

Reference: 20160368

14 December 2016



Thank you for your Official Information Act request, received on 13 October 2016. You requested the following:

- “1. A copy of any reports, briefings and advice prepared by Treasury regarding the 2016 Defence White Paper, since 1 January 2016;
2. A copy of any analysis or modelling undertaken by Treasury relating to the forecast expenditure relating to the 2016 Defence White paper, since 1 January 2015.”

As indicated in my letter of 10 November, I decided under section 15A of the Official Information Act to extend the time limit for deciding on your request by an additional 25 working days. The extension was required because of the consultations needed to make a decision on your request.

Information Being Released

Please find enclosed the following documents:

| Item | Date | Document Description | Decision |
|------|------------------|----------------------------------------------------------------------------------------------------|-----------------|
| 1. | 26 February 2016 | Treasury Report: Briefing for Cabinet National Security Committee, Tuesday 1 March 2016 | Release in part |
| 2. | 1 April 2016 | Treasury Report: Defence: Agreeing a White Paper and Indicative Funding | Release in part |
| 3. | 1 April 2016 | Treasury Report: Briefing for Cabinet National Security Committee, Tuesday, 5 April 2016 | Release in part |
| 4. | 11 April 2016 | Treasury Report: Defence White Paper 2016: Briefing to Minister of Finance and Minister of Defence | Release in part |
| 5. | 12 April 2016 | Aide Memoire: Defence White Paper: Meeting with Minister of Defence | Release in part |

| | | | |
|----|-------------|-----------------------------------------------------------------------------------------|-----------------|
| 6. | 6 May 2016 | Treasury Report: Briefing for Cabinet National Security Committee, Tuesday, 10 May 2016 | Release in part |
| 7. | 16 May 2016 | Pre-Cab Briefing 16 May | Release in part |

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:

- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including deceased people,
- advice still under consideration, section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials,
- names and contact details of junior officials and certain sensitive advice, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions, and
- commercially sensitive information, under section 9(2)(b)(ii) – to protect the commercial position of the person who supplied the information, or who is the subject of the information.

Some information has been deleted because it is not covered by the scope of your request.

With regards to point 2 of your request, I can advise that Treasury did not undertake any independent analysis or modelling of forecast expenditure relating to the 2016 Defence White Paper. We were comfortable with the modelling approach taken by the New Zealand Defence Force (NZDF), and used the forecasts generated by its modelling in our advice.

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

Colin Hall
Manager, Justice, Security and Government Services

OIA Information for Release

| | | |
|----|---------------------------------------------------------------------------------------------------------------------------------------------|----|
| 1. | <u>Treasury Report Briefing for Cabinet Committee on Domestic and External Security Co-ordination Tuesday, 1 March 2016</u> | 1 |
| 2. | <u>Treasury Report Defence Agreeing a White Paper and indicative funding, 1 April 2016</u> | 8 |
| 3. | <u>Treasury Report Briefing for Cabinet Committee on Domestic and External Security Co-ordination Tuesday, 5 April 2016</u> | 27 |
| 4. | <u>Treasury Report Defence White paper 2016 Briefing to Minister of Finance and Minister of Defence, 11 April 2016</u> | 29 |
| 5. | <u>Aide Memoire Defence White Paper Meeting with Minister of Defence, 12 April 2016</u> | 35 |
| 6. | <u>Treasury Report Briefing for Cabinet National Security Committee Tuesday, 10 May 2016</u> | 37 |
| 7. | <u>Pre-Cab Briefing 16 May 2016</u> | 42 |



**Treasury Report: Briefing for Cabinet National Security Committee -
Tuesday, 1 March 2016**

| | | | |
|--------------|------------------|---------------------|-----------|
| Date: | 26 February 2016 | Report No: | T2016/302 |
| | | File Number: | MS-5-NSC |

Action Sought

| | Action Sought | Deadline |
|------------------------------------------------------|---------------------------|--------------------------------|
| Minister of Finance (Hon Bill English) | Read prior to NSC meeting | 4.00 pm, Tuesday, 1 March 2016 |
| Associate Minister of Finance (Hon Steven Joyce) | Read prior to NSC meeting | 4.00 pm, Tuesday, 1 March 2016 |
| Associate Minister of Finance (Hon Paula Bennett) | Read prior to NSC meeting | 4.00 pm, Tuesday, 1 March 2016 |

Contact for Telephone Discussion (if required)

| Name | Position | Telephone | 1st Contact |
|------------------|-------------------------------|--------------------------------------|--------------------|
| Warren Kilmartin | Senior Analyst | 04 890 7423 (wk) ^{s9(2)(a)} | ✓ |
| Colin Hall | Manager, Justice and Security | 04 917 6227 (wk) | |

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Briefing for Cabinet National Security Committee -
Tuesday, 1 March 2016

Executive Summary

We are currently aware of three items on the National Security Committee agenda for Tuesday 1 March 2016. The table below identifies any relevant fiscal impacts and/or provides Treasury's comments/recommendations on one of these. The remaining two papers which we are aware of, for which Treasury has no briefing or comment, are listed below the table for completeness.

| Title | Pg | Recommend | Fiscal Implications (\$m GST excl.) | | | | | Treasury Comment |
|------------------------------------------------------------------|----|----------------|-------------------------------------|-------|-------|-------|-----------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| | | | 15/16 | 16/17 | 17/18 | 18/19 | Out years | |
| Vote Defence Force: Defence White Paper – capability and funding | 4 | do not support | <i>Operating</i> | | | | | <p>We do not support the recommendations in this paper. We recommend that Cabinet either:</p> <p>a. delay approval of the DWP until more work is done on the funding cost pressures; or</p> <p>b. approve the DWP policy settings and include the alternative recommendations attached (Treasury preferred).</p> |
| | | | - | - | - | - | - | |
| | | | <i>Capital</i> | | | | | |
| | | | - | - | - | - | | |

Out of scope of request

Recommended Action

We recommend that you **read** this report prior to the Cabinet National Security Committee meeting at 4.00 pm on Tuesday, 1 March 2016.

Colin Hall
Manager, Justice and Security

Hon Bill English
Minister of Finance

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Vote Defence Force: Defence White Paper – capability and funding

Responsible Person: Colin Hall, Manager, Justice & Security, 917 6227

First Contact Person: Warren Kilmartin, Senior Analyst, Justice & Security, 890 7423

Purpose

This paper seeks Cabinet agreement to:

- an updated Defence force structure; and
- delegate authority to the Minister of Defence to finalise and release the Defence White Paper 2016.

Comment

1. The Treasury considers publishing the new Defence White Paper (DWP) as it stands may expose the Government to unnecessary fiscal risk. If the Defence White Paper is published as recommended in this paper s9(2)(g)(i)

s9(2)(g)(i)

s9(2)(f)(iv)

s9(2)(f)(iv)

Long term affordability

2. In 2013, through the DMRR, Cabinet approved substantial Defence spending to 2030 to deliver on 2010 DWP policy settings s9(2)(f)(iv) of operating expenditure and s9(2)(f)(iv) capital expenditure). The DMRR represented a significant and unprecedented uplift in defence spending and was the maximum amount that Cabinet was willing to spend on the Defence Force at that time.

Cost pressures and new spending

3. In the two years since DMRR, Defence has not put in place mechanisms to live within its long term DMRR envelope s9(2)(f)(iv)

s9(2)(f)(iv)

s9(2)(f)(iv)

Defence has started work to address these issues but further work needs to be done.

4. s9(2)(g)(i)

Neither of the two funding options presented in this Cabinet paper are within the DMRR envelope. s9(2)(f)(iv)

s9(2)(f)(iv)

After some capability trade-offs (e.g. heavy airlift) Defence is proposing an option to meet proposed updated DWP policy settings. The Defence proposed option is more expensive again. The costs associated with the options are summarised in Table 1.

Table 1

| | (\$m) | | |
|-----------|--------------------|-------------------------------------------------------|----------------------------------------------|
| | DMRR total funding | Defence recosted DMRR capability (Alternative option) | Defence preferred option above adjusted DMRR |
| Operating | s9(2)(f)(iv) | | |
| Capital | s9(2)(f)(iv) | | |

5. Both options contain proposals for equipment above that provisioned for in the DMRR (e.g. a significantly enhanced littoral support ship, increasing the cost s9(2)(f)(iv) s9(2)(f)(iv)

6. Our view is that the DMRR envelope already provides a significantly improved Defence Force that achieves the proposed 2015 Defence White Paper policy. If Cabinet wishes to consider additional spending, we recommend it should do this only when the full capital and operating implications are well understood.

Your options for managing the fiscal risk

7. In order to have comfort that the fiscal risk is controlled, Cabinet could either:

- a. direct that more work is done s9(2)(f)(iv) before the DWP is released – this work should include an option within the DMRR envelope; or
- b. approve the release of the DWP, and direct that Defence must deliver the DWP within the DMRR capital and operating envelope (see attached alternative recommendations).

8. Our preference is for option b as it sends a strong signal about Cabinet's expectation that Defence proactively manages its operating and capital cost s9(2)(f)(iv) s9(2)(f)(iv) This approach would allow the Minister of Defence to publish the Defence White Paper as planned.

Treatment of cost assumptions

9. The 2013 DMRR envelope was underpinned by assumptions for future inflation and foreign exchange rates. We consider that there is a case for Cabinet to update some of these assumptions so that the funding envelope remains current. However, the approach Defence has taken to updating the cost assumptions in this Cabinet paper has not yet been explained or approved by Ministers. We propose that further work is done on a mechanism for updating the external assumptions (i.e. external factors only, not extra equipment purchases) and we have included this as part of the alternative recommendations (attached). This would also allow Cabinet to be very clear with Defence about the funding envelope that it is accountable for and must stay within over the long term.

Treasury Recommendation

10. We recommend you **do not support** the recommendations in this paper. We recommend that Cabinet either:
- a. delay approval of the DWP until more work is done on the funding s9(2)(f)(iv)
s9(2)(f)(iv) or
 - b. approve the DWP policy settings and include the alternative recommendations attached (Treasury preferred).

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Alternative Recommendations (funding remains within the DMRR envelope)

1. **note** that Cabinet agreed to the following indicative increases to the Defence Force's operating baselines from 2014/15 to 2029/30 as part of the Defence Mid-Point Rebalancing Review [CAB MIN (13) 39/5];

| DMRR Track 1 | \$m – increase / (decrease) | | | | |
|--------------|-----------------------------|---------|---------|---------|---------|
| | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
| | s9(2)(f)(iv) | | | | |
| | 2020/21 | 2021/22 | 2022/23 | 2023/24 | 2024/25 |
| | s9(2)(f)(iv) | | | | |
| | 2025/26 | 2026/27 | 2027/28 | 2028/29 | 2029/30 |
| | s9(2)(f)(iv) | | | | |

2. **note** that the Defence Mid-Point Rebalancing Review funding track (Track 1) provisioned for total capital expenditure s9(2)(f)(iv) consisting of accumulated depreciation and capital injections, between 2013/14 to 2029/30;
3. **agree** that the 2013 Defence Mid-Point Rebalancing Review funding track (Track 1) as per Recommendations 1 and 2 above be used as the basis, for planning purposes, for the level of NZDF operating and capital funding out to 2029/30, underpinning the 2016 Defence White Paper;
4. **agree** that the Defence Mid-Point Rebalancing Review funding track (Track 1) represents an operating and capital envelope that Defence must manage within;
5. **direct** the Defence Force and the Ministry of Defence to report to the Responsible Minister on their intentions to manage operating and capital s9(2)(f)(iv)
6. **direct** the Treasury, the Ministry of Defence and the New Zealand Defence Force to report to Joint Ministers (Finance and Defence) with options to manage external financial assumptions underpinning the Defence Mid-Point Rebalancing Review funding track; and
7. **agree** that the responsibility for the finalisation and publication of the Defence White Paper 2016 is delegated to the Minister of Defence.



Treasury Report: Defence: Agreeing a White Paper and Indicative Funding

| | | | |
|--------------|--------------|---------------------|-----------|
| Date: | 1 April 2016 | Report No: | T2016/555 |
| | | File Number: | SH-14-1-2 |

Action Sought

| | Action Sought | Deadline |
|------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------|
| Minister of Finance (Hon Bill English) | Note the options to manage the fiscal risks associated with the release of the Defence White Paper Consider whether you wish to table the suggested alternative recommendations at the National Security Committee meeting | Before NSC meeting on 5 April 2016 |
| Associate Minister of Finance (Hon Steven Joyce) | None | |
| Associate Minister of Finance (Hon Paula Bennett) | None | |

Contact for Telephone Discussion (if required)

| Name | Position | Telephone | | 1st Contact |
|-----------------|-------------------------------|------------------|----------|--------------------|
| Stephen Goodman | Senior Analyst | 04 890 7238 (wk) | s9(2)(a) | ✓ |
| Colin Hall | Manager, Justice and Security | 04 917 6227 (wk) | | |

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes (attached)

Treasury Report: Defence: Agreeing a White Paper and Indicative Funding

Executive Summary

- The National Security Committee (NSC) on 5 April is asked to approve a Defence White Paper, indicative capabilities and funding – refreshing the Defence Mid-Point Rebalancing Review (DMRR).
- Different views have emerged as to Cabinet's expectations when it agreed to DMRR. We understood that the DMRR set a cap of Defence expenditure; s9(2)(g),(f) s9(2)(g),(l) : When considering the current papers Cabinet may wish to clarify its expectations in regard to ongoing Defence spending.
- Defence has proposed two options for capability and funding:
 - Alternative Defence Force (within the DMRR capital envelope)
 - Defence-preferred Force s9(2)(f)(iv) extra operating spending and s9(2)(f)(iv) s9(2)(f)(iv) extra capital).
- s9(2)(f)(iv)
- In the Defence-preferred option, the wage bill will increase s9(2)(f)(iv) in the next four years s9(2)(f)(iv) Before 2020 the personnel costs are offset by lower operating costs, inflation and depreciation from project delays, but the result is a more-expensive Defence Force overall.
- Both Force capability options include:
 - Ice-capable Offshore Patrol Vessel s9(2)(f)(iv) and
 - enhanced intelligence and cyber security s9(2)(f)(iv) s9(2)(f)(iv)
- The Defence-preferred option includes additional costs associated with:
 - ice-strengthening for the replacement tanker s9(2)(b)(i)
 - enhanced dive tender replacement s9(2)(f)(iv) capital)
 - additional air surveillance s9(2)(f)(iv) al), and
 - new minor projects added by Defence s9(2)(f)(iv) capital).
- s9(2)(f)(iv)

- The updated DMRR is already an affordability challenge and the Defence-preferred option adds to that affordability challenge: The updated DMRR requires:
 - operating Budget bids s9(2)(f)(iv) and
 - capital injections s9(2)(f)(iv)
- If the Defence White Paper and its associated costs are signed off by Cabinet you may have less ability to manage the ongoing level of Defence spending, both in terms of the s9(2)(f)(iv) and future bids for increases in capability.
- To address this risk your options are to:
 - choose the Alternative Force structure
 - choose the Alternative Force structure and invite the Responsible Minister to propose cost-plus options as part of business cases, or
 - delay the release of the White Paper until you have confidence that fiscal risk is managed.
- We recommend that Cabinet choose the Alternative Force as it best manages the fiscal risk, results in an enhanced Defence Force (with some limitations if Defence is not able to find efficiencies), and sets clear expectations of Defence for ongoing management of Defence spending.
- Under this option Cabinet can still consider proposals for increased capability and funding through individual business cases and Cabinet could invite the Minister of Defence to do so for specific projects.
- We have attached alternative recommendations if you wish Cabinet to:
 - select the Alternative Force structure
 - clarify that there is a fiscal cap for Defence spending, and/or
 - clarify the foreword of the Defence White Paper to further manage fiscal risk.

Recommended Action

We recommend that you:

- a **note** that Cabinet is asked to agree to:
 - releasing a refreshed Defence White Paper; and
 - indicative capability and, by default, funding
- b **note** that it is currently unclear whether the DMRR indicative funding track represents a cap on Defence spending and you may wish to clarify Cabinet's expectations when these papers are discussed

c **note** that Cabinet is presented with two options for preferred capability and funding:

- Alternative Force (within updated DMRR funding)
- Defence-preferred Force (extra s9(2)(f)(iv) capital, s9(2)(f)(iv) s9(2)(f)(iv))

d s9(2)(f)(iv)

e **note** there are questions about the value for money of the additional capital investment in the Defence-preferred Force and Treasury considers these decisions are better addressed in individual business cases

f **note** Treasury's recommendation that Cabinet should select the Alternative Force Structure, as it best enables Cabinet to:

- publish the Defence White Paper
- choose the equipment it wants to achieve its policy
- improve affordability, and
- set the right incentives for Defence to manage ongoing defence spending

g **note** that if Cabinet chooses the Alternative Force Structure, Cabinet will still be able to consider higher levels of capability in individual business cases

h **consider** whether you wish to table the alternative recommendations attached to this report, and

i **indicate** whether you would like to meet with Treasury officials before 5 April to discuss this advice.

Yes/No
Minister of Finance

Colin Hall
Manager
Justice & Security

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Paula Bennett
Associate Minister of Finance

Treasury Report: Defence: Agreeing a White Paper and indicative funding

Purpose of Report

1. This report advises you of Cabinet's options to manage the capability and funding underpinning a refreshed Defence White Paper, to be considered by the National Security Committee (NSC) on 5 April 2016.

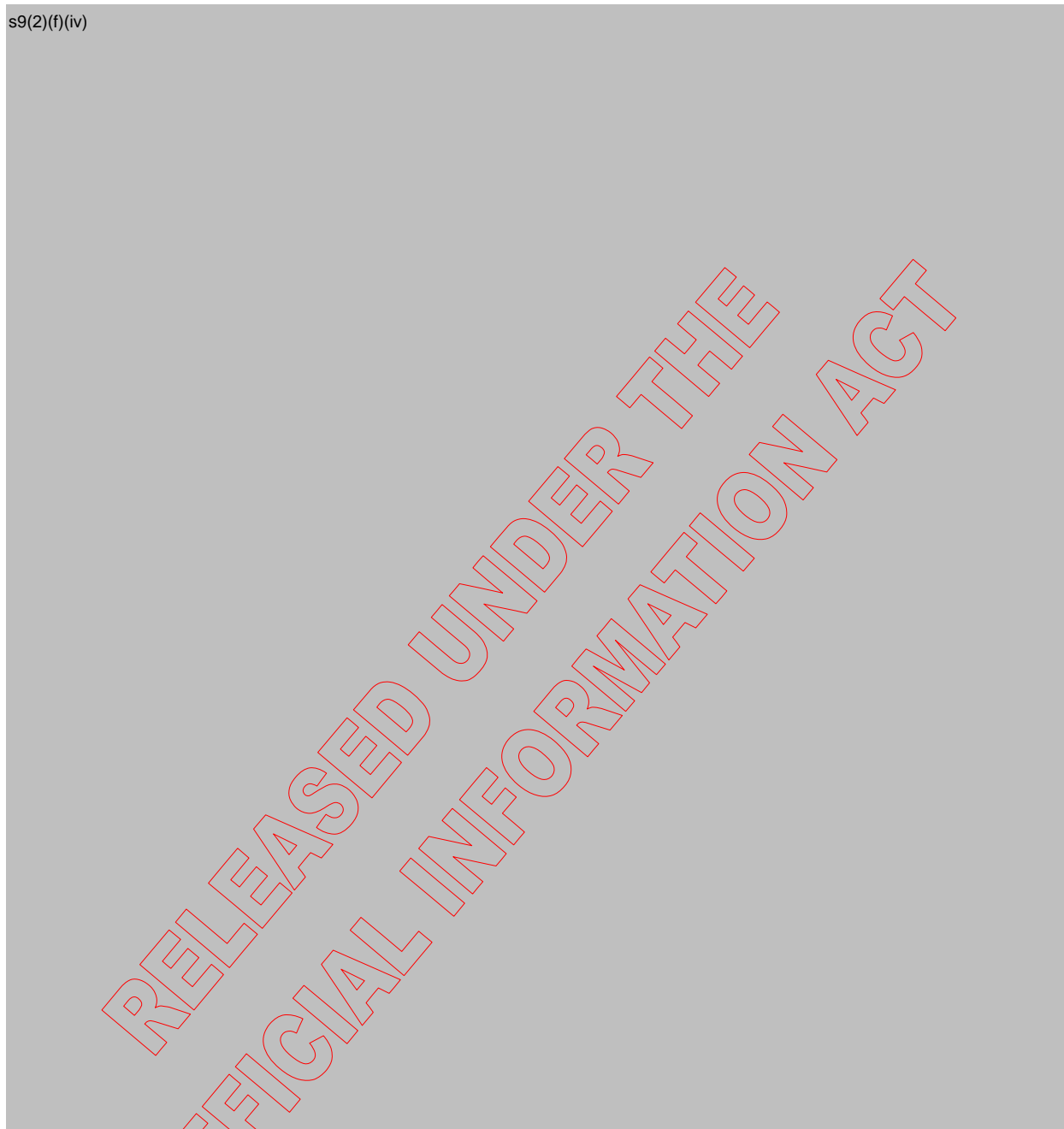
Background

2. In 2015, Cabinet provisionally endorsed a refresh of Defence policy. The roles, tasks and priorities of Defence have not changed since the 2010 Defence White Paper and the 2013 Defence Mid-Point Rebalancing Review (DMRR). However, given an evolving environment Defence signalled that there will be increasing demands in some areas, most notably Antarctica, domestic terrorism and fishing within New Zealand's Exclusive Economic Zone (NSC-15-MIN-0001).
3. On 1 March 2016, NSC considered the capabilities and funding proposed for the Defence White Paper. Defence is seeking additional capital funding and signalling extra operating costs above the DMRR funding track (NSC-16-MIN-0003). NSC asked for more information and consequently, Defence has prepared two Cabinet Papers on capability and funding respectively.
4. Our previous advice cautioned that approving the release of the Defence White Paper s9(2)(g)(i) would expose the Government to fiscal risk of material spending above the DMRR (T2016/302).
5. Officials propose that the Defence White Paper be underpinned by updated external assumptions (foreign exchange, wage increases and inflationary factors) from those used in the DMRR. The Treasury has provided the external assumptions for Defence's use, in a similar way to the DMRR process. The new assumptions are in line with current Economic and Fiscal Update forecasts and forward exchange rates able to be purchased by the NZDMO. The two Defence Force options in the Cabinet Paper are based on the updated assumptions.
6. The changes for the DMRR funding track as a result of external assumptions are negligible before 2020. Inflation and wage growth is moderately softer than the DMRR in the near term. In the 2020s, changes to exchange rate assumptions are the prime contributor to the significant increase in capital costs.

Updated DMRR Assumptions: 14-year aggregate costs

| (\$m) | Operating | Capital |
|--------------------------|--------------|---------|
| 2013 DMRR | s9(2)(f)(iv) | |
| 2015 Updated Assumptions | | |
| Difference | | |

s9(2)(f)(iv)



Ensuring right mechanisms and incentives are in place

11. There is a difference of opinion about what Cabinet's agreement to DMRR constituted. The Treasury understood that Ministers expected DMRR to act as a fiscal cap and if there were cost pressures, Defence was expected to offer trade-offs before further funding was considered. s9(2)(f)(iv)



12. However the DMRR recommendations were not explicit about the set of arrangements to manage the fiscal envelope beyond the first four years and an alternative view is that if there are increases to the capability required and/or the costs of buying and running Defence equipment, the Government would need to fund them by default.

¹ The totals vary from those in the Cabinet paper as sunk costs have been excluded.

13. Capital cost pressures of Defence equipment have grown s9(2)(f)(iv) s9(2)(f)(iv). The cost pressures include s9(2)(f)(iv) minor projects (under Cabinet approval threshold).
14. To best manage the ongoing fiscal risks associated with defence spending we think it is critical to put in place mechanisms that provide Defence with appropriate incentives to make the necessary decisions and trade-offs in defence spending and to ensure it operates efficiently. Putting in place a spending cap within which Defence is required to operate is one way of achieving this. Such a cap could be revisited by Cabinet in the future if circumstances warranted such a revision.
15. In considering the current two papers, we recommend that Cabinet makes its expectations explicit about the ongoing funding arrangements for defence, and in particular whether the agreed funding track represents a level of funding within which trade-offs need to be made as priorities change in response to a changes in the environment..
16. We also recommend further work between Defence and the Treasury to advise you of mechanisms to manage the indicative funding. We propose that this would include advice for Ministers on how to manage inflation and foreign exchange assumptions, and ensure that Cabinet has options and off-ramps from the level of spending indicatively agreed as the security and fiscal environment changes. Alternative recommendations to commission this work are attached to this report.

Selecting a preferred force structure

17. Defence has provided two costed options (“Force Structures”) in the current papers. The following tables summarise the costs of the options, with DMRR (using updated assumptions) used as a baseline for comparison.

Defence-preferred Force Structure – aggregate costs to 2030

| (\$m) | Operating | Capital |
|-----------------------------------|--------------|---------|
| Defence-preferred Force Structure | s9(2)(f)(iv) | |
| Difference from Updated DMRR | | |

Alternative Force Structure – aggregate costs to 2030

| (\$m) | Operating | Capital |
|-----------------------------------|--------------|---------|
| Defence-preferred Force Structure | s9(2)(f)(iv) | |
| Difference from Updated DMRR | | |

Key equipment differences in force structure options

18. Both options maintain the broad range of capabilities that the Defence Force can offer², and both options are underpinned by substantively the same indicative equipment purchases as the DMRR, other than the material variations outlined below.

² The capabilities are: Defending New Zealand’s Sovereignty; Resource and Border Protection, Antarctic Operations, Aid to Civil Authorities; Support to the Community; Stability and Support Operations; Land Combat Operations; Projecting and Sustaining Military Operations Offshore; Maritime Combat Operations; and Humanitarian Assistance and Capacity Building.

Equipment updates contained in both Force Structures

19. Both options contain further capital and operating investment that is affordable within DMRR for the following capabilities:

- ice-capable offshore patrol vessel s9(2)(f)(iv) and
- enhanced intelligence and cyber security s9(2)(f)(iv) operating, s9(2)(f)(iv) capital).

20. According to Defence, these two investments rank high in term of value for money using the DMRR methodology. Given that Defence is proposing to trade off within the DMRR to afford both of these indicative investments, these additions appear logical. Cabinet should still expect to see business cases before approving the investment.

Equipment in the Defence-preferred force structure (marginal above alternative force)

21. The following equipment makes up the main additions in the Defence-preferred force structure:

- ice-strengthening for replacement tanker s9(2)(b)(ii)
- enhanced dive tender replacement s9(2)(f)(iv) capital)
- additional air surveillance s9(2)(f)(iv) capital) and
- new minor projects added by Defence s9(2)(f)(iv) capital).

22. The Treasury participated in detailed Defence workshops over 2015 to develop the Force Structures. In the Treasury's view, there are questions about these additional investments.

- Tanker: Cabinet would need be satisfied of the cost-benefit of ice-strengthening as early analysis indicates that leasing this capability when required would be more cost effective.

- Enhanced dive tender: s9(2)(f)(iv)
s9(2)(f)(iv)

- Air surveillance: s9(2)(f)(iv)

s9(2)(f)(iv)

Key trade-off for both options – s9(2)(f)(iv)

23. s9(2)(f)(iv)

24. s9(2)(f)(iv)

s9(2)(f)(iv)

25. s9(2)(f)(iv)

Fiscal Context

26. As outlined in our advice on the 2013 DMRR, the planned level of Defence investment will be a significant affordability challenge. Under the updated DMRR (and Alternative Force Structure), indicatively, Defence will need:

- operating Budget bids s9(2)(f)(iv) every year s9(2)(f)(iv) s9(2)(f)(iv) and
- capital injections s9(2)(f)(iv) s9(2)(f)(iv)

Updated DMRR: indicative impact on operating allowances⁴

s9(2)(f)(iv)



27. The Defence-preferred option adds s9(2)(f)(iv) of extra capital expenditure on top of the Updated DMRR. s9(2)(f)(iv)

s9(2)(f)(iv)

s9(2)(f)(iv)

Framework for evaluating options

28. We have evaluated the two options using the following factors:

- the extent to which they achieve the Government's defence policy – Cabinet will want to know that it is getting the equipment they want to underpin its policy
- whether they are affordable – within current fiscal constraints (sustainability), and
- provide good incentives for the Defence Force – including a commitment to running Defence efficiently and offering Cabinet investment options that are as efficient as possible (efficiency and control).

29. The following table is a summary of how the options compare against these criteria.

| | Alternative Force Structure (Treasury preferred) | Proposed Force Structure (Defence preferred) |
|---------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Achieves Policy | <p>New investment in cyber security (network defence), intelligence and an ice-strengthened offshore patrol vessel managed through trade-offs.</p> <p>Existing capabilities agreed in the DMRR are maintained⁵, but Defence advises that there will be some level of limitation in Defence response from not increasing funding for an ice-strengthened tanker, enhanced dive tender, and extra air surveillance s9(2)(f)(iv)</p> | <p>All the equipment purchases in the Alternative Force, plus extra spending for investment in:</p> <ul style="list-style-type: none"> • ice-strengthened tanker • enhanced replacement of the <i>Manawanui</i> dive tender • extra air surveillance s9(2)(f)(iv) • minor projects. |
| Affordable | <p>Investment at level of DMRR.</p> <p>s9(2)(f)(iv) operating s9(2)(f)(iv)</p> <p>s9(2)(f)(iv)</p> <p>s9(2)(f)(iv)</p> | <p>Extra s9(2)(f)(iv) operating above DMRR s9(2)(f)(iv)</p> <p>s9(2)(f)(iv)</p> <p>Extra s9(2)(f)(iv) capital above DMRR.</p> |
| Sets the right incentives | <p>Defence explicitly needs to manage operating costs within DMRR.</p> <p>Defence expected to produce trade-offs for Cabinet consideration if further investment above DMRR is sought.</p> | <p>Less pressure on Defence to s9(2)(f)(iv)</p> <p>s9(2)(f)(iv)</p> |
| Pros/Cons | <p>Reduces fiscal risk.</p> <p>Ministers still have the option to increase capability and funding at individual business cases.</p> | <p>Offers greater depth in capability.</p> <p>Offers Defence greater levels of funding certainty.</p> |

⁵ The capabilities are: Defending New Zealand's sovereignty; Resource and Border Protection, Antarctic Operations, Aid to Civil Authorities; Support to the Community; Stability and Support Operations; Land Combat Operations; Projecting and Sustaining Military Operations Offshore; Maritime Combat Operations; and Humanitarian Assistance and Capacity Building.

Your options

30. We are assuming that Cabinet wants to:
- help the Minister of Defence publish the Defence White Paper
 - choose the equipment it wants to achieve policy
 - ensure affordability
 - provide good incentives for Defence to be as affordable and efficient as possible.
31. In order to achieve these goals, your options broadly are to:
- **Agree to the proposed Defence White Paper force structure and costs.** If Cabinet agrees to the preferred option, it will result in the additional costs above DMRR. The s9(2)(f)(iv) extra capital costs will be provisioned into the funding envelope. s9(2)(f)(iv)
s9(2)(f)(iv)
 - **Choose Alternative Force structure.** If Cabinet selects the alternative option, Cabinet would hold operating expenditure at the level provisioned in DMRR, and expect the Defence Force to manage its forecast cost increases. Cabinet would not be allocating funding now for extra investment in ice strengthening a tanker, an enhanced dive tender, and extra surveillance above DMRR. If Defence sought extra capital funding in these business cases, they would need to come up with trade-offs or find innovations (e.g. multi-use equipment).
 - **Choose Alternative Force and invite the Minister of Defence to propose cost-plus options as part of business cases.** A fall-back option is for Cabinet to select the Alternative Force, and invite the Responsible Minister to table proposals for additional investment in:
 - ice-strengthened tanker
 - *Manawanui* replacement (dive tender)
 - additional air surveillance.

Pursuing this fall-back option may need to be carefully managed, as you would need to consider the pros and cons of encouraging Defence to present cost plus options as a matter of routine, as opposed to expecting them to manage within an envelope.
 - **Delay until you have confidence that fiscal risk is managed.** A final option is for Cabinet to delay if you do not have confidence that the fiscal risk is managed.
s9(2)(f)(iv)
s9(2)(f)(iv) The main drawback is that the Minister of Defence is not able to publish the Defence White Paper.

Adjacent redactions removed
s9(2)(f)(iv)

Treasury advice

32. We recommend that Cabinet choose the Alternative Force. The Alternative Force results in a significantly enhanced Defence Force through an unprecedented level of Defence expenditure over the next 14 years. The investment is in line with the DMRR, s9(2)(f)(iv) Choosing the Alternative Force sets the expectation that Defence must manage s9(2)(f)(iv) within the DMRR baselines. Maintaining capital levels within DMRR will encourage Defence to look for innovation (e.g. multi-use equipment) s9(2)(f)(iv) s9(2)(f)(iv)
33. Cabinet does not need to make decisions on the precise equipment it wants now. In our view, the value to Cabinet of a costed White Paper process is to set the broad direction, capabilities and cost that Cabinet is comfortable with (e.g. naval combat, humanitarian assistance), but not to decide on individual pieces of equipment in detail (e.g. oil tanker, dive tender replacements). Cabinet may also want to remain flexible with its broad Defence policy (rather than be specific) to allow you to adjust to an ever changing security and fiscal environment.
34. We consider that there are questions about the value for money of the additional investment proposed in the Defence-preferred Force Structure (for the ice-strengthened tanker, dive tender replacement and extra surveillance s9(2)(f)(iv) that would need to be addressed in business cases. You will be considering the business cases for the tanker and dive tender in 2016. s9(2)(f)(iv) s9(2)(f)(iv)
35. If Cabinet did wish to consider the additional investment being proposed by the Minister of Defence, there may be value in the fall back option of inviting the Minister of Defence to present the proposals for increases as part of business cases.
36. Regardless of the option chosen, we recommend that Cabinet is explicit that it expects Defence to operate within a funding cap over the long term.

Text of Defence White Paper

37. Central Agencies have been consulted on the White Paper's development. s9(2)(g)(i) s9(2)(g)(i) s9(2)(g)(i) However to manage the fiscal risk, you may wish to have explicit clarification that Cabinet is not pre-committed and has off ramps. One way in which you could do this is to include a paragraph in the foreword along the following lines to explain that capabilities are indicative only.

This Defence White Paper points to the current and future capabilities (equipment, people and know-how) that may underpin the Defence Force. Future investment in the Defence Force's capabilities may differ, as the Government considers individual business cases to ensure the equipment meets current need, offers value for money and is affordable in the fiscal environment.

Alternative Recommendations

38. We have attached alternative recommendations if you wish to clarify aspects of the Cabinet decisions:
- Recommendations 1a: select the Alternative Force structure and set a fiscal cap for Defence spending (Treasury preferred)
 - Recommendations 1b: select Defence-preferred Force and clarify fiscal cap for Defence spending (Defence preferred Force Structure)
 - Recommendation 2: invite the Responsible Minister to submit bids for additional funding as part of business cases
 - Recommendation 3: clarification to be made to text of the draft Defence White Paper.

RELEASED UNDER THE
OFFICIAL INFORMATION ACT

Alternative Recommendations 1a: select the Alternative Force structure and set a fiscal cap for Defence spending. (Replace Recommendations 8 to 17 inclusive)

Preferred option

1. **agree** that the alternative force structure be used as the basis for planning purposes for the level of operating and capital for the Defence Force to 2029/30;

Indicative funding

2. **agree** that the funding track for Defence Force operating expenditure remains at the level of the Defence Mid-Point Rebalancing Review, updated for current assumptions for foreign exchange and inflation, comprising the following indicative baseline increases:

| | \$m – increase / (decrease) | | | | |
|-------------------------------------|-----------------------------|---------|---------|---------|---------|
| Alternative force structure funding | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
| | s9(2)(f)(iv) | | | | |
| | 2020/21 | 2021/22 | 2022/23 | 2023/24 | 2024/25 |
| | s9(2)(f)(iv) | | | | |
| | 2025/26 | 2026/27 | 2027/28 | 2028/29 | 2029/30 |
| | s9(2)(f)(iv) | | | | |

3. **agree** that the indicative level of total capital expenditure remain at the level of the Defence Mid-Point Rebalancing Review, updated for current assumptions for foreign exchange and inflation, s9(2)(f)(iv) to 2029/30 to be funded from Defence Force accumulated depreciation with the shortfall funded by capital injections;
4. **agree** that the funding track outlined in Recommendations 2 and 3 above represents a funding cap within which the Defence Force is expected to manage – if funding above this cap is sought then Ministers will be presented with trade-offs for consideration before decisions on additional investment are made;
5. **note** that Defence is advising that it will need to revalidate the costs of the Alternative Force structure to a Budget quality level of detail;
6. **direct** Defence to report to Joint Ministers (Defence and Finance) on the revalidated profile, provided it is affordable within the cap outlined in Recommendations 2 and 3 above, by November 2016;

7. **note** that Ministers may wish to re-examine the funding cap when defence policy is reviewed to ensure policy and funding remain aligned;

Further work

8. **direct** the Defence Force and Ministry of Defence, in consultation with central agencies, to undertake a series of work by mid 2017 s9(2)(f)(iv) with the aim of improving Defence Force's operating costs s9(2)(f)(iv) s9(2)(f)(iv)
9. **direct** officials to report to Joint Ministers (Defence and Finance) in mid 2016 to agree the scope of the work outlined in Recommendation 6 above;
10. **direct** Defence and Treasury officials to report to Joint Ministers (Defence and Finance) by November 2016 on mechanisms for the ongoing management of the funding track outlined in Recommendations 15 and 16 above, including management of external assumptions.

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Recommendations 1b: select Defence-preferred Force and clarify fiscal cap for Defence spending (Defence preferred Force Structure). (Additional Recommendation after Recommendation 9)

Indicative funding

1. **invite** Defence to report to Cabinet to re-establish a cap on operating expenditure following the review of operating costs to be completed in mid 2017;
2. **note** that Ministers may wish to re-examine the funding cap when defence policy is reviewed to ensure policy and funding remain aligned.

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Recommendation 2: invite the Minister of Defence to submit bids for additional funding as part of business cases. (Additional Recommendation)

1. Invite the Responsible Minister to submit proposals for additional investment above the level of the Defence Mid-Point Rebalancing Review, updated for current assumptions for foreign exchange and inflation, for the following:
 - a. Replacement of the tanker *Endeavour*
 - b. Replacement of the dive tender *Manawanui*
 - c. Replacement of the air surveillance fleet.

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Recommendations 3: clarification to be made to text of the draft Defence White Paper. (Additional Recommendation)

1. **agree** to the following addition to the Defence White Paper foreword:

“This Defence White Paper points to the current and future capabilities (equipment, people and know-how) that may underpin the Defence Force. Future investment in the Defence Force’s capabilities may differ, as the Government considers individual business cases to ensure the equipment meets current need, offers value for money and is affordable in the fiscal environment.”

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Treasury Report: Briefing for Cabinet National Security Committee
Tuesday, 5 April 2016

| | | | |
|--------------|--------------|---------------------|-----------|
| Date: | 1 April 2016 | Report No: | T2016/575 |
| | | File Number: | MS-2 |

Action Sought

| | Action Sought | Deadline |
|------------------------------------------------------|---------------------------|-----------------------|
| Minister of Finance (Hon Bill English) | Read prior to NSC meeting | Tuesday, 5 April 2016 |
| Associate Minister of Finance (Hon Steven Joyce) | Read prior to NSC meeting | Tuesday, 5 April 2016 |
| Associate Minister of Finance (Hon Paula Bennett) | Read prior to NSC meeting | Tuesday, 5 April 2016 |

Contact for Telephone Discussion (if required)

| Name | Position | Telephone | 1st Contact |
|-----------------|-------------------------------|------------------|--------------------|
| Stephen Goodman | Senior Analyst | 04 890 7238 (wk) | s9(2)(a) ✓ |
| Colin Hall | Manager, Justice and Security | 04 917 6227 (wk) | |

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Briefing for Cabinet National Security Committee Tuesday, 5 April 2016

Below redaction removed as out of scope of request

Executive Summary

We are currently aware of [redacted] items on the Cabinet National Security Committee agenda on Tuesday 5 April 2016.

Removed as out of scope of request

- Defence White Paper 2016: Funding
- Defence White Paper 2016: Capability

These two papers seek agreement to an updated Defence Force structure, associated funding, and approval to publish a new Defence White Paper. We have provided you with a separate briefing covering these two papers (T2016/555), recommending that Cabinet select the "Alternative Force" option and suggesting some alternative recommendations for your consideration.

Recommended Action

We recommend that you read this report prior to the Cabinet National Security Committee on Tuesday 5 April 2016 at 4.00 pm.

Colin Hall
Manager, Justice and Security

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Paula Bennett
Associate Minister of Finance

Treasury Report: Defence White paper 2016: Briefing to Minister of Finance and Minister of Defence

| | | | |
|--------------|---------------|---------------------|-----------|
| Date: | 11 April 2016 | Report No: | T2016/647 |
| | | File Number: | DL-3 |

Action Sought

| | Action Sought | Deadline |
|---------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------|
| Minister of Finance (Hon Bill English) | <p>note the contents of this advice.</p> <p>direct officials to update the recommendations in the Cabinet Paper(s) to reflect this advice and any other direction from Joint Ministers.</p> | N/A |
| Minister of Defence (Hon Gerry Brownlee) | <p>note the contents of this advice.</p> <p>direct officials to update the recommendations in the Cabinet Paper(s) to reflect this advice and any other direction from Joint Ministers.</p> | N/A |

Contact for Telephone Discussion (if required)

| Name | Position | Telephone | 1st Contact |
|-----------------|-------------------------------|------------------|--------------------|
| Stephen Goodman | Senior Analyst | 04 890 7238 (wk) | s9(2)(a) ✓ |
| Colin Hall | Manager, Justice and Security | 04 917 6227 (wk) | |

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No



8 April 2016

DEFENCE WHITE PAPER 2016: BRIEFING TO MINISTER OF FINANCE AND MINISTER OF DEFENCE

Purpose

1. To provide joint advice for the Minister of Finance and Minister of Defence on the:
 - a) principles underpinning decisions made by Cabinet as part of the Defence Midpoint Rebalancing Review 2013;
 - b) key points of difference between the two force structures outlined in the Defence White Paper 2016: Capability Cabinet paper; and
 - c) objectives of the series of work to be undertaken as part of the Defence White Paper's implementation, including personnel and estate, which will determine whether a Mid-point 'refresh' or update in 2018 is required.

Background

2. Cabinet papers on Defence White Paper 2016 Capability and Funding were deferred at the 5 April Cabinet National Security Committee to enable further discussion between Joint Ministers (Minister of Finance and Minister of Defence).
3. This paper has been drafted jointly by Treasury, Ministry of Defence and New Zealand Defence Force officials. Its purpose is to inform Ministers' discussion on Wednesday 13 April 2016.

Guiding Principles

4. The Defence Midpoint Rebalancing Review 2013 was underpinned by, and confirmed, a set of principles that have guided subsequent Cabinet papers seeking decisions on major capital acquisitions. These principles, which also informed the work of the Defence White Paper 2016, are outlined below. They include:
 - a) Using transparent process to build Ministerial confidence
 - b) Prioritising investment in the Defence Force based on value-for-money
 - c) Giving Ministers a range of choices to maintain an optimal balance between defence policy, capability and funding
 - d) Situating those choices within the context of the Government's overall fiscal position
 - e) Ensuring that the Defence Force is as efficient as possible over time.

2

5. In 2013, Cabinet selected a Force structure and level of funding that meant:
- that the Defence Force would retain (and be able to replace at end of life) its current combat, and resource and border protection capabilities, and that it would be able to lead an operation in the region and/or operate without needing to rely on others, as well as make concurrent contributions to international security;
 - that there will be sufficient flexibility to respond to, and manage, future security challenges
 - that Defence would ensure that capital requirements for its portfolio of projects will not be exceeded over the next four years (to 2017/18).
6. In arriving at this decision, Ministers noted that:
- there are inherent uncertainties in projecting the cost of military capabilities out to 2029/30; and
 - Ministers may wish to re-examine funding when defence policy is reviewed to ensure policy, capability and funding remain aligned.
7. In implementing the Defence Midpoint Rebalancing Review, Defence officials have:
- Used the funding increases provided by the Defence Midpoint Rebalancing Review only for their agreed purpose (whether for regenerating the Defence estate, new capabilities, or personnel growth);
 - Drawn down depreciation and capital charge funding only for the purpose of the specific allocation, and not used this for other operating purposes; and
 - provided choices to Ministers around the management of any cost pressures over a rolling four year window as part of prudent portfolio management.

Force Structure options

8. The Defence White Paper 2016 advice presents two broad choices for Ministers relating to Defence Force capability, funding, and the degree to which Defence policy can be fulfilled into the future.
9. With the overall mix of capabilities agreed to by Cabinet as part of the Defence Midpoint Rebalancing Review remaining broadly appropriate, the two options are distinguished by three key capability choices, relating to:
- an increased air surveillance capability** from the mid 2020s to enable the Government to continue to offer a highly valued capability to international coalition operations without compromising ongoing surveillance operations across New Zealand's exclusive economic zone, the Southern Ocean and the South Pacific;
 - whether to ice-strengthen the naval tanker replacement** in support of New Zealand's civilian presence in Antarctica and to bolster our contribution to the Joint Logistics Pool with the United States; and
 - the level of littoral operations capability** (which supports operations from the sea onto land): a like-for-like replacement of the Defence Force's dive support and hydrographic (underwater mapping) capabilities, or an enhanced

3

capability which increases the range of operations the Defence Force could undertake independently in the South Pacific.

Option One

10. The first force structure option (referred to as the "alternative force structure" in previous advice), contains enhancements for intelligence, cyber security and a third, ice-capable offshore patrol vessel, but does not include the capability enhancements outlined above.

11. This would maintain the Defence Force's capital expenditure within the indicative funding provisioned in the Defence Midpoint Rebalancing Review (using updated economic assumptions – see below). While meeting many of the Defence White Paper 2016 policy objectives it would constrain the Defence Force's ability to respond to policy priorities. This option has the advantage of imposing less pressure on the Crown's finances.

Option Two

12. The second force structure option (the "recommended" force structure in previous advice) builds on Option One to include an increase air surveillance capability, ice-strengthening the naval tanker and an enhanced littoral operations capability (rather than a dive-tender capability).

13. It would require additional capital and operating expenditure (\$1083 million and \$780 million respectively). This option offers more depth and breadth of capability to meet future security challenges.

Updated Economic Assumptions (Foreign Exchange and Inflation)

14. Defence, in agreement with the Treasury, has used updated foreign exchange and inflation figures in re-calculating the funding trajectory provisioned for in the Defence Mid-Point Rebalancing Review, and calculating the cost of capabilities.

s9(2)(b)(ii)

Objectives of White Paper implementation work over 2016-2017

15. Both options include a material increase in personnel expenditure above Defence Midpoint Rebalancing Review. These personnel increases begin in the next four years.

s9(2)(f)(iv)

Defence is signalling that more work will be done on its operating expenses, s9(2)(f)(iv) to seek savings/efficiencies in line with the guiding principles outlined above (in paragraphs 4-7).

s9(2)(f)(iv)

s9(2)(f)(iv)

4

s9(2)(f)(iv)

17. In parallel, a Defence Estate Strategy and Estate Plan, which will provide a framework for the regeneration, management, and use of the Estate out to 2030, will be finalised and submitted to Cabinet in June 2016.

18. The Defence Capability Change Action Plan will also contribute to a better understanding of the Defence Force's long term costs by improving its ability to assess a capability's whole of life costs.

Midpoint update in 2018

19. The work outlined above will result in advice to Joint Ministers about whether a mid-point update is required to provide greater cost certainty and offer options to the Government about any adjustments to the Defence Force's operating funding beyond 2020/21.

20. Informed by the work undertaken over 2016/17, a mid point update would extend financial forecasts from 2029/30 to 2034/35. It would provide an updated capability picture and confirm capital, operating and personnel expenditure in the 2020s underpinned by an efficient long-term operating model.

21. If approved, its Terms of Reference would be determined once s9(2)(f)(iv) and estate work had been completed.

Fiscal management – implementation of funding track

22. The option selected by Cabinet will result in a refreshed operating and capital funding track to 2029/30. Defence broadly has been acting in line with the following set of fiscal management guidelines since 2013 and considering the Defence White Paper is an appropriate point at which Cabinet may want to be explicit about them.

23. In practical terms a Cabinet decision on the Defence White Paper would mean:

- a) The funding track will be used in Four-Year Plans and business case financial cases to show how the investment compares with what was signalled in the Defence White Paper (capital and operating expenditure).
- b) Baseline increases and capital injections are not guaranteed and will be assessed through the normal Budget process each year (remaining subject to available funding).
- c) Individual major investments will be subject to Ministerial and Cabinet consideration in line with the Cabinet Office circular on Investment Management and Asset Performance in the State Services (CO (15) 05).

5

s9(2)(f)(iv)



Recommendations

26. It is recommended that Joint Ministers:

- a) note the contents of this advice.
- b) direct officials to update the recommendations in the Cabinet Paper(s) to reflect this advice and any other direction from Joint Ministers.

T. J. KEATING

for Lieutenant General
Chief of Defence Force

for **HELENE QUILTER**

Secretary of Defence

COLIN HALL

Manager, Justice and
Security,
The Treasury



Reference: T2016/649 SH-14-1-2
 Date: 12 April 2016
 To: Minister of Finance (Hon Bill English)
 Deadline: 5.30pm, Wednesday 13 April

Aide Memoire: Defence White Paper: Meeting with Minister of Defence

You are meeting with the Minister of Defence on Wednesday 13 April at 5:30pm to discuss the capabilities of a refreshed Defence White Paper (DWP). Ministers have been presented with two broad options in a joint briefing paper (T2016/647):

- **Option 1:** funding within the Defence Mid-Point Rebalancing Review (DMRR) envelope (updated for new assumptions), and
- **Option 2:** requiring additional operating and capital costs and capital injections above the updated DMRR s9(2)(f)(iv)

Background

As part of the White Paper process the economic assumptions underlying DMRR have been updated to establish a new base cost line (a reduction in operating costs s9(2)(f)(iv) and an increase in capital costs and capital injections s9(2)(f)(iv)

In addition, Defence has “recosted” the force structure on which DMRR is based to reflect issues such as lower attrition, higher average salary rates, delays in capital projects and additional capital spending.

Option 2 includes additional capability above DMRR to address changes to the security environment.

Incremental Changes to Updated DMRR Costs (total costs 2013/14 – 2029/30)

| | DMRR updated assumptions | Recosted DMRR (cost pressures) | Option 2 |
|----------------------------|--------------------------|--------------------------------|----------|
| Personnel expenses | s9(2)(f)(iv) | | |
| Other operating expenses | | | |
| Depreciation | | | |
| Capital charge | | | |
| Operating costs | | | |
| Capital expenditure | | | |
| Capital Injections | | | |

Option 1 trades off capability to address cost pressures (i.e. both operating and capital costs are close to the updated DMRR) but capital injections are s9(2)(f)(iv) above DMRR due to significantly lower depreciation.

Key issues

There are two key issues in considering the DWP:

- the value and associated cost of the additional capability included in option 2, and
- the significant increase in the operating and capital costs, and flow on impact on capital injections, associated with the “recosting” of the DMRR force structure.

Defence is planning to undertake work over the next 12 months on its cost structure,

s9(2)(f)(iv) to seek savings/efficiencies s9(2)(f)(iv)

s9(2)(f)(iv)

s9(2)(g)(i)

s9(2)(g)(i)

s9(2)(f)(iv)

s9(2)(f)(iv)

Possible discussion points

By selecting Option 2, Ministers risk funding the “cost pressures” by default and you may wish to explore with the Minister of Defence:

- whether the desired capability in Option 2 can be delivered at a lower cost, and
- how Cabinet can set expectations on Defence to get a better balance between desired capability and fiscal parameters.

Value of additional capability/equipment

- What are the implications if Cabinet does not choose Option 2?
- The 2013 process ranked the NZDF’s capabilities – has this ranking changed?
- Why does the Government need to provision for this extra capability now (instead of waiting for business cases)?

Increase in costs associated with the “recosting” of the DMRR force structure

s9(2)(f)(iv)

Stephen Goodman, Senior Analyst, Justice & Security, 04 890 7238
Colin Hall, Manager, Justice & Security, 04 917 6227



Treasury Report: Briefing for Cabinet National Security Committee
Tuesday, 10 May 2016

| | | | |
|--------------|------------|---------------------|-----------|
| Date: | 6 May 2016 | Report No: | T2016/835 |
| | | File Number: | DN-22 |

Action Sought

| | Action Sought | Deadline |
|------------------------------------------------------|---------------------------|-------------------------------|
| Minister of Finance (Hon Bill English) | Read prior to NSC meeting | 4.00 pm, Tuesday, 10 May 2016 |
| Associate Minister of Finance (Hon Steven Joyce) | Read prior to NSC meeting | 4.00 pm, Tuesday, 10 May 2016 |
| Associate Minister of Finance (Hon Paula Bennett) | Read prior to NSC meeting | 4.00 pm, Tuesday, 10 May 2016 |

Contact for Telephone Discussion (if required)

| Name | Position | Telephone | 1st Contact |
|-------------|-------------------------------|---------------------------|--------------------|
| Colin Hall | Manager, Justice and Security | 04 917 6227 (wk) s9(2)(a) | |

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

**Treasury Report: Briefing for Cabinet National Security Committee
Tuesday, 10 May 2016**

Executive Summary

We are currently aware of [redacted] items on the Cabinet National Security Committee (NSC) agenda for Tuesday 10 May 2016. Two of these paper relate to the Defence White Paper [redacted]

The table below identifies any relevant fiscal impacts and provides Treasury's comments and recommendations on these papers.

| Title | Pg | Recommend | Fiscal Implications (\$m GST excl.) | | | | | Treasury Comment |
|--------------------------------------------------------------------------------|----|---------------------------------------------------------|-------------------------------------|-------|-------|-------|-----------|--------------------------------------------------------------------------------------------------------|
| | | | 15/16 | 16/17 | 17/18 | 18/19 | Out years | |
| Defence White Paper 2016: Capability, and Defence White Paper 2016: Funding | 3 | Support but choose the alternate force structure | <i>Operating</i> | | | | | We recommend you support the alternate force structure. |
| | | | - | - | - | - | - | |
| | | | <i>Capital</i> | | | | | There are no immediate fiscal impacts although the updated funding path will feed into future Budgets. |
| - | - | - | - | - | | | | |

All redactions on this page removed as out of scope of request

Recommended Action

We recommend that you **read** this report prior to the Cabinet National Security Committee meeting at 4.00 pm on Tuesday, 10 May 2016.

Colin Hall
Manager, Justice and Security

Hon Bill English Hon Steven Joyce Hon Paula Bennett
Minister of Finance Associate Minister of Finance Associate Minister of Finance

Defence White Paper 2016: Capability and Funding Papers

Responsible Person: Colin Hall, Justice & Security, 917 6227

Purpose

The two papers on the Defence White Paper (DWP) seek agreement to the:

- preferred force structure and its use in Defence planning
- level of operating and capital funding to 2019/20 associated with the preferred force structure, and
- arrangements for the release of the Defence White Paper 2016.

Comment

The Defence White Paper (DWP) provides the framework for the Defence Force to meet the Government's defence policy objectives to 2030 and beyond.

The Capability paper presents two possible force structures – the preferred and alternate structures.

The preferred structure outlines indicative capabilities, including:

- increasing the air surveillance capability from s9(2)(f)(iv) & s9(2)(i) to replace the 6 P-3s flying now
- ice-strengthening the planned third offshore patrol vessel and replacement naval tanker so they can support New Zealand's interests in the Southern Ocean and Antarctica
- a vessel that better supports operations from the sea onto land (littoral support), increasing the speed and range of operations the Defence Force can undertake independently in the South Pacific
- a cyber support capability to protect Defence Force networks at home and abroad, and
- additional intelligence personnel to help maintain awareness of New Zealand's exclusive economic zone and to support operations overseas.

The alternate force structure trades off capability to bring operating and capital costs back in line with DMRR, although required capital injections are s9(2)(f)(iv) above DMRR due to significantly lower depreciation. The alternate force structure does not include ice-strengthening of the new naval tanker or enhancements to littoral support and air surveillance capabilities.

The preferred structure requires additional spending above the updated Defence Mid-point Rebalancing Review (DMRR) - operating costs s9(2)(f)(iv) capital costs s9(2)(f)(iv) and capital injections s9(2)(f)(iv)

Of the s9(2)(f)(iv) increase in the capital costs associated with the preferred force structure, only s9(2)(f)(iv) relates to new capability – the gross s9(2)(f)(iv) cost of new capability is largely offset by trade-offs, s9(2)(f)(iv) totalling s9(2)(f)(iv). Other increases are driven by changes to the costs of the equipment "exemplars" underlying DMRR s9(2)(f)(iv) and additional/recosted minor projects and other changes since DMRR s9(2)(f)(iv). Annex A in the Funding paper provides a breakdown of the various components of the capital cost changes since DMRR.

A key consideration in deciding which of the two force structures Cabinet should approve is balancing the additional new capability delivered by the preferred structure with its cost and

ongoing arrangements to manage defence spending. The following table provides a summary of our assessment of how the options compare against these criteria.

| | Alternative Force Structure | Preferred Force Structure |
|---------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Extent that defence policy is achieved | <p>New investment in cyber security, intelligence and an ice-strengthened offshore patrol vessel managed through trade-offs.</p> <p>Existing capabilities agreed in the DMRR are maintained, but Defence advises that there will be some level of limitation in Defence response from not increasing funding for an ice-strengthened tanker, enhanced dive tender, and extra air surveillance</p> | <p>All the equipment purchases in the Alternative Force, plus extra spending for investment in:</p> <ul style="list-style-type: none"> ice-strengthened tanker enhanced replacement of the <i>Manawanui</i> dive tender extra air surveillance minor projects. |
| Affordability | <p>Investment at level of DMRR.</p> <p>operating</p> <p>million capital.</p> | <p>Extra operating above updated DMRR</p> <p>Extra capital above updated DMRR.</p> |
| Sets good incentives for Defence to manage efficiently within available funding | <p>Defence explicitly needs to manage operating costs within DMRR.</p> <p>Defence expected to produce trade-offs for Cabinet consideration if further investment above DMRR is sought.</p> | <p>Less pressure on Defence</p> |
| Summary | <p>Reduces fiscal risk</p> <p>Delivers a lower level of capability compared to the preferred force structure.</p> <p>Ministers still have the option to increase capability and funding at the individual business case stage.</p> | <p>Offers greater depth in capability.</p> <p>Offers Defence greater levels of funding certainty.</p> <p>Higher fiscal cost.</p> |

Treasury has some concerns about the long term sustainability of defence spending.

- On current forecasts Defence will require additional operating funding of additional capital injections
- The significant increase in funding sought by Defence just two years after DMRR delivered significant increases in funding may indicate that poor incentives are in place for Defence to manage and prioritise spending. Of significant concern is the forecast increase in forecast personnel costs to deliver the updated DMRR capability, driven by lower levels of attrition higher average salaries average salaries rising faster than planned and

For these reasons you may wish to support the alternate DWP force structure rather than the preferred structure recommended in the Capability paper.

s9(2)(f)(iv)

The paper does not give any assurance that costs will be brought back in line with DMRR. You may wish to use Cabinet's discussion on the DWP to set clear expectations that the objective of the work is to improve the affordability of defence spending s9(2)(f)(iv)

s9(2)(f)(iv)

The discussion on the DWP also provides an opportunity to set expectations about any future increases in defence spending. s9(2)(f)(iv)

s9(2)(f)(iv)

s9(2)(f)(iv) operating costs to 2019/20 are forecast to be s9(2)(f)(iv) lower than DMRR due to changes in other operating costs, in particular depreciation and capital charges due to delays in capital spending. Required capital injections to support capital expenditure are forecast to be s9(2)(f)(iv) higher than DMRR, bringing a net funding impact of a saving s9(2)(f)(iv) compared to DMRR.

We therefore recommend you agree to the level of operating and capital funding to 2019/20 associated with the chosen force structure. Before capital is committed business cases on proposed equipment will need to be approved by Cabinet.

Treasury Recommendation

We recommend that you **support** the recommendations in the papers, with the exception of the proposed force structure. We recommend you support the alternate force structure.

You may wish to also take the opportunity to set expectations that:

- the objective of the planned work on operating costs is to improve the affordability of defence spending s9(2)(f)(iv) and

- s9(2)(f)(iv)

Pages 6-7 of this document removed as out of scope

Pre-Cab Briefing – 16 May 2016

Notes:

- The Treasury will brief the Minister of Finance and Associate Ministers of Finance on Monday 16 May in EW 7.6

Papers for Cabinet Consideration

| Item | Title | |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Description and analysis | Fiscal implications | Treasury Recommendation |
| 6 & 7 | Defence White Paper 2016: Capability, and Defence White Paper 2016: Funding | |
| <p>The two papers on the Defence White Paper (DWP) seek agreement to the:</p> <ul style="list-style-type: none"> • preferred force structure and its use in Defence planning • level of operating and capital funding to 2019/20 associated with the preferred force structure, and • arrangements for the release of the Defence White Paper 2016. | <p>There are no immediate fiscal impacts although the updated funding path will feed into future Budgets</p> | <p>Support these Cabinet Papers, which will result in the Minister of Defence publishing the White Paper.</p> <p>Regarding Recommendation 12 of the Capability Paper, we recommend you support the alternate force structure outlined in the paper, due to concerns about the ongoing sustainability of defence spending. (The Cabinet Office and officials would need to amend the recommendations of both Cabinet Papers to reflect this decision.)</p> |

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