

# The Treasury

## Budget 2020 Information Release

### July 2020

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- [29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand
- [33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- [34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;
- [37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
- [38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice
- [39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage
- [42] 18(d) - information is already publicly available or will be publicly available soon.

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## Treasury Report: Baseline Review of Defence: Final Report

<b>Date:</b>	30 January 2020	<b>Report No:</b>	T2020/151
		<b>File Number:</b>	BM-2-7-2019

### Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	<p><b>Note</b> the findings and recommendations of this baseline review of defence.</p> <p><b>Agree</b> to recommendations for further work.</p> <p><b>Discuss</b> preferred funding paths for the Ministry of Defence and New Zealand Defence Force for the Minister of Defence to progress through the Budget process and seek Cabinet approval.</p>	10.30am, 10 February 2020
Minister of Defence (Hon Ron Mark)		

### Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Hamish Coghill	Analyst, Justice, Security & Government Services	[39]	N/A (mob) ✓
Igor Dupor	Acting Team Leader, System Design and Strategy	[23]	

### Minister's Office actions (if required)

**Return** the signed report to Treasury.  
**Refer** a copy to the Minister of Defence.

Note any feedback on the quality of the report

**Enclosure:** No

# Treasury Report: Baseline Review of Defence: Final Report

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## Executive Summary

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In July 2019, you agreed the terms of reference for a baseline review of defence, comprised of the New Zealand Defence Force (NZDF) and the Ministry of Defence (MoD). This final report presents the baseline review's findings, makes recommendations for further work, and provides options for medium-term funding paths for both agencies.

### **Ministry of Defence**

MoD received a significant funding uplift in 2015 for additional personnel and the improvement of processes for the procurement of military capabilities. The current Capability Management System has required investment, but so far it is delivering the expected benefits, and further development of the model could deliver additional value and reduce risk to the Crown.

Other operating funding has been nominally flat, with MoD absorbing inflation-related price increases by adapting management of its baseline. Productivity gains in supporting functions (e.g. corporate services) have been achieved as a result. However, the strategies used to manage inflationary pressures to-date are not sustainable and it would be challenging for MoD to continue to manage these pressures within existing baselines.

The baseline review has assessed MoD's cost pressure bids and developed three medium-term funding path options for your consideration, ranging from [33] to [33] total across the forecast period on top of its existing baseline of \$24.230 million per annum.

### **Veterans' Affairs New Zealand**

Veterans' Affairs New Zealand (VA) is part of NZDF's baseline, but in practice it operates with a degree of autonomy. While extensive investigation has not been undertaken, it appears that VA systems and processes are generally efficient in managing current demand, and that it is effective in managing the current nature of its role. VA carries some risks associated with dependence on [1] and there are likely opportunities for efficiency gains to be made using improved technology.

VA is in the process of initiating transformational change to its services and operating model, as it implements the recommendations of the *Paterson Report* and as the average age of veterans reduces. [33]

### **New Zealand Defence Force**

From Budget 2014 to Budget 2017, NZDF received funding broadly in line with an indicative funding track agreed by Cabinet as part of the *Defence Mid-Point Rebalancing Review 2013* (DMRR). This track was updated following the *Defence White Paper 2016*. At the time, NZDF signalled that changes to the operating model would likely result in higher-than-planned costs post-2019, but no funding was agreed.

At Budget 2019, NZDF submitted cost pressure bids significantly above what was indicated in the DMRR funding track. Treasury had a lack of visibility over what was causing the cost pressures, and recommended a baseline review be undertaken.

The baseline review has highlighted four key trends driving the current state:

- **‘Direct’ operating expenditure supporting the use of military capabilities** [1]  
Providing additional funding for this could have a direct impact to lift activity levels, as well as overall efficiency, by improving asset utilisation.
- **Personnel expenditure has been persistently higher** than DMRR forecasts (by \$64 million in 2018/19), [1] This is driven by growth in civilian Full-Time Equivalents (FTE), increasing seniority, low attrition of senior staff and additional remuneration and allowances. In addition, expenditure on consultants and contractors has tripled since the publication of the DMRR. NZDF has funded this by reprioritising funding from other operating expenditure, contributing to cost pressures elsewhere in the business. [33]
- **Maintenance, repair and overhaul (MRO) expenditure has been consistently higher** than DMRR forecasts, [1] This appears to be driven by major NZDF platforms reaching the end of, or just beginning, their service life. There are opportunities NZDF can take to improve understanding and management of costs in the MRO environment.
- **Historical underinvestment in infrastructure** (particularly the Defence Estate [1] has created risks that need to be addressed. NZDF needs to continue progress implementing the Defence Estate Regeneration Plan [33]

NZDF has a tendency to make reprioritisation decisions without ‘turning off’ activities and instead ‘taking risk’ on them. This approach can cause sustainability issues by creating ‘holes’ in the baseline that require additional funding – Ministers are now being asked to fill these holes. Ordinarily, we would not recommend funding these bids due to the risk of moral hazard. However, under the DMRR, internal reprioritisation was the only way in which unforeseen costs could be funded. We recommend the implementation of a funding path be underpinned by principles that aim to avoid the sustainability issues that have arisen previously.

The baseline review has assessed NZDF’s cost pressure bids and developed four options for a medium-term funding path, ranging from [1,33] total across the forecast period, on top of its existing baseline of \$2.901 billion per annum.

Overall, this baseline review has highlighted the difficulty of reconciling fixed defence policy and funding settings with dynamic changes in NZDF’s costs and operating model. Ministers have three broad choices going forward:

- **Accept the costs of the operating model** that has developed over time, and provide additional funding to support it. This carries the risk that cost trends will continue, with rates of change greater than Government revenue growth, and corresponding impacts on allowances and other Government priorities.
- **Direct changes**, with uncertainty about potential interdependencies. Cost issues cannot be addressed in the short term (one year), would be challenging in the medium term (forecast period), and may result in risk arising in other parts of NZDF if management cannot adapt.

- **Revisit defence policy settings**, in order to reconcile what is expected of NZDF with Government fiscal policy settings. This requires consideration of the likely long-term trends in cost and productivity associated with particular defence capabilities, as well as the strategic defence environment.

The four options we have developed range from applying moderate pressure to the operating model while providing for planned expansion (Option A), through to providing a bare minimum of funding that would likely result in the need to revisit defence policy settings (Option D).

This report also proposes several areas for **further work** by officials in order to address:

[33]

A joint Ministers meeting is scheduled for 10:30am on 10 February for you to discuss the contents of this report and a preferred funding path for the Minister of Defence to progress through the Budget 2020 process.

## Recommended Action

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We recommend that you:

- a **note** that in July 2019, you agreed the terms of reference for a baseline review of defence, comprised of the New Zealand Defence Force (NZDF) and the Ministry of Defence (MoD)

### ***Ministry of Defence (MoD)***

- b **note** that while MoD has had significant funding uplifts for additional personnel since 2015, operating funding has been nominally flat, which is now creating baseline pressure
- c **note** that early evaluation is showing that investment in the capability management system is delivering expected benefits
- d **note** that investment in portfolio management is likely to be high-value and may deliver net fiscal savings
- e **note** the Baseline Review has assessed MoD's cost pressures and has developed three funding paths for your consideration
- f **discuss** a preferred funding path for MoD for the Minister of Defence to progress through the Budget process and seek Cabinet approval

**Veterans' Affairs New Zealand (VA)**

g **note** that VA is currently in the process of transformational change in response to the recommendations of the 2018 *Paterson Report*, and further changes are anticipated to respond to reviews and inquiries currently underway

h [33]

**New Zealand Defence Force (NZDF)**

i **note** that NZDF has managed within the funding track agreed as part of the *Defence Mid-Point Rebalancing Review 2013* (DMRR), but that the cost pressures are now different to the forecast due to personnel, enabling infrastructure (ICT and Estate), and maintenance, repair and overhaul (MRO) costs to support output delivery being higher than anticipated

j **note** that NZDF has lived within the DMRR funding track by prioritising annual baseline funding into these unanticipated cost pressures by scaling, deferring or carrying tension on activities in order to fund output delivery rather than making trade-offs and stopping activities, resulting in sustainability issues and risks to output delivery being mitigated in the short-term, but has not addressed the medium-term sustainability issues currently being faced

*Funding paths*

k **note** the Baseline Review has assessed NZDF's cost pressures and has developed funding paths and reprioritisation options for your consideration

l **discuss** a preferred funding path for NZDF for the Minister of Defence to progress through the Budget process and seek Cabinet approval

*Funding Model*

m **agree** to the proposed approach to implementing the chosen funding path for NZDF, as set out at paragraphs 125-133 of this report

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

*Further work*

n [33]

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

o [33]

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

p [33]

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

q [33]

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

r [33]

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

s [33]

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

t [33]

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

u **note** you are meeting with officials on 10 February to discuss the findings and recommendations of this baseline review.

*Agree/disagree*  
Minister of Finance

*Agree/disagree*  
Minister of Defence

Igor Dupor  
**Acting Team Leader, System Design and Strategy**

Hon Grant Robertson  
**Minister of Finance**

Hon Ron Mark  
**Minister of Defence**



# Treasury Report: Baseline Review of Defence: Final Report

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## Purpose of Report

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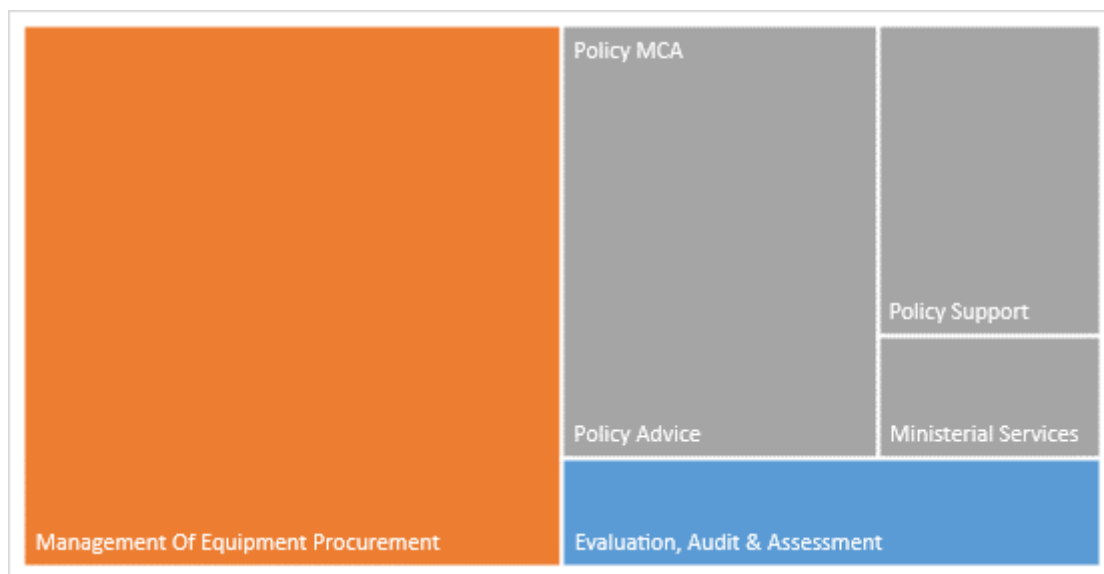
1. In July 2019, you agreed the terms of reference for a baseline review of defence, comprised of the New Zealand Defence Force (NZDF) and the Ministry of Defence (MoD) [T2019/2149 refers]. In September 2019, we provided you with an interim report that included preliminary findings and proposed areas for further investigation [T2019/2783 refers].
2. The Government seeks best value for money from current spending and is prepared to reallocate funding to achieve better outcomes. At the same time, the Government wants departments to be properly funded to achieve their outcomes. Baseline reviews support both of these purposes by seeking to better understand the returns from current spending and to assess future funding needs. They are not intended to be a complete account of the value generated by every dollar of government expenditure. Rather, the objective is to gain insights about key issues that are affecting current and future funding needs and to improve transparency about how Budget and other funding decisions can affect baselines.
3. A joint team from Treasury, MoD and NZDF prepared a detailed analytical report for officials, which underpins the findings and recommendations in this final report. This report:
  - summarises and presents the findings of the baseline review
  - makes recommendations for further work, and
  - provides options for reprioritisation and a medium-term funding path for each department's cost pressures for your consideration.
4. NZDF and MoD's new spending initiatives for Budget 2020 are out of scope for the baseline review and have been assessed in line with the policies and processes established for Budget 2020.
5. This report is organised into sections:
  - Findings for MoD and Veterans' Affairs New Zealand (VA) are provided in single sections.
  - Findings for NZDF include an overview, followed by sections on:
    - i operating expenditure and productivity analysis across Navy, Army and Air Force
    - ii personnel
    - iii logistics
    - iv infrastructure
    - v how NZDF has reprioritised expenditure in the past
    - vi options for a medium-term funding path, and
    - vii recommendations for the funding model used to implement a funding path.

## Ministry of Defence (MoD)

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6. MoD is funded through three departmental output appropriations, with a total baseline of \$24.23 million as at the 2019 October Baseline Update. Approximately 80 per cent of MoD's departmental baseline is personnel-related. This funds around 110 of the 150 staff MoD employs, covering the three main functions of MoD:
- Policy and Planning
  - Capability Delivery, and
  - Tu Aromatawai (independent evaluation, audit and assessment).
7. Figure 1 below provides a visual representation of MoD's appropriations.

Figure 1: Ministry of Defence appropriations



8. The baseline review of MoD had the following key findings:
- **Efficiency:** Productivity gains have been achieved in supporting functions (e.g. corporate services). While base funding has remained flat, functions have continued to be delivered while managing inflationary pressures and a growing workforce.
  - **Effectiveness:** The capability management system that drives procurement of military equipment has required investment, but is so far delivering the expected benefits. Given the costs of failure in this area, investment in a high level of effectiveness is prudent.
  - **Risk:** The combination of MoD's relatively small baseline and project-focused work programme creates risks in managing the baseline when there are changes to the work programme or short-term surplus resource. This is currently managed adequately. MoD's other key risk is recruiting, developing and retaining a sufficient specialised capability management workforce in a limited pool within New Zealand.

- **Sustainability:** The strategies used to manage inflationary pressures to-date are largely not repeatable and it would likely be challenging to continue to manage within the current baseline. The current personnel strategy requires funding to maintain competitiveness over the medium-term, but long-term investment in personnel development and progression could help ease price-sensitivity and reduce personnel risk. For MoD's role in managing capability management risks, reporting and governance is good, but the capacity and systems used to underpin this are relatively thin, and may face sustainability challenges if there is increased demand or turnover in staff.

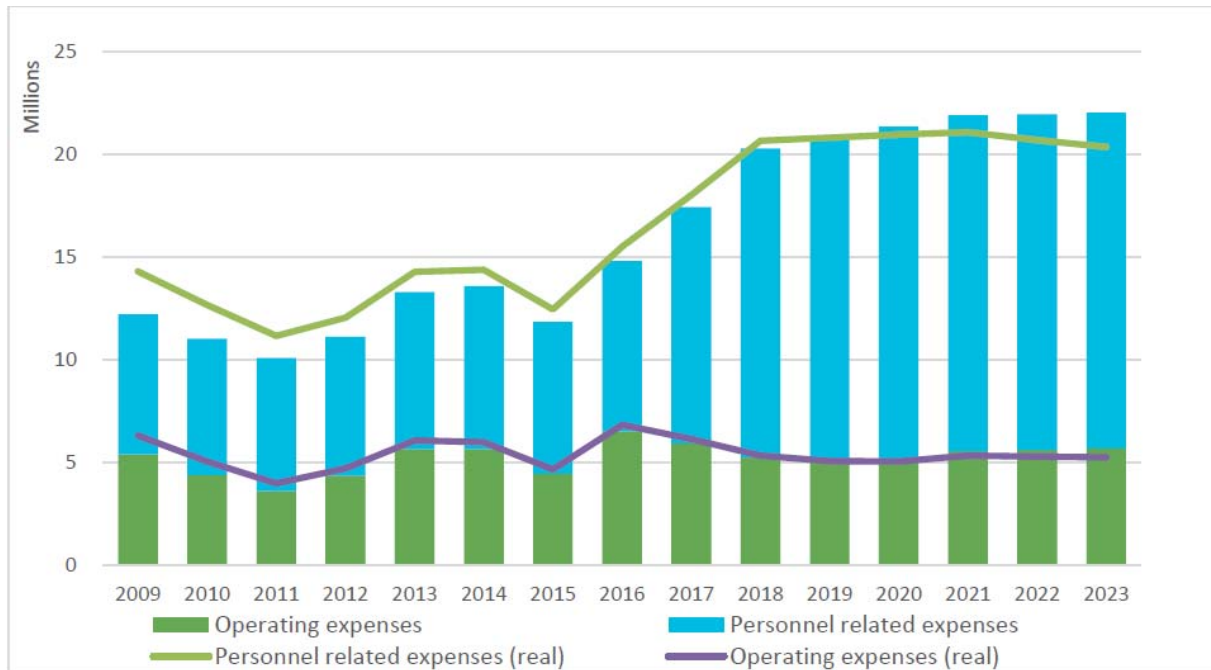
***MoD has had significant funding uplifts for additional personnel since 2015***

9. Following the 2014 Performance Improvement Framework and a PwC review, MoD received Budget 2015 funding of \$27.000 million over four years to increase its workforce and to make a one-off investment in systems.
10. Alongside NZDF, MoD established the Defence Capability Change Action Programme (DCCAP). This programme enriched the collaboration between the two agencies and drew on expertise from both. Two of the key components of the programme was the establishment of Capability Management Framework and the Integrated Project Teams. These bring MoD and NZDF staff together into a single team that spans phases of each capability project:
  - capability definition and selection, and delivery (for which the Secretary of Defence is primarily responsible), and
  - introduction into service (for which the Chief of Defence Force is primarily responsible).
11. The funding also allowed MoD to expand and develop functions, including:
  - project governance
  - a programme management office, and
  - resources for project definition (pre-capital investment) and capacity to meet the 2013 *Defence Mid-Point Rebalancing Review* (DMRR) procurement pipeline.

***Operating funding has been nominally flat***

12. To date, MoD has absorbed inflation-related price increases through adapting management of its baseline. Outside of the systemic change to personnel supporting capability definition and acquisition, operating funding has been flat in real terms as shown by figure 2 on the following page.
13. Though personnel expenditure has had significant increases in the last four years, due to an increase in FTE agreed through DCCAP to improve capability management system, this is now forecast to decrease in real terms over the forecast period due to inflationary effects. Turnover is volatile due to the small size of the agency, but is still high relative to other public sector agencies, particularly in recent years.

Figure 2: Ministry of Defence operating funding over time

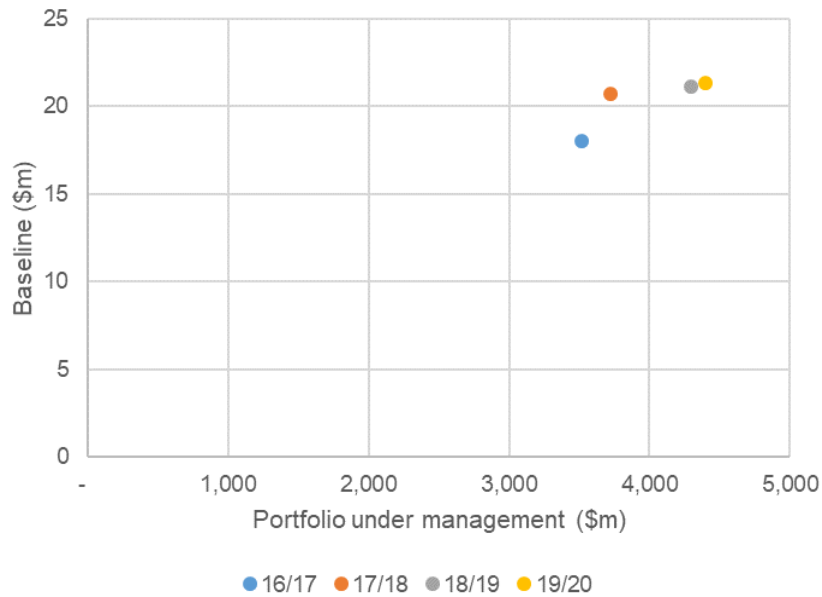


**Capability management expertise has required investment, but it is delivering value**

14. Approximately 80 per cent of MoD’s departmental baseline is personnel-related. This funds approximately 110 of the 150 staff employed by MoD, with the remaining 40 funded through projects in delivery or contributing to NZDF projects and recovered costs.
15. MoD has a high average salary compared to the rest of the public sector at \$130,400.<sup>1</sup> This is primarily due to the salaries of project delivery personnel and managers, and their relatively high proportion of the overall workforce at 48 per cent. [33]
16. The Budget 2015 investment appears to have largely achieved its intended objectives, and significantly improved effectiveness, as well as managing a much larger defence capability portfolio. Project delivery performance has improved, as evidenced through the ‘A’ investor confidence rating for the Defence Capability Portfolio.
17. As at 30 June 2019, MoD is managing a portfolio of \$4.3 billion, which includes the P-8A Poseidon (P-8s) maritime patrol aircraft (\$2.3 billion), the Frigate System Upgrade (\$0.6 billion) and Maritime Sustainment Capability (\$0.5 billion). Figure 3 on the following page compares the MoD baseline and the total approved portfolio under management.

<sup>1</sup> Based on most recent available comparison data for 2018.

Figure 3: Ministry of Defence baseline and total approved portfolio under management



**Further development of the model could deliver further value**

18. Investor confidence rating feedback from Treasury and the Review of Defence’s Procurement Practice by Sir Brian Roche have highlighted the relatively immature portfolio management capability and the benefits that would result from investment in this area. For example, managing risk and contingencies for projects at the portfolio level would enable a lower overall contingency requirement.
19. This additional level of management is unlikely to be achievable within MoD’s current baseline without changes to the scope of planned work. A bid has been submitted for Budget 2020 for the development of portfolio management capability, and a similar bid was submitted through Budget 2019.

**The Baseline Review has assessed MoD’s cost pressures**

20. MoD has identified three major areas of cost pressure, totalling [33] over the forecast period (a [33] annual growth rate).
  - **Inflationary pressures and remuneration:** This initiative is a non-discretionary cost pressure, required to preserve competitive remuneration and manage operating baseline pressures. The intervention logic is clear and MoD has provided good evidence about how pressures have been managed previously. Given MoD has not had inflationary funding increases for some time, risk would accumulate if this is not funded. It is recommended funding the full increase.
  - **Portfolio management risk:** This bid has been presented as driven by increased demand on its departmental baseline corresponding with increases to the capital under management (e.g. portfolio investment planning and project management practice improvements) and maintaining fit for purpose processes (e.g. contract and financial management systems). There is a good case to fund a scaled form of this as a means of reducing risk to the Crown (particularly if no further funding is to be considered over the next four years).

- **Policy pressures:** This is driven by changes to expectations for policy and international engagement, particularly relating to the Pacific Reset. This bid cannot be supported as a cost pressure, as it is being made in order to pursue policy commitments that were made by Cabinet with the expectation that they would be funded from within baselines. This bid was subsequently submitted as a new spending 'other' initiative for consideration through the Budget 2020 process.

21. There are relatively limited options for reprioritisation within the MoD baseline due to its size and limited range of functions (i.e. there are few functions that can be fully stopped). [33]

- [33]

- 

Figure 4: MoD cost pressures and assessments

Cost pressure bid	2020/21	2021/22	2022/23	2023/24 & outyears	TOTAL (\$m)
[33]	[33]				
<hr/>					
<b>Total funding sought</b>					
<b>Total funding supported</b>					

***Three options for funding paths have been identified for your consideration***

22. Three packages were developed for the supported cost pressure bids based on the order of priority:

- **Option 1** provides a bare minimum increase to maintain competitive remuneration and manage retention risk.
- **Option 2** provides for the above, in addition to addressing other inflationary operating pressures.
- **Option 3** includes a scaled component of the portfolio management risk bid. While this is a substantially larger package in relative terms, this investment would be expected to have a positive overall fiscal impact over time due to improved risk management.

Figure 5: MoD funding path options

Option	2020/21	2021/22	2022/23	2023/24 & outyears	TOTAL (\$m)
[33]					

## Veterans' Affairs New Zealand (VA)

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23. VA is a key part of NZDF's commitment to its veterans who have served New Zealand in operations overseas where significant risk of harm has been recognised. It supports New Zealand veterans and their families with services such as case management, health and rehabilitation support, financial entitlements, and services to help veterans maintain their independence. VA also provides policy advice, supports remembrance events and maintains Services Cemeteries. VA has a multi-faceted role, but is primarily a small social agency concerned with the administration of benefits and purchasing of services.
24. VA is funded through a single departmental multi-category appropriation that forms part of Vote Defence Force, with a total baseline of \$10.272 million as at the 2019 October Baseline Update. VA administers benefits and other non-departmental expenditure \$114.803 million across 14 separate appropriations.
25. The baseline review had the following key findings in relation to Veteran's Affairs:
  - **Efficiency:** VA systems and processes are generally efficient in managing current demand, but there is likely potential for further efficiency gains through improved technology.
  - **Effectiveness:** VA is effective in managing the current nature of their role and there is good evidence of a responsive, innovative and veteran-centred culture. VA is likely to face challenges in managing the changing nature of demand from 'old' to 'new' veterans.
  - **Risk:** VA relies on [1] for the administration of veteran's entitlements. Accordingly, they face the same risks [1] though with VA-specific impacts (for example, potential payment failure).
  - **Sustainability:** If key system risks can be addressed, VA could sustain its current operating model. [33]

### ***VA is about to initiate transformational change***

26. As noted in the baseline review's Interim Report [T2019/2783 refers], the *Paterson Report* noted that the "support system was under-resourced and ill-prepared to provide a comprehensive response to needs". It made 64 recommendations, most of which are now the basis of a work plan agreed with the Minister for Veterans. Significant investment is likely to be required to implement the recommendations in full, which will require changes to systems and operating models.
27. The Minister for Veterans put forward a Cabinet paper in November 2019 outlining the progress that had been made implementing the recommendations of the Paterson Report, and noting that 26 of the recommendations are already implemented through more flexible use of policy and practice, or action to implement them is underway [CAB-19-MIN-0566 refers]. It was agreed that 13 proposals would be addressed through the Veterans Support Amendment Bill placed on the 2020 legislative programme. Approval was granted for the associated changes to appropriations to be charged against the Between-Budget Contingency established as part of Budget 2019.

## **Significant changes in the operating model and associated funding needs are likely in the foreseeable future**

28. Following the *Paterson Report*, there will be a number of opportunities for investment that arise when the future state is clearer:
- Additional innovations (such as online self-service for veterans) that could improve administrative efficiency.
  - Collaborative opportunities such as leveraging ACC's ICT platform for faster payments and improved procurement management could be taken, but are likely to have upfront costs.
  - Changes to the nature of VA services to implement the recommendations of the *Paterson Report* could require further investment in infrastructure, systems, policy and practice.
  - Recommendations from the Veterans Advisory Group, welfare reform inquiry and the Health and Disability System Review may have funding implications beyond Budget 2020.
  - A number of undetermined factors will affect non-departmental costs (e.g. eligibility, revised definition of a veteran, and support for families, changes to approaches to Veteran's needs, growing demand and the complexity of support). These matters are ongoing beyond the timeframe of this review.
29. NZDF has submitted a cost pressure for VA seeking <sup>[33]</sup> total operating funding across the forecast period. The baseline review has been unable to complete its assessment at this stage, however we expect to be able to provide advice ahead of your meeting on 10 February.

## **New Zealand Defence Force (NZDF) Overview**

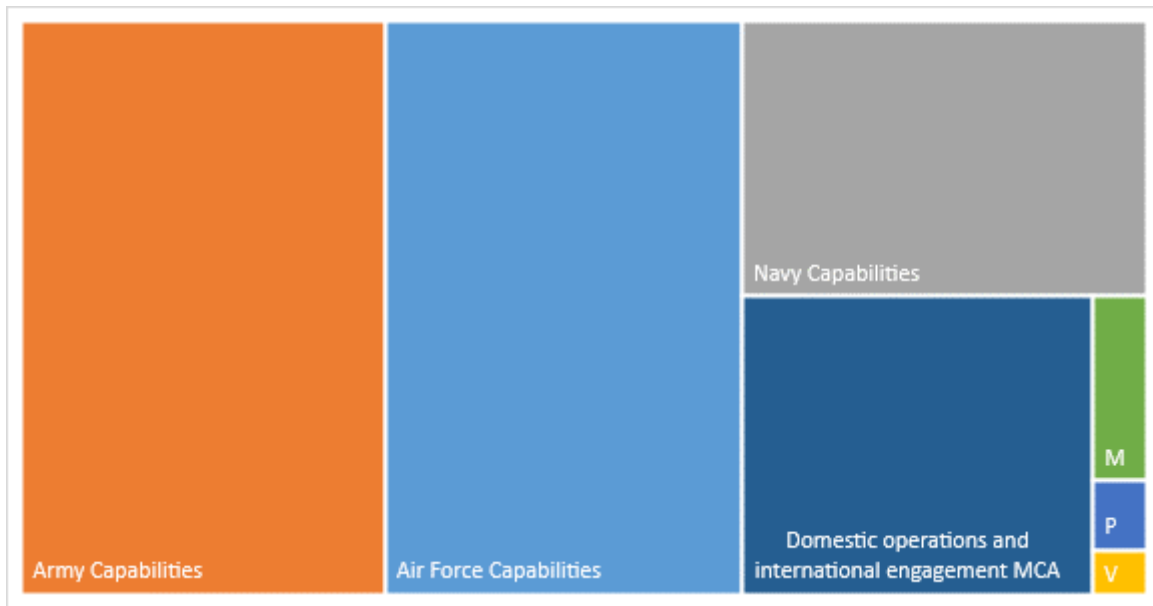
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30. NZDF (excluding VA) is funded through six departmental output appropriations totalling baseline of \$2.901 billion as at the 2019 October Baseline Update, shown in Figure 6 on the following page. Of this amount:
- \$1.101 billion or 38 per cent is personnel-related expenditure
  - \$895 million or 31 per cent is other operating expenditure
  - \$465 million or 16 per cent is depreciation funding, and
  - \$440 million or 15 per cent is capital charge funding.
31. NZDF is responsible for the development, sustainment and readiness of military capabilities. Through these capabilities, the Defence Force supports a diverse range of security and community activities. NZDF describes its contribution to supporting New Zealand's security, resilience and wellbeing through three Defence outcomes: delivering value to the Community, Nation and World:
- **Community:** through supporting New Zealand's community and environmental wellbeing and resilience.
  - **Nation:** by promoting a safe, secure and resilient New Zealand, including on its border and approaches; and contributing to maintaining New Zealand's prosperity via secure air, sea and electronic lines of communication and secure access to space-based services.



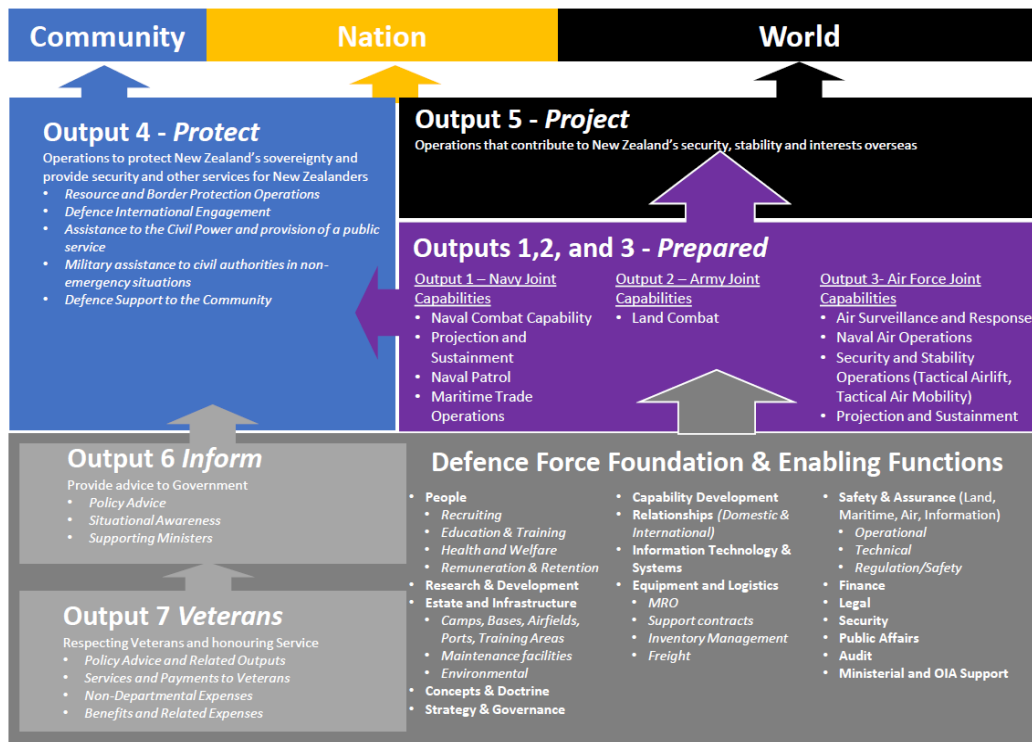
- **World:** by contributing to the maintenance of the international rules based order; and contributing to New Zealand’s network of strong international relationships.

Figure 6: NZDF appropriations (“M” = operations MCA; “P” = policy advice MCA; “V” = Veterans).



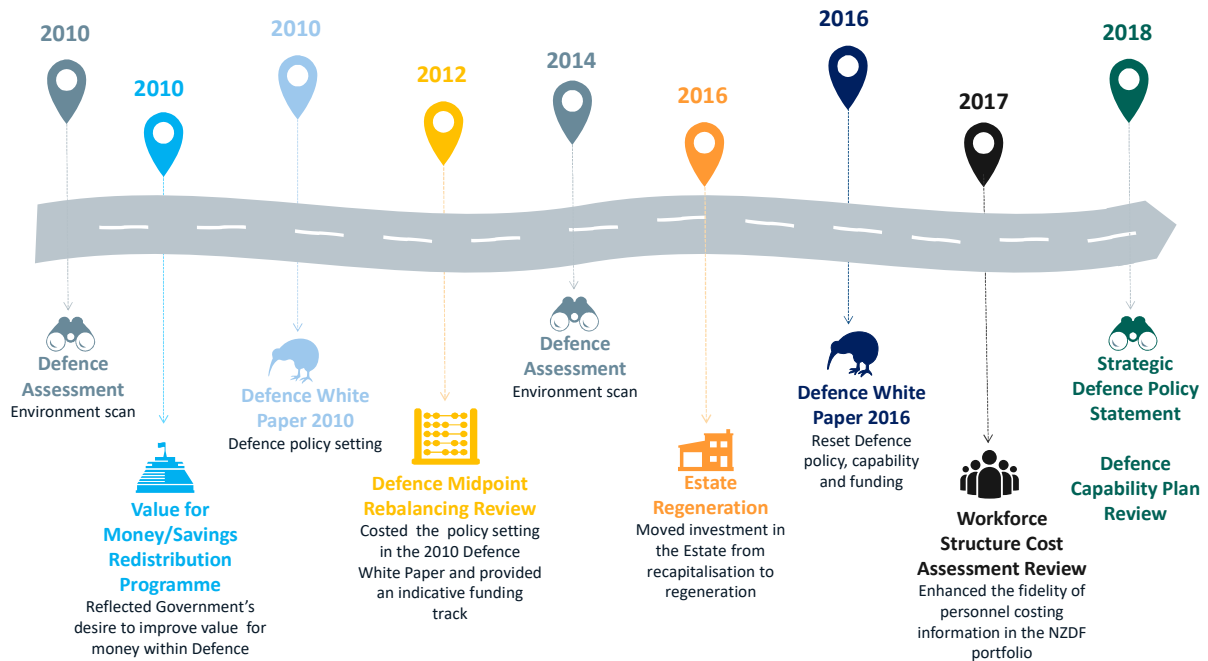
32. The 2014 Output Framework focuses on the primary components of NZDF that generate and deliver military effect; preparedness of Navy, Army and Air Force capabilities (Outputs 1, 2 and 3) which enables operations to protect New Zealand and New Zealanders (Output 4) and operations contributing to New Zealand’s global security, stability, and interests (Output 5). Other outputs focus on advice to Government (Output 6) and support to Veterans (Output 7).

Figure 7: Defence Force Outputs and Defence Outcomes



33. NZDF produces an annual Output Plan that is agreed at Ministerial level. The Output Plan agrees output delivery required to achieve policy outcomes and provides a mechanism for managing and reporting performance to Government.
34. Reviews of defence policy and funding settings are regular as shown in figure 8 below:

Figure 8: NZDF policy and funding settings since 2010



### ***NZDF operated under a funding track model between 2014/15 and 2018/19***

35. From Budget 2014 to Budget 2017, NZDF received funding broadly in line with a funding track agreed by Cabinet as part of the DMRR, and which was subsequently updated as part of the *Defence White Paper 2016* (DWP 2016). At Budget 2018, the additional funding provided was \$30 million per annum less than provided for under the funding track from 2019/20 onwards.
36. The DMRR was undertaken to address the funding implications of the policy and capability decisions made by Cabinet through the *Defence White Paper 2010*. The DMRR forecasted the total cost of defence out to 2030, including both capital injections and operating expenditure (broken down into personnel expenditure, operating expenditure, depreciation and capital charge).
37. In November 2013, Cabinet agreed NZDF should use Track 1 (the highest of the multi-year operating cost funding tracks) for planning purposes and agreed to the indicative funding increases identified in the funding track for the period 2014/15 to 2017/18 [CAB Min (13) 38/5 refers]. These indicative allocations didn't guarantee new funding and NZDF was required to demonstrate how the additional funding met NZDF's strategic direction and the Government's priorities at each Budget. The funding track was to be actively maintained to account for changes to project timings (delays in capital expenditure also delayed depreciation and capital charge requirements) and underlying cost assumptions (such as inflation, asset revaluations, foreign exchange and military inflation).

38. As part of the DWP 2016 process, the funding track was updated and effectively revised down over the short-term to reflect lower costs due to updated economic assumptions (foreign exchange, wage increases and inflationary factors) [CAB-16-MIN-0220 refers]. At this time, NZDF's revised Whole-Of-Life-Cost model saw forecast personnel and operating cost pressures increase by \$359 million cumulatively out to 2029/30. New capabilities agreed at the time added an additional \$421 million.
39. The fiscal impacts of this change in the force structure were partly offset by changes in economic assumptions in the short-term. While Cabinet noted that these changes would result in higher funding needs post-2019, and agreed that the updated force structure be used as a basis for defence planning purposes, it did not agree to provide additional funding.
40. At the same time, it was becoming apparent that critical assumptions underpinning the DMRR were not eventuating:
- [1]
  
  - **maintenance, repair and overhaul** costs were underestimated, with both aging and new capabilities proving more expensive to maintain than originally expected, and
  
  - **personnel costs** were higher than planned due to higher average remuneration, lower than expected attrition, and larger than planned civilian staff numbers.
41. Cabinet directed officials to “undertake a series of work by mid-2017 focussing on the NZDF’s workforce structure and remuneration, with the aim of providing assurance on long-term cost pressures and improving the sustainability of NZDF’s operating costs” [CAB-16-MIN-0220 refers]. Work was undertaken to improve the quality of personnel costing, but the trends in remuneration, attrition and civilian numbers that were driving increased costs have continued.
42. At Budget 2019, NZDF submitted cost pressures significantly over the funding track at [1,33] per annum rather than the [1,33] per annum indicated in the funding track. The trends identified at DWP 2016 had continued, as highlighted by Figure 9 below which shows areas of actual expenditure against DMRR forecasts:

[1]

43. NZDF's Budget 2019 initiatives were assessed by Treasury without reference to the funding track and instead in accordance with general guidance on non-discretionary cost pressures. NZDF were provided with new funding of \$49 million per annum, and Treasury recommended that a baseline review of defence be undertaken given the lack of visibility it had over NZDF's baseline and what was causing the cost pressures.

#### **Headline findings of the baseline review**

44. The baseline review had the following key findings in relation to NZDF:

- **Efficiency:** There is evidence of productivity gains in parts of defence output generation, in particular in the management of activity levels with nominally flat direct operating expenditure (for example, costs per sea day) and the delivery of outputs with reduced activity levels (for example, through increased use of simulation for training across the services). But while operations continue to be delivered, the cost of delivering outputs has increased due to:
  - i [1]
  - ii higher than expected costs from maintaining aging platforms and introducing new platforms into service, and
  - iii increased personnel costs driven by increased seniority and FTE.
- **Effectiveness:** The *Defence Capability Plan 2019* (DCP 2019) and broader defence policy settings have been clear exclusions from the scope of this review. The relationship between outputs and outcomes (effectiveness) is largely defined by these settings, and the review team is not generally qualified or mandated to comment. However, we did note that in general stakeholders have high regard for the effectiveness of NZDF in delivery of outputs and operations.
- **Risk:** NZDF continues to carry significant risks due to historical underinvestment [1] Estate infrastructure, though this is improving. [33,1]

Infrastructure is likely to remain an ongoing challenge. Other risks were identified in relation to processes and systems for the management of an increasingly complex contracting environment – expenditure under the top 20 contracts was \$523 million in 2018/19.

- **Sustainability:** Personnel costs were noted as a sustainability concern at the time of the DWP 2016 [CAB-16-MIN-0220 refers] and this continues to be the case. If the current trajectory does not change, [1]

Capital is also a significant sustainability concern. A large proportion of NZDF assets require renewal over the next 10-20 years, but accumulated depreciation reserves are low and the baseline level of capital expenditure is high relative to the amount of asset renewal that is achieved.

45. Overall, this baseline review has highlighted the difficulty of reconciling changing defence policy and capability settings (DWP 2016 and DCP 2019) and fixed funding settings (DMRR) with dynamic changes in NZDF's costs and operating model. When feedback loops do not resolve these tensions as they arise, risk accumulates and sustainability issues develop that leave Ministers with three broad choices:

- **Accept the costs of the operating model** that has developed over time, and provide additional funding to support it. This carries the risk that cost trends will continue, with rates of change greater than revenue growth, and corresponding impacts on allowances and other Government priorities.
  - **Direct changes**, with uncertainty about potential interdependencies. Cost issues cannot be addressed in the short-term (one year) and would be challenging in the medium-term (forecast period) and may result in risk arising in other parts of NZDF if management cannot adapt.
  - **Revisit defence policy settings**, in order to reconcile what is expected of NZDF with Government fiscal policy settings. This requires consideration of the likely long-term trends in cost and productivity associated with particular defence capabilities, as well as the strategic defence environment.
46. The four funding options we have developed range from applying moderate pressure to the operating model while providing for planned expansion (Option A), through to providing a bare minimum of funding that would likely result in the need to revisit defence policy settings (Option D).

## Capability

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47. Capability in the defence context refers primarily to military capabilities, which are the complete integration of equipment, the people who operate it, their training, technical systems and management and support structures. The NZDF has a range of military capabilities and for each mission, the best available combination is selected to create a tailored task force.
48. Compared to defence forces internationally, NZDF is an outlier due to its relatively high complexity, its small size and its reliance on imports of military equipment. This limits the usefulness of international comparisons to other militaries.

### ***Direct operating expenditure has been essentially held flat for Navy, Army and Air Force since 2013***

49. For the purpose of analysis, we have considered 'direct' operating costs, meaning those in each 'service' portfolio excluding personnel costs, maintenance repair and overhaul (MRO) costs, and contributions to pan-NZDF functions (i.e. infrastructure and corporate functions). This provides a clearer picture of how expenditure relates to activity.
50. The graphs below show how operating expenditure for NZDF's key capabilities have trended against DMRR forecasts. Overall, the graphs to the left show NZDF's total operating expenditure has generally been in line with DMRR forecasts. [1]

[1]

Activity levels include sea days and flying hours and are key inputs to ensure NZDF has appropriately trained personnel to meet readiness requirements, and to deliver outputs such as border protection.

## *Navy*

52. Direct operating expenditure for the Navy fleet is strongly correlated with activity levels. [1]

53. Fleet availability has also been a key driver of sea days. As old ships are refitted or decommissioned and new ships are yet to come into service, there is reduced opportunity to utilise the assets and correspondingly there is less demand for operating expenditure. There has also been a slight reduction in sea day costs because of lower than forecast fuel costs.

## *Army*

54. Army's primary platform is its people, numbers of which have increased in line with DMRR forecasts until 2018/19. [1]

55. Assessing Army activity levels is difficult since the primary input is people, for which cost does not vary with activity. [1]

#### *Air Force*

56. [1]

57. Lower activity levels can result in a reduction in the delivery of outputs, risks in the readiness and sustainability of the capability, and slower aircrew progression resulting in insufficient qualified flying instructors to sustain the pilot pipeline.

#### ***Additional operating funding for NZDF could have a direct impact to lift activity levels, as well as overall efficiency***

58. NZDF's capabilities have large fixed costs and marginal operating costs in general make up less than [1] of total capability expenditure. Relatively small increases in operating funding should result in higher asset utilisation and increased efficiency of expenditure.

#### *Navy*

59. For the Navy, analysis shows a relationship between a higher number of sea days resulting in lower costs per sea day, suggesting economies of scale. Because approximately [1] of Navy expenditure is 'fixed' in the short-term (personnel, depreciation and capital charge), spreading these costs across more sea days effectively reduces total expenditure per sea day.



[1]

### *Army*

60. Analysis suggests approximately [1] of Army's expenditure is 'fixed' in the short-term (personnel, depreciation and capital charge). However, the [1] discretionary spending enables training to occur and higher-end capabilities to be developed. Investment in training ensures personnel can undertake expected tasks, with the required level of readiness to respond when needed.
61. [1,33]

### *Air Force*

62. Approximately [1] of Air Force costs are fixed in the short term. In general, costs per flying hour decrease as flying hours increase. Platforms with lower levels of flying hours over the last couple of years [1] have had an associated increase in cost per hour.

[1]

### ***Future outlook***

63. All three services have significant capability acquisition programmes in the coming years under the DCP 2019. While costs that are directly attributable to these new capabilities are included within the whole-of-life-costings approved by Cabinet through each business case, this is likely to result in second and third-order effects associated with continuing to manage existing capabilities while introducing new ones into service. These risks will require active management to successfully transition to the new capabilities, while effectively operating and supporting existing capabilities.

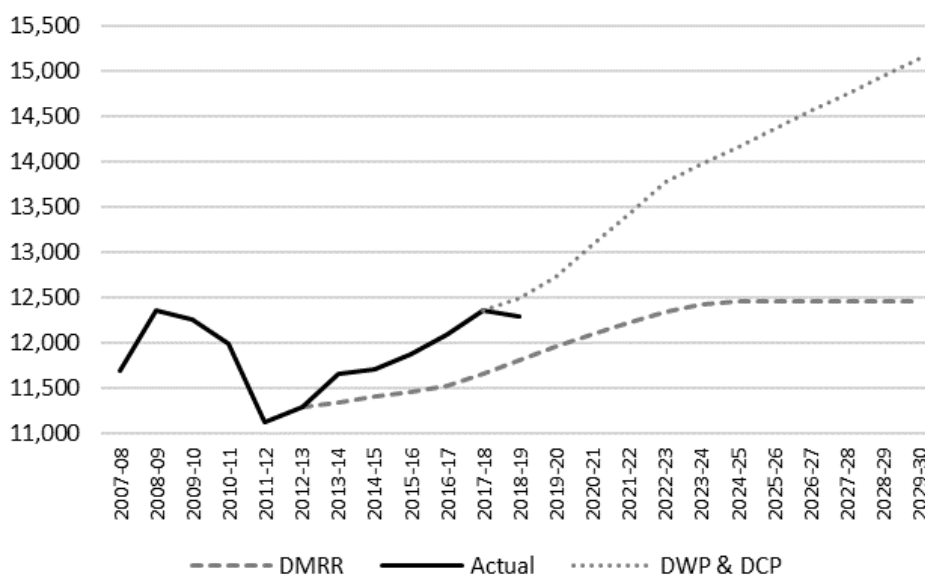
## Personnel

64. NZDF capabilities and outputs are delivered and deployed with the support of trained and committed personnel. To implement current policy settings, NZDF needs to attract, develop and retain a workforce with skills that are in high demand across the broader labour market. Skilled personnel are critical for output delivery and the introduction of future capabilities.
65. Personnel costs have been persistently higher than forecast, with expenditure in 2018/19 being \$64 million higher than DMRR. This increased personnel expenditure has been funded by reprioritisation from other operating expenditure, which has subsequently reduced NZDF's ability to reprioritise funding to address emerging organisational cost pressures.

### ***NZDF's current trajectory for personnel expenditure is unsustainable***

66. The DMRR funding track agreed in 2013 incorporated forecasts for NZDF's FTE numbers and expenditure, including workforce and rank structures. Since then, NZDF's workforce structure has diverged materially from DMRR, with FTEs being 2.0 per cent higher and average salaries 6.7 per cent higher than forecast.
67. The largest contributor to change since the DMRR has been in civilian personnel, which have both higher than expected FTEs and a workforce that is more senior. Similarly, although the number of military force FTEs are broadly consistent with the DMRR, they are more expensive than anticipated, due to the increased seniority of personnel.

Figure 23: NZDF total FTEs against forecasts



68. The civilian workforce has been the major cause of increasing costs, as demonstrated by figures 24 and 25 on the following page, that illustrate the extent of the divergence from DMRR forecasts. Civilianisation of NZDF's workforce was undertaken in response to the recommendations made by the *2010 Value for Money Review*. However, the DMRR then forecast civilian numbers to decrease as a means of decreasing the overall cost of the funding path. It was unclear how the organisation was expected to apportion these cuts and what outcomes could be expected.

69. Following the DMRR, the civilian workforce has instead increased, with the Communication and Information Systems (CIS) and Defence Estate and Infrastructure (DEI) branches driving growth. Since 2013/14, CIS and DEI have grown by 128 FTEs in total (an increase of over one third) accounting for the bulk of civilian personnel growth across NZDF. Similarly, the Capability Branch has increased by 60 FTEs or 28.4 per cent since 2013/14.

Figure 24: Civilian FTEs against forecasts

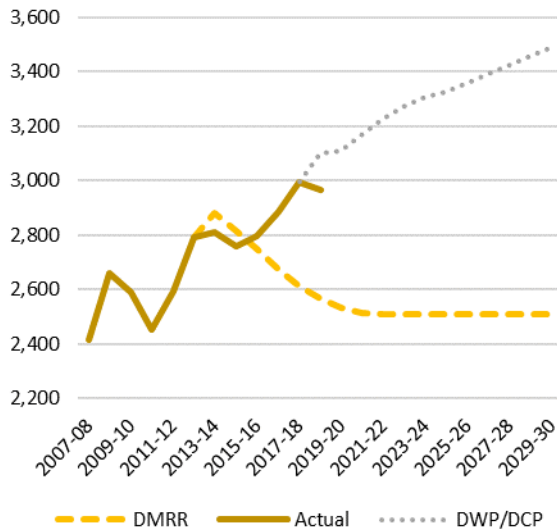
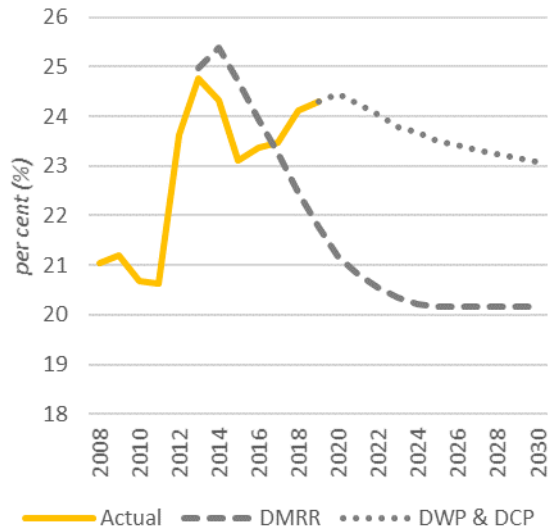


Figure 25: Civilian FTEs as a percentage of NZDF's total FTEs against forecasts



70. Following WWP 2016, Cabinet agreed to a new force structure for planning purposes that saw civilian numbers held steady as a proportion of the overall NZDF workforce. Cabinet agreed (but did not fund) the increased costs associated with this structure, while adjusting the funding path down for updated economic, depreciation and capital charge assumptions. While this decision had negligible fiscal impacts for Cabinet in the short-term, NZDF signalled that this would likely result in higher-than-planned costs post-2019. Cabinet directed that work be undertaken providing assurance on long-term cost pressures and improving the sustainability of NZDF's operating costs. While work was undertaken to improve the fidelity of personnel costings, this was not subsequently reported back to Cabinet, and cost trends have continued on the same trajectory.

71. NZDF would benefit from better functional management and a coherent workforce strategy for its total civilian workforce. At present, each of the ten portfolio owners is accountable for their civilian workforce numbers. This makes management of the total civilian organisation difficult, in contrast to the management of Regular Force numbers where a single service chief has responsibility for their respective service. The Chief People Officer is responsible for providing oversight of personnel trends, however management responsibility sits with individual portfolio owners.

72. [1]

73. [1]

74.

75.

76.

[33]

77.

78.

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[33]

[33]

79. [33]

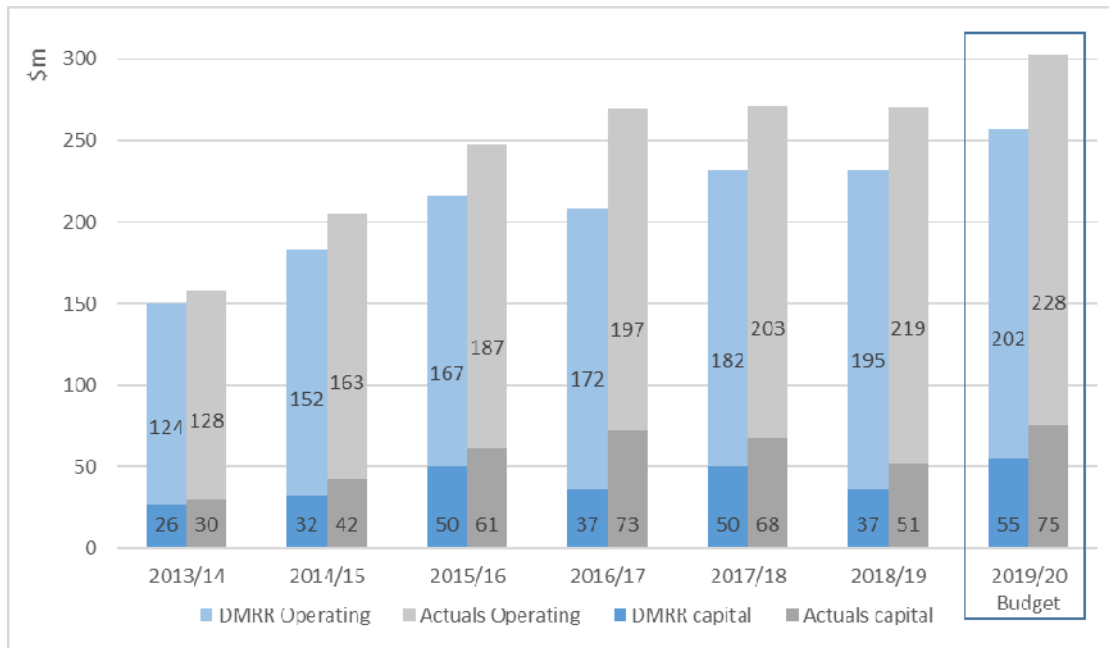
## Logistics and Maintenance, Repair and Overhaul

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80. The majority of spending on the logistics functions across NZDF is on maintenance, repair and overhaul (MRO) costs, [1]

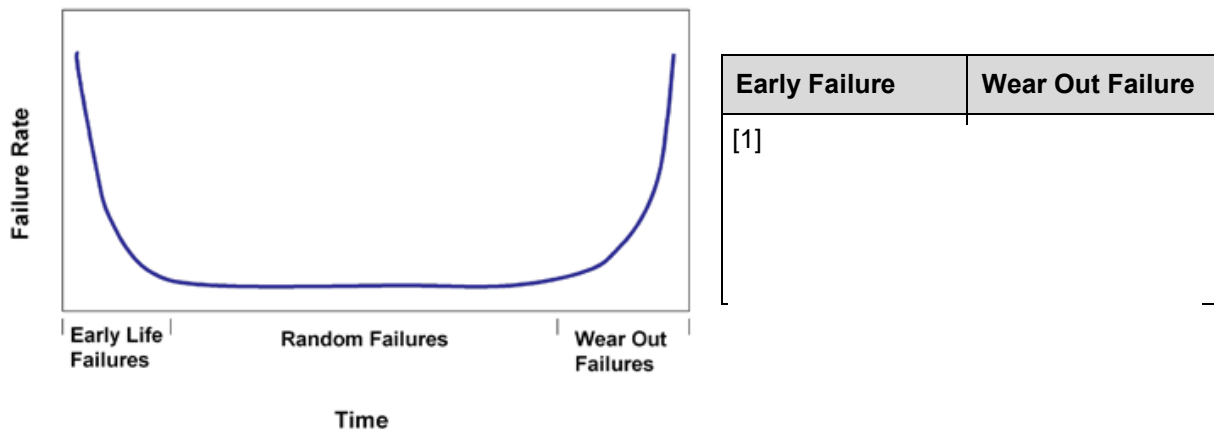
81. MRO consists of both capital and operating expenditure. Figure 30 overleaf shows total MRO expenditure has exceeded DMRR forecasts by an average of 14 per cent per annum, with capital expenditure exceeding forecasts by 39 per cent and operating expenditure by 11 per cent.

Figure 30: NZDF MRO expenditure against forecasts from 2013/14 to 2019/20



82. A key cause of this trend appears to be that major NZDF capabilities are either reaching the end or are just entering into their service life. The graph below shows the so-called 'bath-tub' effect, with the table to the right including examples of where some NZDF platforms fall on either end of the curve.

Figure 31: 'Bath-tub' effect observed in MRO expenditure



**NZDF needs to prioritise improvements in the MRO environment**

83. NZDF has a number of opportunities ahead or currently underway to improve the understanding and management of costs in its MRO environment:

- Spend-to-save initiatives**, [33] offer opportunities to deliver cost savings through improved inventory and equipment management and care/maintenance.
- Whole of Life Costing** for new capabilities has improved significantly in recent years, which helps Cabinet to make more informed decisions and helps avoid unexpected cost pressures for NZDF. Ongoing refinement will continue to deliver benefits.

- **Tools to enhance analytics, planning and forecasting** would improve NZDF's ability to focus on proactive rather than reactive maintenance. There also appears to be a lack of key performance indicators and metrics surrounding existing spending. This made it difficult for the baseline review to identify how much of the increase in MRO spending was price or activity driven, whether that spend was efficient and effective, and whether NZDF is receiving value for money. Some recent progress has been noted and should be continued across the NZDF environment – we understand there are multiple work programmes currently underway.

***Initiatives to improve contract management should also be a priority***

84. While procurement is an NZDF-wide function, it has been considered as a review of the logistics function because MRO is often delivered through support contracts with third parties. Manufacturers of military equipment are also now increasingly moving to include through-life-support contracts in their business models.
85. NZDF's procurement processes are generally acceptable and have improved since the 2017 Commercial Improvement Programme. [33]
86. With MRO spending totalling approximately \$270 million in 2018/19, NZDF should accelerate progress implementing its Commercial Improvement Programme. This would have benefits across the procurement function.

**Infrastructure (ICT and Defence Estate)**

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87. Since the implementation of DMRR, NZDF has undertaken significant internal reprioritisation to fund the transformation and recapitalisation of ICT infrastructure and the Defence Estate.

[1]

88. For NZDF's ICT infrastructure, the DMRR used the 2012/13 CIS/ICT baseline and adjusted it by inflation to forecast future expenditure. This was immediately following the implementation of the Savings and Redistribution Programme resulting from the 2010 *Value for Money Review*.
89. A 2015 review of the maturity of NZDF's ICT infrastructure conducted by KPMG found NZDF was spending [1] of its organisational running costs on ICT, which was significantly less than similar organisations such as New Zealand Police [1] and the Australian Defence Force [2]
90. NZDF subsequently internally approved a CIS Change Transformation Programme (CIS/CTP) in 2016. Given the size of the investment, Cabinet approval was required under Cabinet Office circular CO (15) 5 (subsequently replaced by CO (19) 6), however this was not sought at the time. NZDF acknowledge this, but note the effect of the decision was to approve a programme business case where, aside from obtaining agreement to changes in the ICT workforce, individual business cases for the key investments identified in CIS/CTP with significant financial implications were to come forward for approval by the appropriate decision-maker in future. [33]



91. Implementing CIS/CTP was projected to require a total of [1] additional funding on top of existing baselines between 2016/17 and 2021/22, with the consequence that NZDF's ICT expenditure would increase to [1] of its organisational running costs and increase its ICT expenditure in 2015/16 by [1] over four years. [1]
92. DMRR did not correctly estimate the cost of maintaining and transforming NZDF's CIS Branch and ICT infrastructure, and no additional funding has been provided to NZDF. This expenditure has instead been funded through reprioritisation.

[1]

### ***NZDF needs an overarching enterprise view of its ICT expenditure***

93. There does not appear to be a comprehensive enterprise view of ICT across NZDF and defence more broadly. [1]

94. [1]

### ***The current increased focus on the Defence Estate needs to continue***

95. The Defence Estate has a similar legacy of underinvestment. The DMRR acknowledged this, setting aside \$1.7 billion capital and \$2.2 billion operating funding over the period to 2029/30 based on 90 per cent of the cost of recapitalisation of current assets. At the same time NZDF were directed to develop a high-level plan to outline intended investments out to 2029/30.
96. This became the Defence Estate Regeneration Programme 2016-2030 which was agreed by Cabinet following the agreement to DWP 2016. An updated plan was agreed by Cabinet in April 2019, following agreement to DCP 2019 that increased forecast capital investment to \$2.1 billion and operating expenditure to \$2.9 billion over the period to 2030.

97. As the plan has started to be implemented, funding provided under DMRR has proved inadequate due to:
- higher unscheduled maintenance costs
  - higher construction costs
  - higher utility costs, and
  - higher costs to meet minimum health and safety requirements – e.g. three waters, seismic integrity, healthy homes standards and environmental standards.
98. NZDF's DEI Branch is still in the early-stages of implementing the plan, although so far progress against the capital investment plan has been slower than expected. Capacity and capability within DEI Branch has been identified as a constraint. Reprioritisation within NZDF has allowed for increasing the size of the workforce, and DEI Branch is also in the process of procuring a strategic alliance to improve access to key professional advisers (such as asset management, project management and ICT).

## Prioritisation of expenditure

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99. Because the DMRR funding track was intended to act as a fiscal cap on defence spending, internal reprioritisation was the only way in which un-forecasted costs that subsequently arose could be funded.
100. Internally, NZDF operates a top-down balanced budget each year where reprioritisation decisions are approved by the Executive Committee (ExCo - NZDF's Executive Leadership Team). Each domain and portfolio submits activities that could be scaled, deferred or stopped. ExCo then make decisions to change budget allocations with the objective of minimising the impact of reprioritisation decisions. Each domain and portfolio then manages their budget allocation by stopping activities, deferring or 'carrying risk'.

### ***NZDF has a tendency to make internal reprioritisation decisions without 'turning off' deprioritised activities***

101. Domains and portfolios often 'carry risk' on activities that are not funded. These activities may eventually receive funding due to slippage or underspending elsewhere in the organisation, or they may result in a cost pressure initiative being submitted in future Budgets (as per Budgets 2019 and 2020).
102. This approach of 'carrying risk' can cause sustainability issues by creating 'holes' in the baseline that require additional funding to be provided from elsewhere in the business in the future to cover the shortfall.

### ***Ministers are now being asked to fill the 'holes' this has created in the baseline***

103. NZDF are now seeking funding to fill these 'holes' which have been created in the baseline as a result. For example, Navy submitted cost pressures seeking [33] operating funding over the forecast period for the Frigates and the new replenishment ship Aotearoa. [1]

104. In general, this type of cost pressure is not supported through Budget, due to the risk of moral hazard from shielding agencies from the consequences of reprioritisation decisions. However, NZDF is a unique case in that it was expected to operate within a fiscal cap. Following DWP 2016, it was signalled that it was unlikely that the existing funding path was sustainable in the long-run. These issues now need to be addressed.
105. Ministers now face the choice of accepting the costs of the operating model that has developed, or providing direction that this will need to change in order to meet current and future fiscal constraints. If change is preferred, this will need to have regard to scale, pace and associated risks. Large changes are not likely to be achievable in the short-term without creating significant risks.

***In future, Ministers will need to directly address trade-offs at the time they are made in order to avoid undesirable impacts on sustainability***

106. A 2018 internal NZDF Financial Management Review identified this was an issue, recommending NZDF improve its processes to:

- enable clear decision making about funding priorities
- manage the implications of decisions, and
- create transparency and visibility of management decisions that impact upon resources.

107. It also recommended:

*“Decision makers should be presented with clear choices about what can be stopped or paused in line with organisational wide priorities – i.e. rather than receiving permission or direction to ‘carry risk’.”*

108. Continued progress against the Financial Management Review’s recommendations would improve sustainability. Recommendations for the funding model later in this report include moving away from the understanding that the funding track is a ‘cap’ on spending regardless of policy settings. Encouraging NZDF to seek new funding for significant new investments or organisational changes should provide Ministers with better visibility of decisions, and avoid accumulation of risk.

109. This is not a new issue. As far back as 2007, a review of the Defence Sustainability Initiative noted that:

*“...[the message] from Treasury and SSC was that the adequacy of funding was not an issue, but Defence’s ability to live within the existing funding envelope was. The contrasting message from Defence was the impossibility on an ongoing basis of living within the envelope and the impact of this.”*

110. This appears to be due to diverging expectations created by the process of matching policy and funding paths. A more recent example of this is in how maintaining the DMRR funding track following the introduction of the DWP 2016 created diverging expectations. While the additional funding that was forecast by NZDF to be required post-2019 was not agreed, Cabinet’s agreement to policy changes created a sustainability issue. While NZDF was balancing budgets year-to-year within the DMRR funding track, this was not expected to be sustainable, resulting in deferrals and a bow-wave of cost pressures. Treasury’s expectation was that NZDF would have to change its workforce structure and operating model in order to improve sustainability.

111. In future, this could be avoided by considering defence policy, capability and funding settings together at the same time and adapting funding paths, the operating model, capability or policy settings to changes in assumptions. The next opportunity to do this appears to be the Defence White Paper currently scheduled for 2022.

## Funding paths for NZDF

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112. The baseline review was tasked with assessing the efficiency, effectiveness, sustainability and resilience of expenditure within existing baselines, and providing choices to Ministers for funding paths for the medium-term.

### ***The baseline review has assessed NZDF's cost pressures***

113. NZDF submitted 80 individual cost pressure initiatives to the baseline review for assessment that totalled [33] across the four-year forecast period. These initiatives, and the baseline review's assessment of them, are set out in Annex C.

114. The baseline review has assessed these cost pressures based on the areas of focus in this report and with reference to the wider approach taken to cost pressures across government. Funding for cost pressures in Budget 2020 is limited to those pressures that are clearly driven by:

- **volume** or **price**, including price/volume-driven personnel pressures, or
- existing or impending **legislation** or **regulation**.

115. Good evidence must be provided demonstrating there are significant risks if the cost pressure isn't funded, e.g. preventing critical service failure.

116. The baseline review has applied these criteria more loosely than would be the case in the Budget process in order to take account of unfunded defence policy settings and consider requirements of the next four Budgets. Each cost pressure was given a low, medium or high ranking where:

- **low** means there is little discretion relating to the cost pressure and it likely cannot be avoided
- **medium** means there is some discretion relating to the cost pressure though trade-offs with risk may be necessary, and
- **high** means there is greater discretion relating to the cost pressure and it is more likely related to planned expansion driven by defence policy settings.

117. These rankings were then used to develop the option sets within each area of focus based on the level of risk willing to be taken. The funding packages in Annex A were developed based on varying levels of risk chosen for each area of focus.

118. NZDF's new spending initiatives are out of scope for the baseline review and have been assessed by Treasury's defence vote team consistent with broader practice for Budget preparation. This advice is being provided to the Minister of Finance separately.

119. The baseline review also identified several areas of potentially low-value expenditure within NZDF's baselines that Ministers may want to consider for re-prioritisation or significant reduction. NZDF has taken the position that it is largely already very efficient and there are minimal opportunities for reprioritisation. More information about options for reprioritising this existing expenditure can be found in Annex C, including:

- reduction in **travel** not supporting direct military outputs
- reduction in **contractor/consultant** spend, and
- spending on the **OEAPR** housing allowance (not recommended).

120. These specific examples offer limited potential to offset NZDF's cost pressures. The largest lever available to manage funding requirements relates to personnel expenditure. [33]

- [33]
- 
- 

***We have identified 4 options for funding paths for your consideration***

Figure 33: Funding paths developed by the baseline review

[33]

121. More details about the implications of each option can be found in Annex A. The packages have the following core characteristics:

- **Option A – Comprehensive Package:** This package would allow NZDF to implement the policy settings articulated in the DCP 2019 with minor risk to output delivery, as well as increase use of current capabilities, prepare for the introduction of new capabilities, and meet compliance and transformation requirements with a minor level of risk. Significant efficiencies would need to be achieved in personnel structure and the use of contractors.
- **Option B – Increasing Activity and Capability:** This package would focus on increasing NZDF's activity levels and preparing for the introduction of new capabilities. New and returning capabilities should be able to be utilised as planned. [1]

[33]

- **Option C – Sustaining Capabilities and Infrastructure:** This package focuses on maintaining current capability and introducing new capabilities in the medium term. Scaled logistics funding [1]

[33] One year of funding for remuneration increases is provided,

- **Option D – Base Funding:** This funding scenario provides limited funding for new FTE growth, scaled funding for MRO, operating capabilities, remuneration increases for one year. [33]

One year of remuneration funding is provided, [33]

[1]

122. In deciding a preferred funding path, you may want to consider:

- **Capability:** [1]
- **Infrastructure:** Spending on the defence Estate has lagged behind DMRR forecasts, with substantial risk being carried by the portfolio due to an increasing backlog of deferred maintenance. CIS is currently undergoing major transformation through the CIS Transformation programme.
- **Enabling functions:** The enabling functions underpin personnel and capability. However, the level of funding chosen for enabling functions is unlikely to directly impact other categories. The options here are have net negative totals due to suggested reprioritisation.
- **Logistics:** Logistics is closely linked (but not directly proportional) to the capability category. Actual MRO operating costs have increased year on year, with an overall increase of [1] between 2013/14 and 2019/20.
- **Personnel:** Personnel has been a major driver of cost pressures across NZDF. Pressure could be applied to this in order to encourage a more strategic approach, but this needs to consider what pace and scale of change to the current trajectory is achievable.

123. At the higher end, funding path options would provide for expansion of current activity levels and FTE growth to better align policy and funding settings, while creating pressure to address areas of the operating model where efficiencies could be created. At the lower end, more risk should be expected in relation to defence policy settings, and further work would be required over the forecast period to determine the appropriate level of personnel funding based on a revised workforce strategy.

## Funding model to implement a preferred option

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### ***Lessons can be learned from the operation of previous funding models for NZDF***

124. A number of lessons can be learned from the experience of previous funding models for NZDF:

- A funding path can only remain credible if there are shared expectations of how an agency is expected to manage within it. Trade-offs for policy, force structure and funding need to be made in concert at the time that decisions are made in order to avoid creating sustainability issues or accumulation of risk.
- Any expectations for changes to the operating model over time need to be realistic and monitored to determine if assumptions will hold.
- When assumptions about cost change or unexpected trends develop, the causes need to be investigated and addressed as soon as possible. Reprioritisation is an important part of managing within a constrained environment, but this should avoid shifting costs into the future.

### ***We recommend these principles underpin the new funding model***

125. Drawing on these lessons, we recommend the following principles underpin the preferred funding path:

- it shouldn't incorporate the operating costs associated with **planned new investments**, in the same way the DMRR funding track attempted
- it should only fund **cost pressures** based on the shape of NZDF in 2019
- it should include realistic expectations for **efficiency gains** if Ministers wish to incentivise NZDF to address particular issues (for example, personnel costs), and
- it should be adjustable so that **changes in assumptions** do not impact on outputs.

126. This should provide Ministers:

- **confidence** that the funding required to meet defence's cost pressures for the next four years has been identified
- **agreement** between Ministers, NZDF and MoD about what is being purchased, and the decision rights for changing that agreement, and
- **control** over whether to approve any new spending proposals that would have the effect of adding additional costs into baselines.

### ***We recommend the chosen funding path lock in the first two years***

127. Implementing a multi-year funding model would provide NZDF with a level of certainty about the increase in operating funding they can expect over the medium-term while providing Ministers with a level of fiscal certainty regarding defence expenditure.

128. Ministers have options to vary the degree of funding certainty provided by:
- deciding how many years of the funding track are **'locked in'** and counted against the Budget 2020 allowances or pre-committed against future allowances
  - for those years of funding not 'locked in', deciding the **level of certainty** that should be provided about that funding, and
  - deciding whether to make access to future funding dependent on **future decisions**, such as through the use of tagged contingencies or withholding funding altogether.

129. The table below helps illustrates how a funding path interacts with Budget allowances based on the cost pressures originally submitted by NZDF to the baseline review:

Figure 34: Funding paths and the impact on Budget allowances

\$/m	2020/21	2021/22	2022/23	2023/24 & outyears	TOTAL
Year 1	[33]				
Year 2					
Year 3					
Year 4					
<b>Total</b>					

130. Whichever funding path Ministers agree to take to their colleagues, we recommend that only Years 1 and 2 of that funding path are counted against the Budget 2020 allowances in order to:

- allow a number of areas of **further work** being recommended to be completed, [33]
- [33]
- [33]
- provide **opportunities to make savings** and reduce the funding required in Years 3 and 4
- provide **opportunities to grant additional funding** to address unforeseen cost pressures in Years 3 and 4, and
- generally, to have a set **'check-in' point** for Ministers to review the performance of the selected funding track over the previous two years.

131. For Years 3 and 4 of the selected funding path, we recommend you seek the indicative agreement of your Cabinet colleagues. This decision can be sought in the recommendations for Vote Defence Force in the Budget 2020 'Significant' paper at the same time most other Budget 2020 decisions are made.

132. While not providing the same degree of certainty as 'locking in' the funding against the current or future Budgets, this approach was used under the DMRR model and did provide NZDF with sufficient certainty for its planning purposes.



133. [33]

[33]

134. The outcome of volatility of foreign exchange and fuel prices on NZDF's activity levels and outputs can be significant. In 2018/19, [1] of operating costs were to be settled in foreign currency and [1] litres of fuel were to be purchased. The full year impact of a 1c movement in foreign exchange was estimated to be [1] and [1] for a 1c movement in fuel prices.

135. While current practices provide an economic hedge, accounting standards and appropriation practices (which do not allow gains on derivative contracts to offset expenditure losses) render these hedges ineffective. [33]

- [33]

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136. [33]

137. [33]

[33]

138. As forecast in the DMRR and DWP 2016, there is a significant gap between the cost of replacing NZDF's existing assets and the funds available on the balance sheet. The capital plans included in DWP 2016 and DCP 2019, both indicatively costed at \$20 billion, signalled the accumulated depreciation reserves would not be sufficient to fund the entirety of planned capital expenditure and that capital injections of approximately [33] would be required.

139. While Cabinet indicatively approved these capital plans, they also expressly required each capital acquisition project to be considered on their own merits by the appropriate decision maker at the time they were ready. Acknowledging their indicative nature, defence uses these capital plans for its internal planning purposes.
140. The graph below demonstrates [1] the future liability to replace assets (“accumulated depreciation” in blue) and the funding available on the balance sheet to meet this liability (“liquid assets” in green):

[33]

141. Aside from a brief period following the GFC in 2010-2012, Cabinet circulars have clearly laid out the responsibility of chief executives to accumulate depreciation funding to appropriately provide for future replacement of existing assets to maintain services. However, there has often been a strong preference from Ministers for funding projects from depreciation reserves. This tension is exacerbated by agencies seeking to minimise capital charge. In recent years, NZDF has been operating under a policy to actively avoid the accumulation of depreciation reserves, on the basis that this was implicitly agreed by Cabinet when capital plans were set by the DWP 2016.
142. For basic replacements this is not an issue, but when funds are used for assets that are higher cost, or include new services or capabilities, this causes problems for the sustainability of government services.

143. [33]

144. [33]

## Next Steps

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145. A Joint Ministers meeting is scheduled for 10.30am on 10 February to discuss the outcome of the baseline review. We recommend you discuss and select a preferred funding path for cost pressures for the Minister of Defence to progress through the Budget process, with regard to other priorities being progressed as new initiatives.







[1]





[1]

[1]

[1]



[1]









[1]