed approach based on achieving depth in land forces and air transport focuses on what it has historically done well and gives the Government the ability to front with well-equipped and credible force elements. Marketing this to our partners will require demonstrating that this gives more credible deployment options than a force structure based on a wider spread of increasingly poorly equipped capabilities.

### Recommended Action

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13. Treasury recommends that you **note** this report for you to use, if you wish, at the meeting of key Ministers on the defence review.

**John Wilson**

Director, External and Government  
for Secretary to the Treasury

**Hon Dr Michael Cullen**

Treasurer/Minister of Finance

## Aide Memoire – Defence Review Meeting with Ministers

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### **Review Process**

A sustainable Defence Review outcomes requires:

- clarity of Government requirements;
- rigorous Ministerial involvement;
- long term focus;
- credible budget constraint; and
- simple process.

### **What the Review Should Cover**

#### ***New Zealand's Strategic Environment***

- New Zealand is not directly threatened by any country.
- New Zealand is unlikely to be involved in any widespread armed conflict within the next five years.
- New Zealand will face a number of challenges over the next five years including problems caused by unstable Government in South Asia and the Pacific and by pressures on the multilateral system.

#### ***Government Response***

- New Zealand will contribute to UN peacekeeping/peacemaking requests;
- New Zealand will respond to local/regional security issues in a cooperative way with Australia and others; and
- New Zealand will continue a strong relationship with Australia.

#### ***Force Element Priorities***

- The basic structure would be based on a shift to a more land force centred Defence Force.

#### ***Joint Force***

- The Defence Force should also look at joint-force structures.

### ***Re-equipment Plan***

- A prioritised re-equipment plan would be based on:
  - vehicles and weapons for the Army;
  - acquiring a military sealift capability - probably upgrading the Charles Upham;
  - upgrading air transport – Hercules and possibly the current 727; and
  - upgrading rotary wing transport – currently the Iroquois.
- Capabilities that appear to deliver lower value for money include:
  - maritime surveillance; and
  - air strike.

### ***Gaining Acceptance From Our Allies***

- Marketing this to our partners will require demonstrating that this gives more credible deployment options than a force structure based on a wider spread of increasingly poorly equipped capabilities.

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