Resource Management in Defence

Briefing to
Financial Management Institute
October 22, 2015
Brigadier-General Werner Liedtke
Director General Financial Management
• Background
• Defence Funding Model
• Managing Defence Supply
• Accrual Envelope
• Investment Planning
• Expectations from Central Agencies
1. Background
Department of National Defence

- Size and complexity of Department is unparalleled
- Largest organization in government in terms of budget $20.5B

- In terms of workforce:
  - Regular Force 66,130
  - Reserves 24,209
  - Civilians 22,011

- In terms of inventory of assets: $6.5B vs Government $7.5B
• FY 2014-15 estimated expenditures represent 7.7% of total government spending

• FY 2014-15 estimated expenditures represent 15% of total government program expenditures

• 46% on personnel, 28% on Operating & Maintenance, 25% on Capital and 1% on Grants and Contributions

• Actual expenditures have increased by 27.8% from FY 2005-06 to FY 2013-14
Resource pressures have driven fundamental change

- Commitment to a balanced budget in FY 2015-16
- Major reviews have focused on the cost of federal programs, the identification of new efficiencies and the adoption of innovative approaches

Funding for new initiatives is limited

- Departments must demonstrate excellence and restraint in resource management
- DND has taken a disciplined and comprehensive approach to address its unique requirements and attributes
DND Financial Context (con’t)

• Since 2008, the Government has taken the necessary steps to balance the budget. DND has contributed to reduce deficit as follows:
  ➢ Budget 2010 cost containment - $350 million
  ➢ Strategic Review - $1.0 billion
  ➢ Deficit Reduction Action Plan - $1.1 billion
  ➢ Budget 2013 cost containment - $240 million

• Transfer of responsibilities and funds to Shared Services Canada, CSE, Canada School of Public Service, Web renewal and HR system centralization.

• Defence Renewal underway – a multi-year exercise to streamline processes and re-invest any savings in operational capabilities and readiness
2. The Defence Funding Model
Two components:

• Multi-year departmental reference levels approved by the Treasury Board each year through Estimates process:
  – the 2% defence escalator;
  – the costs of increased salary levels and benefits associated with the collective bargaining process except for increases during the operating budget freezes (2010-11 to 2012-13 and 2014-15 to 2015-16); and
  – the incremental costs of major deployments. In Canada First Defence Strategy the Government recognized this funding as being in addition to the funding set-aside in the fiscal framework and the defence escalator.

• Funding set aside in the Fiscal Framework to finance the incremental requirements associated with Canada First Defence Strategy but requiring Treasury Board approval to be access – this is the Accrual Envelope.
Operations and Maintenance Funding

• The “discretionary” portion of the Defence budget

• Funds the normal day to day requirements, such as training, fuel, travel, general supplies and operations

• In-year financial pressures have to be managed from this portion of the budget

• Can defer some training or exercises but may affect future readiness
Defence Escalator

- Escalator of 1.5% started in 1998
- Budget 2008 announced the implementation of a 2% defence escalator, starting in 2011-12
- Budget 2015 announced the implementation of a 3% defence escalator, starting in 2017-18
- Escalator is unaffected by Strategic Review and Budget 2012
- Escalator provides partial funding stability:
  - Technological inflation – 2% to 5%
  - Lack of substitution/competitive options
  - Exchange rate fluctuation – 1¢ change $16M
- No defence escalator for accrual envelope
### Defence Escalator

#### Defence Escalator ($M$)

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Escalator</th>
<th>Cumulative From 2008-09</th>
<th>Cumulative From 2013-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008-09</td>
<td>190</td>
<td>190</td>
<td>190</td>
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<tr>
<td>2009-10</td>
<td>192</td>
<td>382</td>
<td>574</td>
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<tr>
<td>2010-11</td>
<td>198</td>
<td>580</td>
<td>768</td>
</tr>
<tr>
<td>2011-12</td>
<td>281</td>
<td>861</td>
<td>1,142</td>
</tr>
<tr>
<td>2012-13</td>
<td>334</td>
<td>1,195</td>
<td>2,337</td>
</tr>
<tr>
<td>2013-14</td>
<td>340</td>
<td>1,535</td>
<td>3,803</td>
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<tr>
<td>2014-15</td>
<td>347</td>
<td>1,882</td>
<td>5,685</td>
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<tr>
<td>2015-16</td>
<td>354</td>
<td>2,236</td>
<td>8,141</td>
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<tr>
<td>2016-17</td>
<td>361</td>
<td>2,597</td>
<td>10,738</td>
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<tr>
<td>2017-18</td>
<td>368</td>
<td>2,965</td>
<td>13,703</td>
</tr>
<tr>
<td>2018-19</td>
<td>376</td>
<td>3,341</td>
<td>17,044</td>
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<tr>
<td>2019-20</td>
<td>383</td>
<td>3,724</td>
<td>20,768</td>
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<tr>
<td>2020-21</td>
<td>391</td>
<td>4,115</td>
<td>24,883</td>
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<tr>
<td>2021-22</td>
<td>399</td>
<td>4,514</td>
<td>29,397</td>
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<td>2022-23</td>
<td>407</td>
<td>4,920</td>
<td>34,317</td>
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<td>2023-24</td>
<td>415</td>
<td>5,335</td>
<td>39,652</td>
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<tr>
<td>2024-25</td>
<td>423</td>
<td>5,758</td>
<td>45,410</td>
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<tr>
<td>2025-26</td>
<td>431</td>
<td>6,190</td>
<td>51,600</td>
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<tr>
<td>2026-27</td>
<td>440</td>
<td>6,630</td>
<td>58,230</td>
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<tr>
<td>2027-28</td>
<td>449</td>
<td>7,079</td>
<td>65,309</td>
</tr>
</tbody>
</table>
Accrual Envelope: Unique to DND

- Unlike other departments (which must fund projects from reference levels), DND enjoys the benefit of an “Accrual Envelope” in addition to its Reference Levels.
- Funding set aside in Fiscal Framework to finance incremental requirements associated with CFDS.
  - The Accrual Envelope is accessed, consumed and reported upon in a much different fashion than Reference Levels.

<table>
<thead>
<tr>
<th>Reference Level (A-Base)</th>
<th>Accrual Envelope</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Limited availability</td>
<td>• TB approval required for all allocations from the AE</td>
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<tr>
<td>• Charged dollar for dollar</td>
<td>• No escalation factor</td>
</tr>
<tr>
<td>• Current year carry-forward flexibility</td>
<td>• Cost is spread over useful life of asset</td>
</tr>
<tr>
<td>• Escalator factor</td>
<td>• Future year funds can be re-profiled but current year funds cannot</td>
</tr>
</tbody>
</table>
3. Managing Defence Supply
• 2005-06 to 2010-11: Budget growth related to increased operational deployments particularly in Afghanistan

• 2011-12 to 2014-15: budget declines related to DND’s contributions to the Government's deficit management priority

• 2005-06 to 2013-14: Authorities increased by 33% and Defence Spending increased by 27%

  - Operating budget growth predominately related to Defence escalator, which increases from 2% to 3% commencing 2017-18.
  - Capital funding fluctuates based on Treasury Board approvals. Future approvals will increase this funding line.

Note: FY 2014-15 data as at 8 May 2015. Final data will be available upon completion of Public Accounts
• Many elements of the budget are "fixed" with limited short-term flexibility (e.g., salaries, capital, infrastructure)
• Operations and Maintenance budgets (18% of total budget) are more flexible in responding to unforeseen pressures
• Operations and Maintenance has been reduced by $600M, or 15%, between 2010 and 2015

Note: 2015-16 Authorities based on Main Estimates, Supplementary Estimates (A), 2014-15 Carry Forward, and Reimbursement of Eligible Paylist
Total Authorities by Vote 2014-15

- Vote 1: $13.8 billion
- Vote 5 Investment Cash: $3.2 billion
- Vote 5 A-Base: $1.6 billion
- Vote 10: $0.2 billion
- Statutory: $1.3 billion
- Total: $20.1 billion

Breakdown by Vote and $ based on page proofs – Supplementary Estimates (C) 2014-15
Proposed Total Authorities
## Authorities to Date

<table>
<thead>
<tr>
<th>Authorities</th>
<th>Vote 1</th>
<th>Vote 5</th>
<th>Vote 10</th>
<th>Statutory</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Main Estimates 2014-15</strong></td>
<td>12,513,999,319</td>
<td>4,730,059,209</td>
<td>178,183,820</td>
<td>1,239,312,039</td>
<td>18,661,554,387</td>
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<tr>
<td><strong>Supplementary Estimates (B) 2014-15</strong></td>
<td>881,614,659</td>
<td>-6,227,688</td>
<td>581,066</td>
<td>9,221</td>
<td>875,977,258</td>
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<tr>
<td><strong>Supplementary Estimates (C) 2014-15</strong></td>
<td>142,026,509</td>
<td>-1,200,500</td>
<td></td>
<td>1,471,074</td>
<td>142,297,083</td>
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<tr>
<td><strong>Other Adjustments</strong></td>
<td>275,535,956</td>
<td>112,926,761</td>
<td>0</td>
<td>3,413,092</td>
<td>391,875,809</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>13,813,176,443</td>
<td>4,835,557,782</td>
<td>178,764,886</td>
<td>1,244,205,426</td>
<td>20,071,704,537</td>
</tr>
</tbody>
</table>

Other Adjustments: Carry Forward (Vote 1 $167,730,638, Vote 5 $112,926,761), CF Superannuation Act (Statutory $3,413,092), TB Compensation Adjustment (Vote 1 $7,805,318) and TB Pay List Reimbursement (Vote 1 $100,000,000).
Total Authorities by Vote 2015-16

Vote 1 - $13.5 billion
Vote 5 Investment Cash - $2.6 billion
Vote 5 A-Base - $1.4 billion
Vote 10 - $0.2 billion
Statutory - $1.2 billion
TOTAL - $18.9 billion

Breakdown by Vote and $ based on page proofs – Main Estimates 2015-16
Lapses over time ($M)

- Planned Lapse is part of the normal financial management strategy of a department.
  - For Defence, planned lapse is predominantly the reprofile for Capital Projects and the allowable carry forward.
  - Planned Lapse reflects prudent budget management by realigning funding to the future.
- Residual Lapse is funding not available for future use.
## Historical Use of Authorities ($K)

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Final Authority</th>
<th>Actual Expenditures</th>
<th>Public Accounts Lapse</th>
<th>Carry Forward</th>
<th>Residual Lapse</th>
<th>% of Revised Authorities</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005-06</td>
<td>14,721,638</td>
<td>14,682,343</td>
<td>25,686</td>
<td>11,356</td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td>2006-07</td>
<td>15,922,439</td>
<td>15,682,631</td>
<td>226,319</td>
<td>123,376</td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td>2007-08</td>
<td>18,778,156</td>
<td>17,524,049</td>
<td>1,236,706</td>
<td>200,000</td>
<td>302,872</td>
<td>1.7%</td>
</tr>
<tr>
<td>2008-09</td>
<td>19,855,430</td>
<td>19,184,852</td>
<td>670,247</td>
<td>100,819</td>
<td>-</td>
<td>0.0%</td>
</tr>
<tr>
<td>2009-10</td>
<td>21,045,387</td>
<td>19,855,670</td>
<td>1,179,551</td>
<td>410,455</td>
<td>123,440</td>
<td>0.6%</td>
</tr>
<tr>
<td>2010-11</td>
<td>22,754,618</td>
<td>20,298,257</td>
<td>2,445,456</td>
<td>443,509</td>
<td>950,419</td>
<td>4.5%</td>
</tr>
<tr>
<td>2011-12</td>
<td>21,718,125</td>
<td>20,218,758</td>
<td>1,482,643</td>
<td>303,681</td>
<td>36,290</td>
<td>0.2%</td>
</tr>
<tr>
<td>2012-13</td>
<td>21,428,484</td>
<td>19,978,190</td>
<td>1,422,625</td>
<td>356,189</td>
<td>37,455</td>
<td>0.2%</td>
</tr>
<tr>
<td>2013-14</td>
<td>19,696,475</td>
<td>18,764,374</td>
<td>926,025</td>
<td>280,657</td>
<td>24,366</td>
<td>0.1%</td>
</tr>
</tbody>
</table>
4. The Accrual Envelope
Since 2006, the Government has made unprecedented investments to rebuild the Canadian Armed Forces into a first-class, modern military.

In that year, the Accrual Envelope was implemented to ensure long-term funding stability:

- Recognized challenges of defense procurement
- Limitations of A-Base capital resources
- Introduced flexibility through the Accrual Envelope
- Use Accrual Envelope to fund Vote 1 Operating pressures

In 2008, Canada First Defense Strategy was announced and the Accrual Envelope was identified as the source of funds.

In June 2014, the Investment Plan was approved and some limitations were imposed on the use of the Accrual Envelope.
Accrual Envelope Guiding Principles

• TB approval is required for all allocations from the Accrual Envelope (AE) to National Defence reference levels
• Approval of the Minister of Finance and Prime Minister are required for access to the AE for purposes not otherwise provided for
• Allocations from Accrual Envelope are on a project-by-project basis and are tracked separately
  – Investment Cash cannot be re-allocated across projects or re-profiled across years by DND without Department of Finance support and TB agreement
• The AE is a component of a larger, integrated Defence funding model.
Examples of major investments to be funded:

- North Warning Systems
- Tactical Narrowband Satellite Communication System
- Canadian Multi-Mission Aircraft
- Land Command Support Service

$128.9 B over 20 year view (2015-2034)

- Investment Space consists of $104.2B Accrual Envelope and $24.7B A-Base.
How it is managed

• Deputy Minister is responsible for resource allocation through the development of Investment Plan and ongoing process to monitor, track and report expenditures.

• In June 2014, TB approved a three-year DND Investment Plan that outlines how resources will be allocated:
  - Investment Plan includes 101 projects (minor projects were bundled together)
  - Total acquisition cost excluding tax is $82.8 billion of which $36.2 billion will be amortized over the next 20 years
  - Conditions include the use of principles to codify management of the Accrual Envelope and a 3rd party review of the Governance and oversight regime

• New priorities falling outside the normal three-year Investment Plan process, must be approved by the Deputy Minister through the Investment Resources Management Committee, normally semi-annually (Annex A).

• Governance and oversight regime are in place to ensure that resources are expended on highest priority capability requirements:
  - Internal process:
    - Ongoing Capital Investment Plan Program Review (CIPPR) identifies in June priority projects for the period of the next 2 Investment Plans
    - Proposed capital projects will not exceed 50 percent of the remaining balance to ensure funding is available for new priorities, inflation, exchange rate fluctuations and contingencies
  - External process
    - Central Agencies exercise oversight using criteria presented in previous slide
    - TBS is to lead an Independent 3rd party review with a formal report to TB Ministers no later than Dec 2015
• Approximately $110 billion (86%) of the total $128 billion has been allocated.
• Last Investment Plan approval reduced the available investment space to $20.6 billion.
• Since then, individual project approvals, adjustments and contingency for increases in costs reduced the available balance from $20.6 billion to $17.7 billion:
  - Balance in A-Base – $10.4 billion represents less than 41% of the total $25 billion.
  - Balance in the Accrual Envelope – $7.3 billion represents less than 7% of the total $103 billion.
5. Investment Planning
• Departmental investment planning is the function of allocating and reallocating resources to new and existing assets and acquired services that are essential to program delivery

• It is influenced by and supports departmental strategic planning; in DND, the highest level policy driver of investment planning is the *Canada First Defence Strategy (CFDS)*
  – Envisions modern, combat-ready forces with the necessary equipment and infrastructure to make them effective and sustainable in the performance of their missions

• Effective departmental investment planning strikes the balance among the four pillars on which that vision is predicated: personnel, equipment, readiness and infrastructure
The typical funding path for new projects is through the DND Investment Plan (IP), which is governed by the Investment and Resource Management Committee (IRMC), which is chaired by DM

- IP provides a platform for considering the overall alignment of investments to departmental and governmental policy and priorities
- Ensures that the department’s spending plans, both short and long term, are affordable with identified sources of funds
• DND has the largest and most complex capital program in government, with many projects having long lead times and significant risk

• Vast real property portfolio including government-owned and leased buildings, works and land

• Value of department’s non-financial assets is 6 times that of the second largest (PWGSC)

• The Investment Plan was approved by TB in 2014 covering a 20-year portfolio of $58B
  – Since then, other projects have been added
• Complexity of rules and conditions for new versus replacement capabilities, e.g.:
• “Choke Points” over the next 20 years:
• Risk Management Important: 50% of Investment Planning Space ($17.7B) over the next 20 years is reserved for new priorities, inflation, exchange rate fluctuations and contingencies:
• Approach does not always recognize that:
  ➢ Replacement capabilities often cost more than what is replaced
  ➢ In support service for replacement capabilities often cost more
  ➢ Increases from foreign exchange fluctuations and other costs may deplete contingency
  ➢ Flexibility is required to support new priorities

• Different rules to manage unused funds:
  ➢ Accrual Envelope - Flexibility to move resources to future years with no loss of value
  ➢ A-Base - Flexibility to move resources to future years limited to carry forward
5. Expectations from Central Agencies
• Need to demonstrate ongoing affordability from an acquisition and sustainment perspective

• Must continue to improve governance and decision-making information and processes

• Regular reporting to TBS on IP additions, deletions, and revised forecasts to support its ongoing oversight role
• DND does not operate in a vacuum; it is subject to central agency policy and financial frameworks, as well as “whole-of-government” solutions

• Examples of current initiatives which have an impact:
  – 5-Year Financial Management Policy Suite Review
  – Costing Center of Expertise & CFO Attestations
  – Talent Management for Financial Executives
  – Financial Management Transformation
  – Policy on Investment Planning (Assets & Acquired Services)
  – “Procure-to-Pay’ Implementation
<table>
<thead>
<tr>
<th>Issues</th>
<th>Stakeholders</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Plan</strong></td>
<td></td>
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<tr>
<td>➢ Strategic Reprofile of Accrual Space</td>
<td>Finance, TBS, PCO</td>
</tr>
<tr>
<td>➢ Review A-Base/Accrual Envelope methodology</td>
<td></td>
</tr>
<tr>
<td>➢ Long term affordability</td>
<td></td>
</tr>
<tr>
<td><strong>Carry Forward/Reprofile</strong></td>
<td>TBS, Finance</td>
</tr>
<tr>
<td>➢ Negotiate new flexibilities</td>
<td></td>
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<tr>
<td><strong>Operations Funding</strong></td>
<td>PCO, TBS, Finance</td>
</tr>
<tr>
<td>➢ Confirm threshold to internally absorb</td>
<td></td>
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<tr>
<td><strong>Vote 1 / Vote 5 Capital Definition</strong></td>
<td>OCG, Finance</td>
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<tr>
<td><strong>TB Submission</strong></td>
<td>TBS, PWGSC</td>
</tr>
<tr>
<td>➢ Significant time pressures to meet TB requirements (late letters)</td>
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<tr>
<td>➢ PWGSC Involvement (contracting submission)</td>
<td></td>
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<tr>
<td>➢ Demand exceed capacity</td>
<td></td>
</tr>
<tr>
<td><strong>Travel and Event Policy</strong></td>
<td>TBS</td>
</tr>
<tr>
<td>➢ Review current process and negotiate exemptions</td>
<td></td>
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</tbody>
</table>
QUESTIONS?