



House of Commons
Defence Committee

**Ministry of Defence
Annual Report and
Accounts 2004–05:
Government Response
to the Committee's
Sixth Report of Session
2005–06**

**Seventh Special Report of Session
2005–06**

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The Defence Committee

The Defence Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Ministry of Defence and its associated public bodies.

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Ministry of Defence Annual Report and Accounts 2004–05

The Defence Committee published its Sixth Report of Session 2005–06 on the Ministry of Defence Annual Report and Accounts 2004–05 on 20 April 2006, as House of Commons Paper No. 822. The Government's response to this report was received on 19 June 2006. This is appended below.

Appendix: Government response

1. The Government welcomes the Committee's report on the Ministry of Defence Annual Report and Accounts 2004–05. The Government's response to the conclusions and recommendations contained in the Committee's report is set out below.

We are concerned that as at 1 April 2005 there was a 4.9 per cent manning shortfall in the Royal Navy / Royal Marines against the overall requirement. We note that by April 2006 the shortfall is expected to reduce to 3.6 per cent and look to MoD to take action to ensure that the improvements continue and to address the serious shortages at Petty Officer level. (Paragraph 9)

2. We are taking action to address the manning shortfall in the Royal Navy and Royal Marines, specifically through standard manpower levers such as Extensions of Service, Acting Higher rank and the use of Full Time Reserve Service and firm requirement control. At 1 April 2006 there was a 3.7% manning shortfall in the Royal Navy / Royal Marines against the overall requirement—an improvement of 1.2 per cent.

3. To address the shortages at Petty Officer level we have introduced streamlined and Fast Track promotion which increases the manpower flows to this level and mitigates the impact of the cutback in recruitment in the early 1990s. Despite these measures we recognise that there will continue to be shortages.

We note that there have been some breaches of Harmony Guidelines in all three Services, but that the impact has been greater in the Army owing to the level of operational tempo. Members of the Armed Forces need time for training as well as for recuperation after operations, and they need time with their families, and we look to MoD to take action to ensure that breaches of Harmony Guidelines are minimised. Greater priority should be given to developing management systems which allow the pressure on individuals to be monitored. (Paragraph 13)

4. We agree that members of the Armed Forces need time for training as well as for recuperation after operations and that they need time with their families. We minimise breaches through a number of initiatives, including gapping posts in front line units, encouraging appropriate contributions from our NATO Allies (if appropriate), mobilising reservists, contractorisation and, where possible, by ensuring that the operational deployments are shared amongst service personnel. Although we monitor this closely and take action where possible to minimise breaches, some force elements and specialist cadres have to deploy more often than others thereby breaching harmony guidelines.

5. Management systems are being developed under the auspices of the Manning Pinch Point Working Group which was formed to review critical trades, harmony guidelines and other related matters. As set out in our response to the Committee of 27 February 2006, the Joint Personnel Administration system will help inform this work.

We are concerned that there are critical shortages, in various specialist trades, in all three Services, including aircrew and medical personnel. We note that the overall shortfall in medical personnel has reduced from 23 per cent to 20 per cent, and look to

MoD to take further action to address this substantial shortfall in such a vital area. (Paragraph 18)

6. We are making strenuous efforts to reduce the shortfall in medical personnel. In addition to aiming to ensure that pay remains broadly comparable with the NHS, we seek to minimise shortfalls through:

- direct recruitment including through the use of Golden Hellos;
- establishing alternative means of meeting operational commitments utilising civilian “agency” contractors and working closely with allies and partners on operations;
- influencing retention and return of service through the new pension arrangements; and,
- managing consultant deployments on a Tri-Service basis to allow the load to be reduced and spread equitably and for adequate notice of forthcoming deployments to be given.

We note that MoD considers that the impact of manning shortages on the deployment to Afghanistan is manageable, but we plan to monitor this closely in our inquiry on that deployment. (Paragraph 19)

7. Our commitments to Afghanistan take account of our continuing commitment in Iraq, and vice versa. The Armed Forces are heavily committed, but the numbers of regular Armed Forces deployed on operations has reduced over the course of last year. However, in 2006, as we increase our scale of effort in Afghanistan, tour intervals for supporting / enabling personnel are likely to breach harmony levels in some areas such as medical, intelligence, helicopter crews, logistic, provost and engineers. We continue to encourage appropriate contributions from our NATO Allies in Afghanistan in order to take some of the pressure off these areas. Overall, we judge that the impact on personnel of our deployment to Afghanistan is manageable, but will inevitably constrain our capacity to respond elsewhere.

We support MoD’s drive for greater efficiency but note that it is likely to result in substantial numbers of civilian job losses. We look to MoD to undertake the appropriate consultation with the organisations which represent its civilian staff and to provide as much support as possible to those who lose their jobs. (Paragraph 25)

8. We consult regularly with the appropriate Trades Unions on the implementation of the MOD’s Efficiency Programme and we have good relations with them. We consult with the Trade Unions at both at a Department-wide level, for example on the implementation of an Early Release Scheme, and at TLB level for local issues such as on the Army TLB collocation project.

9. A number of civilian posts will be cut as a result of the Efficiency Programme but a large proportion of these reductions are expected to be made through natural wastage. Individuals whose posts are cut are given priority consideration when filling new or vacant posts across the Department, and only when there is no suitable candidate may management seek to recruit more widely. Every effort will be made to minimise and,

wherever possible avoid compulsory redundancies. It may not be possible to do so for certain groups of staff in certain locations.

10. We help staff leaving the Department under the Early Release Scheme or on redundancy to find alternative employment through the MOD Outplacement Service. For those leaving on early or normal retirement terms, a 2-day workshop on “Planning for Retirement” is provided.

MoD’s performance against its diversity targets has been mixed in relation to both its Service and civilian personnel. It is disappointing that both the Royal Navy and the RAF failed to meet their target for recruiting from ethnic minorities. MoD was significantly below some of its targets relating to women, ethnic minority and disabled personnel in the Civil Service. We look to MoD to identify ways to improve in those areas where it is falling significantly below its diversity targets. (Paragraph 27)

11. The MOD is committed to increasing diversity in our workforce to ensure that we make the most of the range of talent, experience and expertise available across the working population. The Royal Navy, Army and RAF commit significant effort and resources to engage minority groups and raise awareness of Armed Forces’ careers. All three Services have specialist Diversity Action Teams aimed at promoting Armed Forces careers. They concentrate their efforts in areas with large ethnic minority populations, especially greater London, creating and building on community partnerships with secondary schools, local/borough councils, community organisations, religious organisations, employment groups, youth centres, festival organisers and the ethnic media.

12. Despite these efforts, the RAF and, to a lesser extent, the Royal Navy fell short of recruitment goals for 2004–05. A major contributory factor was the reduction in the size of the Armed Forces, with the RAF in particular facing a reduction of 50% in its overall intake target, which has reduced our recruitment levels and therefore the opportunity to recruit ethnic minorities.

13. Encouraging young people from ethnic minority backgrounds to consider an Armed Forces career is difficult, but the Services remain determined to become more representative of our diverse society, harnessing the wealth of talent and skills of individuals from different backgrounds across all ethnic groups. Overall ethnic minority representation in the Armed Forces has increased from 3.5% on 1 April 2002 to 5.5% on 1 April 2006.

14. On the civilian side, our ability to meet our diversity targets is constrained by having employment opportunities available in the first instance; developing the capability in our feeder grades to fill those opportunities; and ensuring that our ‘proposition as an employer’ attracts people from under-represented Groups. We remain committed to increasing staff numbers from under-represented groups and to identifying and removing any barriers that prevent those groups from achieving their full potential. Although we are making progress, in the short term our scope for increasing the numbers of under-represented groups in the MOD is heavily influenced by the demographic legacy of a department which has historically been predominantly male, the reducing size of the Department and the relocation of defence work from more to less diverse parts of the country.

15. We are trying to increase the pace of refreshment at the Senior Civil Service level; reviewing our arrangements for promotion to the Senior Civil Service ; revising Equality and Diversity training to ensure it focuses on the business case for diversity; promoting our work-life balance policies more widely; introducing an improved equality and diversity impact assessment process to be applied to all polices and services; and ensuring we continue to work within the intent and spirit of equality and diversity related legislation.

16. We will continue to work in partnership with Unions and people from under-represented groups in delivering on these and those related actions required if we are to meet our diversity targets and embed diversity into the way we go about MoD business.

MoD's Performance Report shows that MoD only 'partly met' its PSA Target relating to procurement, missing the targets relating to time slippage and cost increases. In contrast, the Report shows that the Defence Procurement Agency met five of its six Key Targets, only missing one target on customer satisfaction. We expect MoD to review the way that its performance in relation to defence equipment procurement is reported in order to provide a clearer picture on whether performance is improving or not. (Paragraph 30)

17. The committee has highlighted the variance between the performance shown against the Defence Procurement Agencies (DPA) Key Targets and that shown against the Department's PSA procurement target. The Public Service Agreement Targets reported in the *Annual Report and Accounts 2004–05* were set during Spending Review 2002. They cover the 20 Major Projects reported to Parliament in the Major Projects Report 05 that had passed their Main Investment Decision. In contrast the Defence Procurement Agency Key Targets report the performance of the top 60 or so Category A–C projects. Reporting against the wider target is a more comprehensive representation of MOD equipment acquisition performance overall and also encompasses a greater level of risk

18. The *Annual Report and Accounts 2005–06* will report our performance against the new SR04 Public Service Agreement targets. The SR04 PSA Procurement target is more closely aligned to the DPA key targets, although with different target levels. The PSA targets reflect the highest level of performance the Department aims to achieve over the Spending Review period and are DPA stretch targets. The DPA targets, whilst still challenging, reflect a level of performance against which Ministers can realistically hold the Agency to account—these are hard targets.

19. Presentation of historic information provides an indication on whether the Agency's performance is improving or not. The *Annual Report and Accounts 2004–05* shows that over the last 3 years acquisition performance has improved, but that there is more to be done.

20. At a Departmental level we are currently considering how to adapt our current targets to reflect better the broader acquisition process. We plan to expand our targets beyond the procurement process to encompass wider critical elements such as in-service support costs. This will ensure that the top level targets we set drive acquisition behaviours that are consistent with the management of through life.

We note that in 2004–05, in-year cost decreases of some £699 million were reported on the top 20 major defence equipment projects. However, a 'significant element' of this

decrease related to a reduction in the numbers of equipments being ordered. In our view, it is not a great achievement to report an in-year cost decrease, if this is only because less equipment, or less capable equipment, has been acquired. (Paragraph 33)

21. Headline figures in MPR2005 are an indicator that the Department is starting to bring costs under control and that project slippage is slowing. The National Audit Office recognised in MPR2005 that most of the cost reduction in 2004–05 was a result of changes by the Military Customer through trading off performance and time—this is one of the key principles of Smart Acquisition.

22. In the past the Department has concentrated its efforts in trading either cost or time. Following on from the recommendation of the Public Accounts Committee, the Department has started to explore trades in performance. As the Chairman of the Public Accounts Committee stated at the hearing on the Major Projects Report 2005 in February 2006, ‘[the figures] ... have improved because you have made cuts and these are cuts which we, ourselves, recommended you make in the past.’

We fully support MoD’s efforts to improve procurement performance. We note that a review of defence procurement has been instituted and expect the recommendations of the review to be implemented both quickly and fully. Improvements in the way MoD procure equipment are vital to the success of the Defence Industrial Strategy and we plan to monitor this closely. (Paragraph 37)

23. We welcome the committee’s support of our efforts to improve procurement performance and the recognition that implementation is the key to the Defence Industrial Strategy. We expect that 2006 will be the year of transformation with the implementation of our proposals in 2007. As set out in the Defence Industrial Strategy, officials are reviewing the Ministry of Defence’s current acquisition arrangements. The Review Team has completed its work and announcements will be made following Ministerial consideration.

We find MoD’s explanation as to why they had scrapped a target for reducing the cost of training a military recruit to be unconvincing. As part of its consideration of the outcome of the Defence Training Review, we recommend that MoD reconsider whether they should have a value for money target in such a key area as training. (Paragraph 40)

24. As set out in the written evidence to the Committee on 19 January 2006, before 2004, multi-disciplinary specialist training was delivered across 24 different sites with the site controlling training output standards. After the recommendations made in the Defence Training Review (DTR) Report published in 2001, ‘virtual’ Defence Training Establishments were created which realigned the management of training delivery by specialism, not site. Six specialisms were initially chosen and ‘virtual’ Defence Colleges created under a lead Agency for each. The original Training efficiency measure derived a per capita cost of training for each Service by relating the overall cost of training to the throughput of trainees. With the rationalisation of training it is no longer possible to identify an overall cost of training by Service nor hence of a per capita cost by Service.

25. Irrespective of this it is unlikely that this target would have been achieved. This is because we made changes to implement recommendations by the Committee, the Director of Operational Capability and the Adult Learning Institute on initial training (which had

the effect of increasing the cost of initial training), and we have reduced the throughput of trainees following reductions in the required size of the Armed Forces. Rather than seek to continue reporting against a dysfunctional measure that had specifically been overturned, we therefore agreed with the Treasury to treat it as 'not met'.

26. We agree with the Committee that we should try and achieve efficiency gains in Training. Under the Defence Training Rationalisation Programme we aim to modernise the delivery of specialist training using best practice learning techniques through newly created national centres of excellence for each specialism and to rationalise and improve the quality of the remaining training estate. Other expected benefits include the transfer of risk for training demand and the increase of first time pass rates achieved by students. We expect the rationalisation process to be completed by 2012, and the overall programme to produce benefits in the order of £3Bn over a 25 year period. We are currently evaluating several bids. Additionally, all three Services continue to look at ways to improve the management of recruits and to reduce the numbers of recruits choosing to leave, sharing ideas and good practice. If successful, such measures will increase the efficiency of the initial training system.

MoD reports substantial savings in its Annual Report and Accounts yet, when pressed by us, informs us that some of the reported savings “cannot be validated”. This is worrying. We expect figures in MoD’s Annual Report and Accounts to be based on robust evidence and look to MoD to introduce systems which can generate accurate figures relating to savings, rather than figures which cannot be substantiated fully. Overstating savings undermines confidence in the accuracy of the Performance Report. (Paragraph 44)

27. It was clearly stated that the logistics efficiency figures published in the Annual Report and Accounts reflected the best information available to the Department at the time of publication and would be subject to audit. Accounting for efficiency is a complex area. It is validated through detailed scrutiny of a proportion of the efficiency claim by the Director of Internal Audit (DIA) and extrapolated from that to reach an overall total. This arrangement is visible to the NAO and the conclusions are shared with them. The Logistics Transformation Programme comprises more than 1000 individual projects—being driven across the Defence Logistics Organisation and the Front Line Commands - and the process to validate the figures therefore inevitably takes some time.

28. This process has now been completed for the 2004–05 figures. As a result of the audit we have concluded that there is evidence to substantiate at least £280M of benefits achievement. This is a conservative judgement. We may have achieved more but the work has indicated that there were deficiencies in the evidence supporting some areas of the claim and, in other cases that the savings did not qualify as efficiency. While this is disappointing, it shows that the Department takes a rigorous approach to efficiency reporting to ensure that the figures are properly evidenced. Steps have been taken to ensure that the Integrated Project Teams and others responsible for efficiency reporting maintain robust audit trails for the efficiency achievements which will be claimed for 2005–06 and subsequent years. These steps include improved benefits and evidence guidance, internal sampling of projects to review evidence to support the reported benefits, and clear management direction on individual responsibilities.

We consider that there is a strong case in the future for the National Audit Office to provide an opinion on the savings figures claimed by the MoD in its Performance Report, as we have little confidence in the accuracy of such figures. (Paragraph 45)

29. DIA work very closely with their NAO counterparts on strategic and forward programme planning. All DIA reports are shared with the NAO, and joint work is undertaken where appropriate. Given the size and complexity of the Department, NAO place reliance on DIA work where possible in reaching conclusions on the Department's assurance arrangements. The Department agrees that the validation of efficiency reporting requires a robust audit process but in light of the existing arrangement we do not believe there would be any added management value from further NAO validation of our efficiency claims.

Follow-up information provided by MoD showed that the savings of £88 million on Tornado aircraft support were achieved in two years, not four years as stated in MoD's Performance Report. This is a notable achievement. Nevertheless, once again, it raises questions about the accuracy of information provided in the Performance Report and we look to MoD to ensure that more accurate information is provided in the future. (Paragraph 49)

30. We do our best to ensure that the information in the Performance Report is accurate. We very much regret this error and welcome the Committee's acknowledgement of what was a notable achievement. We will continue to provide the most accurate information we can.

We are surprised to learn that stock sold under a rationalisation programme had to be bought back for some £73,000 as it was subsequently found to be needed. We expect MoD to learn lessons from this case and, in future, to assess properly the future need for items before they are disposed of. (Paragraph 52)

31. There is a balance of judgement in deciding the level of stores we need to hold. £73,000 is a very small proportion (less than one-hundredth of 1%) of the Departments annual stock consumption of over £1.1 billion. We always seek to use public money as effectively as possible. The relevant Integrated Project Team (IPT) has introduced a new process to mitigate the possibility of having to buy back equipment that has been disposed of under a stock rationalisation programme. The new process was devised from a lessons learnt exercise and now requires approval from both the IPT inventory desk officer and the appropriate equipment project manager before an equipment disposal can be authorised.

In principle, we support MoD's policy of rationalising the number of Defence Agencies, particularly those very small agencies where the costs of retaining agency status can be high. However, for some agencies there may be a strong case for retaining agency status and we expect MoD to review each agency on a case by case basis. (Paragraph 56)

32. We keep our organisational structure under review to ensure that it remains efficient and effective. We have reduced the number of agencies in the Department in recent years as we have rationalised and improved Departmental processes. There is no specific policy to remove agency status across the board and each case is examined on its merits, with the burden of proof resting on demonstrating that the benefits which will result from the removal of agency status are greater than those of retaining it.

We note that there are plans to collocate the Defence Procurement Agency's Executive Board and the Defence Logistics Organisation's Board. We support the move to bring both organisations close together, particularly given that projects are now managed on a through-life basis. (Paragraph 59)

33. Work is continuing on options to collocate the Headquarters of the Defence Logistics Organisation and the Defence Procurement Agency. We have delayed collocation of the Management Boards to allow us to prioritise on examining the case for collocation of the Integrated Project Teams and Support Groups. Where appropriate we intend to bring together enabling and support groups to provide a joint service to both organisations.

We found it difficult to judge the performance of the Defence Agencies, as set out in the Annual Report and Accounts, as both their achievements against the targets set, and the number of targets set, vary considerably from year to year. We look to MoD to ensure that in the future, changes are made to the reporting of the performance of Defence Agencies, so that it is easier to assess whether their performance is improving. (Paragraph 64)

34. The table at Annex E of the *Annual Report and Accounts 2004–05* provided a summary of the performance of each of the department's agencies. Full details are in the individual agency annual report and accounts. In line with Treasury guidance, we aim for as much continuity in agency key targets as possible, in order that judgements can be made as to how well the agencies are performing over time. But some changes from year to year are inevitable because of the changing nature of the environment in which the agencies operate. Following the Committee's comments we are introducing a number of changes to the way the data is presented in the 2005–06 Annual Report and Accounts. This should help when comparing performance from one year to the next.

The fact that MoD's resource accounts for 2004–05 received an unqualified audit opinion for the second year running suggests that MoD's initial problems with Resource Accounting and Budgeting are being overcome. (Paragraph 67)

35. We welcome the Committee's recognition of our financial performance. The MOD resource accounts for both 2003–04 and 2004–05 received unqualified audit opinions. This reflects the considerable progress made throughout the Department to improve the quality of financial management, and the supporting financial accounting systems. We continue to work to simplify and improve them further.

A new contingent liability of some £400 million, relating to a liability to clean up training sites in Canada should the UK cease training there, has been included in the 2004–05 financial accounts. We consider this to be a substantial liability and expect MoD to re-assess, on a regular basis, the size of this liability and consider how such a liability of this scale would be funded if it fell due. (Paragraph 70)

36. Defence training is conducted in Canada under arrangements between the UK and Canadian Governments, which provide for comprehensive discussion of respective liabilities, were we to cease training in Canada for any reason. If this were to arise, the timetable for agreeing the actual liability would be long enough to allow the necessary funding arrangement to be agreed. The values of all contingent liabilities are reviewed annually as part of the production of our accounts.

We note that losses reported in MoD's 2004–05 Financial Accounts had reduced compared with the previous year, but consider that the sums are still substantial. We expect MoD to take appropriate action to minimise losses in the future. (Paragraph 74)

37. The total value of the losses arising in 2004–05 (both advance notifications and closed cases) was £167M compared with £533M arising in 2003–04—a reduction of 69%. Nevertheless, the Department takes the number and value of losses seriously and continues to work to minimise the number of new cases that arise.

We find it hard to understand why the procurement of these four ships, which are not particularly sophisticated, is likely to cost in the region of half a billion pounds, substantially over the initial contract price. The Landing Ship Dock (Auxiliary) programme cannot be considered to have achieved value for money. MoD seems to have given the lead contractor on the programme an open-ended cheque book. (Paragraph 81)

The first contract for two ships, on the Landing Ship Dock (Auxiliary) programme, was let in December 2000. While this was some time after the launch of the Smart Procurement initiative, this procurement cannot be considered 'smart'. It raises questions about how MoD assesses whether a contractor has the necessary skills to deliver a specific equipment programme. We expect the lessons from this sorry episode to be identified and implemented. We wish to be kept informed of the progress on this programme. (Paragraph 82)

38. Prior to award of the LSD(A) contracts, in common with all contracts, a detailed assessment of the contractor was undertaken to ensure that they were able to complete the contract and that they had the necessary resources, skills, capacity and expertise, and experience of similar work.

39. The original contract price for the 4 LSD(A) vessels was £332M. A breakdown provided below confirms the original costs agreed by MOD to each shipbuilder in delivering the 4 Ship LSD(A) class:

- £210M to Swan Hunter for the build of ships 1 & 2, that includes £62M for the provision of Lead Yard Services and Equipment to BAE SYSTEMS;
- £122M to BAE SYSTEMS for the build of ships 3 & 4.

40. These costs were within the original programme approval, agreed in October 2000 and do not represent a cost growth within the project. The current total value of the contracts for the 4 ships is £485M, and represents an increase of £153M over this original contract price of £332M. This increase in costs represents:

- £84M contract amendment with Swan Hunter in December 2004 for the design and build of their 2 LSD(A) vessels, as a result of the technical difficulties encountered by the company
- £48M in delay and dislocation claims from BAE SYSTEMS

- £10M variations in contract for design changes
- £11M for spares.

41. We agreed to the contract amendments following careful consideration of the options in taking forward the LSD(A) programme. We judged that this was the most effective way of protecting the investment made to date and in delivering the much needed capability to the Royal Navy.

42. All four ships have been successfully launched, with two vessels accepted off contract. RFA Mounts Bay, the first of the BAE SYSTEMS vessels, was accepted off contract on 15 December 2005 and is now undergoing her Stage 2 capability trials in readiness for meeting her In-Service Date in late 2006. RFA Largs Bay, the first of the Swan Hunter vessels was accepted off contract on 25 April 2006 and is also undergoing further trials in preparation for her In-Service Date in early 2007. Build and commissioning work is continuing on Lyme and Cardigan Bay at the Swan Hunter and BAE SYSTEMS shipyards.

43. We plan to hold a lessons learned review after we have resolved the current difficulties with the programme, as part of the drive to replicate successes and learn from the mistakes—with findings highlighted and implemented as appropriate.

44. We will keep the Defence Committee informed of progress on this project.

We are amazed at the scale of the losses relating to a building at AWE Aldermaston which could not be used. The total losses amount to some £147 million. MoD's acknowledgement that the project "was handled badly" is a considerable understatement. It is essential that the lessons are learned and we do not expect to see a repetition of such a debacle in the future. (Paragraph 86)

We are concerned that the two losses relating to the building at AWE Aldermaston, one of £65 million and the other for £82 million, were listed separately in the losses statement in the Annual Report and Accounts, and that there was no way of linking the two losses from the information provided. In future, we expect MoD to provide sufficient information for related losses to be identified. (Paragraph 87)

45. We accept that this was a serious failure. At the then Secretary of State's direction, the Chief of Defence Procurement personally reviewed the history the Radioactive Liquid Effluent Treatment Plant project (summarised at Annex A) and the principal lessons from an independent post project evaluation conducted during 2004–05. The post project evaluation was promulgated in a Learning from Experience event at Abbey Wood on 31 January 2006 (summarised at Annex B).

46. The project was conceived on the back of a public imperative to demonstrate the MOD's commitment to safety at AWE in the late 1970s. The perception this generated, as well as more general failings at the time, did not promote sound project management disciplines. All of this predates the current AWE contract and the benefits of Smart Acquisition.

47. The current contracting arrangements at AWE include specific disciplines and mechanisms governing the visibility, approval, monitoring, management and review of capital projects by stakeholders across the acquisition, finance, customer and scrutiny

community. The project approvals procedures for individual capital facilities have been approved by the Department's Investment Appraisal Board (IAB); and the arrangements with the AWE contractor are subject to regular review, development and improvement, using Earned Value Management disciplines.

48. The adoption of Smart Acquisition principles—had they been mandated at the time—would have avoided the degree of failure we experienced with the Radioactive Liquid Effluent Treatment Plant project. For example, the initial requirement for the facility (which proved ultimately to be over-specified) would have had very little chance indeed of surviving the rigorous scrutiny now applied in the IAB approvals process. And, even if the project had proceeded, the requirement for delivery within approved performance, cost and time parameters would have prompted the re-examination and refocusing of the investment at a much earlier stage. Further, the systematic application of risk management techniques and 3-point estimating—now the norm—would, we judge, have resulted in more informed decision-making based on clearer evidence.

49. The combination of new contract arrangements, a tailored, IAB-endorsed process for approving AWE capital projects and the now well-established disciplines of Smart Acquisition fully address the lessons from Radioactive Liquid Effluent Treatment Plant as they relate specifically to AWE capital projects. More widely, Smart Acquisition was itself a response to the types of behaviour that this project exemplifies, and so helps avoid the circumstances that led to the write-off.

50. Where there is a clear relationship between individual losses the Annual Report and Accounts will identify this.

We do not find MoD's explanation for the four month delay in informing Parliament of a gift of a value exceeding £250,000 sufficient and we call on MoD to report its gifts promptly in future. (Paragraph 92)

The UK sought to assist the US following Hurricane Katrina by gifting Operational Ration Packs at a total cost of some £5.1 million. We have no objection to the gifting of the Operational Ration Packs and only regret that they were not used to help the victims of Hurricane Katrina as intended. We are satisfied that this was for reasons outside MoD's control and hope that it has learned lessons for the future. (Paragraph 95)

51. We explained to the Committee that the circumstances in which this gift was made were particularly unusual. A great deal of discussion and consultation was required, both within and outside MoD, to ensure that we accounted and reported for this gift correctly, giving proper consideration to all the options. We take Parliamentary procedures very seriously and it was our desire to ensure that they were properly taken into account that caused the delay in this instance. We will continue to report gifts promptly.

We note that the flotation of QinetiQ has taken place and that £250 million from the sale will be retained by MoD to be invested in the defence programme. We look to MoD to inform us as to how its proceeds from the sale will be used. The NAO has announced that it is to examine the privatisation of QinetiQ to assess whether value for money was achieved: we await this report with interest. (Paragraph 101)

52. The proceeds from the sale of QinetiQ have not been allocated to a specific, separately identifiable area within the defence programme, but have increased the Department's capital budget in financial years 2006/07 and 2007/08, and will be invested across defence to help deliver an overall programme that is balanced, coherent and affordable.

53. We welcome the NAO decision to examine the project and are co-operating fully with their work.

We note that MoD has put in place arrangements to ensure that its 2005–06 Annual Report and Accounts are published before the parliamentary Summer recess. We look to MoD to push forward with these arrangements so that the publication target is achieved. (Paragraph 105)

54. We continue to expect to publish the *Annual Report and Accounts 2005-06* before the summer recess.

ANNEX A: Building A91 and Radioactive Liquid Effluent Treatment Plant—Brief Project History

55. Following competition, the MOD awarded a contract to Babcock Woodhall-Duckham Limited in the late 1970s for the construction of Building A91 and the Radioactive Liquid Effluent Treatment Plant (RALETP). Then scheduled to become operational in 1991, the RALETP was intended to process aqueous wastes arising from activities carried out in various buildings at AWE Aldermaston.

56. During non-radioactive commissioning of the plant in 1990, leakage due to corrosion was discovered in stainless steel pipework and filter vessels. As a consequence, active commissioning had to be halted. A taskforce was set up in 1991 to examine the corrosion problem. Following extensive investigations the taskforce concluded that the corrosion of the stainless steel was due to a combination of high levels of chloride in the liquid effluent and contamination of the system by bacteria known to corrode stainless steel.

57. Tenders were then invited for project definition of corrosion rectification in the RALETP. The successful tenderer was NNC Limited, to whom the MOD awarded a contract in October 1993. In April of the same year, management and operation of AWE had been contractorised following competition, with a seven-year contract being awarded to Hunting BRAE Limited (HBL) under Government Owned Contractor Operated (GOCO) arrangements. Under the term contract, the RALETP rectification contract with NNC Limited was novated to HBL.

58. Despite the (purported) completion of pre-commissioning in September 1998, corrosion was again identified in January 1999. Active commissioning was, once again, brought to a halt. There being no reasonable prospect of rectifying the technical problems within any practicable timescale, the MOD recognized that there was no future for the facility. Formal written rejection of the works was notified to HBL on 29 March 2000. (By that time, and following competition, the award of a new AWE management and operation contract to a new consortium, AWE Management Limited, had been announced. This became effective on 1 April 2000.)

59. Legal advice was that MOD had a sufficiently robust case to pursue a claim against HBL for the re-imburement of the costs of refurbishment, consequential damages and expenses incurred. A settlement was reached in April 2003, under which the MOD received £12M from HBL.

60. Following the evaluation of a number of options, it was determined that there was no viable use for building A91. Both it and the RALETP have therefore been written off as a constructive loss amounting to £147M.

61. A post project evaluation was conducted in 2004/05. The lessons from this were promulgated in a Learning from Experience seminar at Abbey Wood on 31 January 2006.

62. A timeline of key project events is shown below.

1978	Following a report which highlighted inadequate waste management facilities at AWE, public undertaking given to replace inadequate facilities and overhaul safety procedures.
1980	Process for defining requirements of new facility begins.
1985	Building construction begins.
1986	Further Treasury approval sought following cost increases and project slippage.
1990	White commissioning begins (testing process using ordinary water).
Mar 1991	Corrosion found.
Oct 1991	Report confirmed the extent of the corrosion.
Dec 1991	Decision taken to repair A91 and not to pursue alternative options.
1993	Plan for rectification of problems agreed.
Apr 1993	AWE contractorised and contract novated to HBL.
Oct 1993	Contract placed for rectification of A91.
Jan 1999	Further corrosion found.
Mar 2000	MOD formally rejects RALETP.
Apr 2000	AWE ML takes over GOCO contract from HBL.
2001	Treasury Solicitor submits formal claim on HBL on MOD's behalf.
Mar 2003	Value of RALETP written down in 02/03 accounts to amount likely to be recovered in settlement.
Apr 2003	Commercial settlement reached between MOD and HBL.
Dec 2003	Advance notification of write off submitted to CDP.
Feb 2004	Building written down to zero in 03/04 accounts to reflect that the conversion of the building is unlikely to be cost effective.
May 2005	Post project evaluation for project produced.
Oct 2005	Case submitted to CDP for formal write-off within his delegated authority.
Jan 2006	Learning from Experience seminar at Abbey Wood.
Jan 2006	HCDC interest stimulated through scrutiny of MOD Annual report and Accounts.

ANNEX B: Building A91 and Radioactive Liquid Effluent Treatment Plant—Key Lessons Learnt

Issue	Lesson/Resolution
a. The A91 requirement was based on a flawed analysis. It was too complex and ambitious; lack of adequate external knowledge and controls resulted in inadequate scrutiny and accountability; and there was only limited consideration of an alternative, related project that would have reduced the A91 requirement by two thirds.	All projects are now subject to rigorous scrutiny through IAB approvals procedures. The requirement and the options for meeting them are scrutinised by a wide range of stakeholders.
b. No investment appraisal was undertaken. In 1991 a decision point was reached, but an alternative option was dismissed by senior management without adequate examination of its merits.	Investment appraisals are prepared for every new facility to support the business case for each under IAB procedures. Costs of options are now supported by 3 point estimates and rigorously scrutinised for risk and assumptions.
c. Perceived production pressures led to construction work commencing before the plant design was complete. This led to cost and time delays later in the programme.	The IPT maintains a project plan and risk register. These are reviewed regularly and ensure that adequate planning is undertaken before irreversible commitments are made.
d. Processing technology of A91 was not tested until commissioning when deficiencies were identified. A pilot plant may have highlighted the problems.	Where new technologies are employed these are rigorously tested and proven before and during the demonstration phase within the CADMID cycle before they are incorporated irrevocably into designs.
e. Management and Contractual relations were complicated and inefficient, leading to disrupted timescales and cost overruns.	Current AWE contract makes clear the respective responsibilities of the MOD and the contractor. MOD does not seek to interfere with the contractor's supplier selection.
f. Poor commissioning practices led to liquid stagnation, microbes and corrosion. Previous mistakes were repeated in this process.	Satisfactory commissioning standards agreed at the outset. Encourage contractors to adopt LFE practices.
g. Cost escalation and delays occurred in the early 1980s due to shortages of the special steel required and skilled manpower.	Conduct adequate risk analysis and early survey of industrial capacity.
h. Modifications identified as necessary in the mid 1980s may have been successful if the work had been carried out in accordance with the project definition report. The MOD devolved all responsibility to the subcontractor, maintaining only limited oversight of the work.	Current AWE contract provides clear definition of responsibilities. Performance and payment arrangements demand regular review and high visibility of progress. Implementation of Earned Value Management will greatly assist this process.
i. A91 was to be a flagship project to show that AWE was serious about health and safety. As time elapsed, the perceived imperative to demonstrate this to an external audience was pursued at the expense of value-for-money discipline.	Smart Acquisition incorporates a demanding IAB approvals process coupled with a requirement to monitor and re-examine investments against pre-agreed parameters. Specific approvals arrangements have been agreed by the IAB for all AWE facilities projects.