



House of Commons
Defence Committee

Ministry of Defence Main Estimates 2006–07

Ninth Report of Session 2005–07

*Report, together with formal minutes and
written evidence*

*Ordered by The House of Commons
to be printed 27 June 2006*

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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The following Members were also Members of the Committee during the Parliament.

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The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at:

www.parliament.uk/defcom

Committee staff

The current staff of the Committee are Philippa Helme (Clerk), Richard Cooke (Second Clerk), Ian Rogers (Audit Adviser), Stephen Jones (Committee Specialist), Adrian Jenner (Inquiry Manager), Sue Monaghan (Committee Assistant), Sheryl Dinsdale (Secretary) and Stewart McIlvenna (Senior Office Clerk).

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Summary

This report presents the evidence we have obtained from the Ministry of Defence (MoD) as part of our scrutiny of the Main Supply Estimates 2006–07.

We have identified no issues which require to be brought to the especial attention of the House prior to the debate on the Main Estimates in July, but believe that the information contained should be available to other Members of the House and to the public.

We note that the MoD's Main Estimate does not contain provision for the cost of peace-keeping operations in Iraq, Afghanistan or in the Balkans, and therefore greatly underestimates the total expected cost of the MoD's conflict prevention activities. We call on the Government to reconsider whether provision for peace-keeping operations might be included in the Main Estimates in future.

Report

Our scrutiny of the Main Estimates

1. The Main Supply Estimates 2006–07—by which the Government requests resources from Parliament to meet its expenditure plans for the financial year ahead—were laid before the House on 2 May 2006.¹ The House of Commons will be asked to agree them on 3 July.
2. The Main Estimates contain a resource-based Estimate for each department and, separately, for public service pension schemes. This Committee's interest has focused on the Ministry of Defence (MoD) Estimate² and the Estimate for Armed Forces retired pay, pensions etc, which covers both the Armed Forces Pension Scheme and the Armed Forces Compensation Scheme.³
3. The MoD provided the Committee, on publication of the Main Estimates, with a memorandum on each of these two Estimates. These are printed as Appendix 1 to this report.⁴
4. A Departmental Minute was received from the MoD on 22 May reporting a contingent liability for the underwriting of funding for the Armed Forces Memorial. This is printed as Appendix 2 to this report.⁵
5. We asked the MoD to answer some additional questions arising from the Estimates and their Estimates memoranda, and from the Departmental Minute. The MoD's response is printed as Appendix 3 to this report.⁶
6. The purpose of this report is to publish the evidence received from the MoD on the Main Estimates, as we believe that this should be made available to other Members of the House of Commons and to the wider public.

Ministry of Defence Requests for Resources

7. The MoD's Main Estimate requests resources of £33 billion, with a net cash requirement of £31.5 billion. The MoD's Estimate is split between three Requests for Resources (RfR):
 - RfR1: Provision of defence capability (personnel and equipment costs for the Armed Forces etc)
 - RfR2: Conflict prevention (conflict prevention and peace-keeping etc)

1 Central Government Supply Estimates 2006–07, *Main Supply Estimates*, May 2006, HC 1035

2 HC 1035, pp 295–318

3 HC 1035, pp 319–328

4 Ev 1

5 Ev 6

6 Ev 7

- RfR3: War Pensions and Allowances etc (payment of war disablement and war widows pensions)⁷

By far the largest part of the resources requested falls within RfR1. The headline figures are set out in table 1 below. A breakdown by top-line budget is given in the Estimate.⁸

Table 1

	£'000			
	2006-07	2005-06		2004-05
	Provision	Provision	Forecast Outturn	Outturn
RfR1: Provision of defence capability	31,985,856	34,664,525	34,250,782	30,071,985
RfR2: Conflict prevention	47,326	1,101,276	984,987	938,181
RfR3: War Pensions and Allowances etc	1,029,951	1,072,972	1,071,999	1,109,521
Net resource requirement	33,063,133	36,838,773	36,307,768	32,119,687
Net cash requirement	31,495,938	31,501,992	30,901,568	30,419,930

Source: HC 1035, page 16

Cost of peace-keeping operations

8. The MoD's Estimate includes provision for conflict prevention of £47 million, of which £31 million is shown to be for Sub-Saharan Africa and £16 million for the rest of the world.⁹ There is no provision in the Main Estimates for the costs of operations in Iraq and Afghanistan, nor for peace-keeping in the Balkans. Provision will be included in the Supplementary Estimates process, as in previous years.¹⁰

9. In our report on the Spring Supplementary Estimate 2005–06, we recommended that in future provision for commenced operations be made in the Main Estimates, if necessary with a large element for contingency.¹¹ The Government's response did not accept this recommendation, arguing that costs were difficult to forecast in fast moving operational circumstances and Supplementary Estimates were the first occasion when the Department can reach a reasonably firm conclusion. However, the Government has undertaken to seek provision for conflict prevention for commenced operations in the MoD's 2006–07 Winter Supplementary Estimate, rather than waiting until the Spring Supplementary Estimate as

7 A full description of what costs fall under each of the RfRs is given in the Main Estimates, HC 1035, p 297

8 HC 1035, pp 299–302

9 Ev 3, para 14

10 *Ibid.*

11 Fourth Report from the Defence Committee, *Costs of peace-keeping in Iraq and Afghanistan: Spring Supplementary Estimate 2005–06*, HC 980, para 15

in the past.¹² We welcome this concession, but we remain unpersuaded that it is impossible to include at least indicative provision in the Main Estimates. **We recommend that the Ministry of Defence reconsider whether provision for commenced operations might be included in the Main Estimates in future.**

10. We also recommended that in future the MoD provide to this Committee regular, perhaps quarterly, updates on the cost of operations.¹³ The Government's response did not respond positively to this recommendation, but it did accept our recommendation that more detailed information on the cost of operations should be published in the MoD's Annual Report and Accounts 2005–06.¹⁴ These are expected to be published before the Summer Adjournment.¹⁵

11. Provision for the cost of peace-keeping operations in the Balkans is sought by the Foreign and Commonwealth Office (FCO) in the Main Estimates¹⁶ and some of this will be transferred to MoD through a Supplementary Estimate later in the Financial Year.

12. In our report on the Spring Supplementary Estimate, we questioned why funding for Balkans operations was not sought directly by the MoD, and recommended that in future provision for these be set out in the MoD's Main Estimate.¹⁷ The Government's response rejected this recommendation, on the grounds that the FCO had always been the lead department for administering the Global Conflict Prevention Pool, that managing the UK's peace-keeping activities as a whole was beneficial and that the current arrangement allowed flexibility to respond to a volatile international scene.¹⁸ **While we appreciate the value in managing peace-keeping activities centrally, we cannot see why this should preclude separation of the anticipated costs of operations in the Balkans by department in the Main Estimates. We recommend that the Government reconsider this.**

13. **The current arrangements mean that the provision for conflict prevention in the MoD's Main Estimate greatly underestimates the total expected cost of the MoD's conflict prevention activities.**

Contingent liabilities

14. The MoD's Main Estimate lists the Department's contingent liabilities which, if they matured, would involve the voting of additional expenditure.¹⁹ This list includes liability of £45 million in respect of the QinetiQ pension fund. The MoD's supplementary memorandum states that this liability was paid at the end of March 2006, after the

12 Fifth Special Report from the Defence Committee, Session 2005–06, *Costs of peace-keeping in Iraq and Afghanistan: Spring Supplementary Estimate 2005–06: Government Response to the Committee's Fourth Report of Session 2005–06*, HC 1136, para 4

13 HC 980, para 16

14 HC 1136, paras 2 and 5

15 Seventh Special Report from the Defence Committee, *Ministry of Defence Annual Report and Accounts 2004–05: Government Response to the Committee's Sixth Report of Session 2005–06*, HC 1293, Appendix 1, para 54

16 The FCO's Main Estimate includes provision for £100 million for global peace-keeping: HC 1035, p 331

17 HC 980, para 17

18 HC 1136, paras 11–14

19 HC 1035, pp 313–315

completion of the Initial Public Offering of QinetiQ’s shares, and the Main Estimates do not reflect the fact that the liability had been discharged. This will be corrected in the Winter Supplementary Estimates.²⁰

Sale of assets

15. The MoD’s Main Estimate anticipates sales of assets of a value of only £7.2 million in contrast to £537.9 million in the last Financial Year.²¹ We asked the MoD to explain why the asset disposal strategy was so limited this year. Its response explains that the figure given is understated through oversight: it is expected that the disposal of Estates will bring in receipts in excess of £150 million. The figures will be put right at the Winter Supplementary Estimates.²²

Accessibility of information

16. We acknowledge the efforts made by the MoD to follow the guidance issued by the House of Commons Scrutiny Unit on the production of Departmental Estimates Memoranda, and the speed with which the Department has responded to our request for further information. But the fact remains that the Department’s Estimates memoranda are not easily understandable by the non-expert reader. **We recommend that the MoD consider further, in consultation with this Committee and with the House of Commons Scrutiny Unit, how the information presented in its Estimates memoranda could be made more accessible, and expressed in plainer language.**

Conclusion

17. **We have identified no issues of sufficient concern to require a debate in the House before it is asked to agree to the Main Estimates.**

18. **We believe that it is essential to our future security that the MoD and our Armed Forces are properly funded, and we will be monitoring the progress of the Spending Review with very close interest. We will also be continuing to monitor the MoD’s Estimates process. The Government should not take the House’s acquiescence to its spending plans for granted.**

20 Ev 9 (xii)

21 HC 1035, p 308

22 Ev 8 (ix)

Conclusions and recommendations

1. We recommend that the Ministry of Defence reconsider whether provision for commenced operations might be included in the Main Estimates in future. (Paragraph 9)
2. While we appreciate the value in managing peace-keeping activities centrally, we cannot see why this should preclude separation of the anticipated costs of operations in the Balkans by department in the Main Estimates. We recommend that the Government reconsider this. (Paragraph 12)
3. The current arrangements mean that the provision for conflict prevention in the MoD's Main Estimate greatly underestimates the total expected cost of the MoD's conflict prevention activities. (Paragraph 13)
4. We recommend that the MoD consider further, in consultation with this Committee and with the House of Commons Scrutiny Unit, how the information presented in its Estimates memoranda could be made more accessible, and expressed in plainer language. (Paragraph 16)
5. We have identified no issues of sufficient concern to require a debate in the House before it is asked to agree to the Main Estimates. (Paragraph 17)
6. We believe that it is essential to our future security that the MoD and our Armed Forces are properly funded, and we will be monitoring the progress of the Spending Review with very close interest. We will also be continuing to monitor the MoD's Estimates process. The Government should not take the House's acquiescence to its spending plans for granted. (Paragraph 18)

Formal minutes

Tuesday 27 June 2006

Members present:

Mr James Arbuthnot, in the Chair

Mr David S Borrow

Mr David Crausby

Linda Gilroy

Mr Brian Jenkins

Mr Kevan Jones

Robert Key

Willie Rennie

John Smith

Ministry of Defence Main Estimates 2006–07

The Committee considered this matter.

Draft Report (Ministry of Defence Main Estimates 2006–07), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 18 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Ninth Report of the Committee to the House.

Several papers were ordered to be appended to the Report.

Ordered, That the Chairman do make the report to the House.

[Adjourned till Tuesday 11 July at Ten o'clock.]

Defence Committee Reports in this Parliament

Session 2005–06

First Report	Armed Forces Bill	HC 747 (<i>HC 1021</i>)
Second Report	Future Carrier and Joint Combat	HC 554 (<i>HC 926</i>)
Third Report	Delivering Front Line Capability to the RAF	HC 557 (<i>HC 1000</i>)
Fourth Report	Costs of peace-keeping in Iraq and Afghanistan: Spring Supplementary Estimate 2005–06	HC 980 (<i>HC 1136</i>)
Fifth Report	The UK deployment to Afghanistan	HC 558 (<i>HC 1211</i>)
Sixth Report	Ministry of Defence Annual Report and Accounts 2004–05	HC 822 (<i>HC 1293</i>)
Seventh Report	The Defence Industrial Strategy	HC 824
Eighth Report	The Future of the UK's Strategic Nuclear Deterrent: The Strategic Context	HC 986

Written evidence

APPENDIX 1

Memorandum from the Ministry of Defence

MAIN ESTIMATES 2006–07

SUMMARY OF RESOURCES SOUGHT IN THE ESTIMATE

1. This Memorandum covers the Main Estimate for the Ministry of Defence (MOD). The Department's spending plans for 2006–07 are based upon the outcome of the Government's Spending Review 2004, which was published in the Government's Expenditure Plans 2005–06 to 2007–08 (Cm 6532). As announced by the Secretary of State for Defence on 21 July 2004, the key features of the settlement for Defence were:

- An increase in the Defence budget of £3.7 billion, representing 1.4% average annual growth in real terms over the period to 2007–08.
- A commitment to achieving £2.8 billion of efficiencies by 2007–08, all of which will be reinvested in Defence. Details of these are recorded in Cm 6532.

2. The Ministry of Defence requests in Main Estimates totals of:

	<i>£ million</i>
Net resources within Request for Resources 1	31,986
Net resources within Request for Resources 2	47
Net resources within Request for Resources 3	1,030
Net Cash Requirement	31,496

DETAILED EXPLANATION OF CHANGES SINCE SR04

3. The transfers and other changes outlined in the Introduction to the Estimate are analysed in this section of the memorandum.

4. The MoD has reorganised the two Navy Top Level Budget Holders (TLBs) Commander-in-Chief Fleet and Second Sea Lord/Commander-in-Chief Naval Home Command into a single TLB called Commander-in-Chief Fleet TLB, as part of its rationalisation process. This is referred to as "Commander in Chief Royal Navy Single TLB" in the Estimate. Prior years' balances (2005–06 provision and 2004–05 Outturn) are shown against the two previous TLBs lines.

5. There have been a number of transfers between TLBs, reflecting routine adjustments resulting from the Departmental planning process. Further changes in the organisation's structure will mean these will be updated in the Supplementary Estimates; one of these changes is the impact of the transfer of assets to the MOD's new single balance sheet owners. This is explained in more detail in Para 17.

6. The table below shows how the Estimate is compiled, taking the figures for 2006–07 published in Cm 6532, and identifying subsequent changes. The figures for AME, non budget and cash release of provisions are not published in Cm 6532. These are explained further in the following paragraphs.

<i>All £ million¹</i>	<i>Direct R DEL</i> 1	<i>Indirect R DEL</i> 2	<i>Total R DEL</i> 3	<i>AME</i> 4	<i>Non budget Near cash</i> 5	<i>Non budget Total Net Resources</i> 6 7	<i>Capital DEL</i> 8	<i>Capital AME</i> 9	<i>Total Net Capital</i> 10	
GEP figures										
Cm 6532	21,482.4	11,224.5	32,706.9	225.6	50.3	-21.2	32,961.7	6,970.0	-7.0	6,963.0
Accounting Treatment changes ²	-9.6	-37.9	-47.5	-47.5	-37.9	21.2	-28.3			
Transfers in	10.1		10.1							
Transfers out	-222.6		-222.6							
Restructuring	100.0		100.0							
Urgent Operational Requirements							-15.0			
Flexibility	50.0	-50.0	0.0							
Armed Forces Memorial	1.5		1.5							
Total	21,411.8	11,136.6	32,548.4	178.1	12.4	0	32,738.9	6,926.7	-7.0	6,919.7

Ev 2 Defence Committee: Evidence

<i>All £ million</i> ¹	<i>Direct R DEL</i> 1	<i>Indirect R DEL</i> 2	<i>Total R DEL</i> 3	<i>AME</i> 4	<i>Non budget Near cash</i> 5	<i>Non budget Non cash</i> 6	<i>Total Net Resources</i> 7	<i>Capital DEL</i> 8	<i>Capital AME</i> 9	<i>Total Net Capital</i> 10
Less Non voted items in SR 04										
Departmental Unallocated Provision		- 470.0	- 470.0							
Nuclear cash release	- 258.4		- 258.4							
Royal Hospital Chelsea	- 12.6	- 11.6	- 24.2					- 0.7		
Fleet Arm Museum	- 0.6		- 0.6							
RFR1 Total	21,140.2	10,655.0	31,795.2	178.1	12.4	0	31,985.7	6,926.0	- 7.0	6,919.0
RFR2 Provision	47.3		47.3							
RFR 3 Provision Previous				1,026.0						
War widows benefit				4.0						
RFR3 Provision				1,030.0						
Estimate Total*	21,187.5	10,665.0	31,842.5	1,208.1	12.4	0	33,063.0	6,926.0	- 7.0	6,919.0

* Minimal differences may occur due to roundings.

¹ Definitions of the column headings are shown at Annex A.1

² This line reflects the changes to the Treasury control regime, which affects provisions, accounting for Private Finance Initiative deals, and long term prepayments and debtors.

RFR 1 PROVISION OF DEFENCE CAPABILITY: EXPLANATION OF CHANGES

Transfers in and Out

7. The Estimate includes a number of transfers to and from other Government Departments. Some of these are follow-on transfers from last year's Supplementary Estimates, and where applicable it is expected that MOD's baseline will be adjusted to reflect a permanent transfer in the next Spending Review.

TABLE SHOWING TRANSFERS IN TO MOD FROM OTHER GOVERNMENT DEPARTMENTS IN RFR1

<i>Exporting Department</i>	<i>£'000</i>	<i>Purpose</i>
Department for Environment & Rural Affairs	4,863	Contribution to National Meteorological Programme and Severe Weather Warning System
Department of Transport	3,903	Contribution to National Meteorological Programme and Severe Weather Warning System
Department for Work and Pensions	1,345	Postal Contract costs for the Veterans Agency. MoD is now responsible for meeting the cost from its budget
Cabinet Office	8	Costs of the Treasury Solicitors European Division. Treasury Solicitors are introducing a levy based system. Treasury Solicitors have disaggregated their costs to Departments.
Total	10,119	

TABLE SHOWING TRANSFERS OUT OF MOD TO OTHER GOVERNMENT DEPARTMENTS IN RFR1

<i>Importing Department</i>	<i>£'000</i>	<i>Purpose</i>
Department for Trade and Industry	- 215,000	Transfer of responsibility for setting up of the Nuclear Decommissioning Agency. This was agreed in Spending Review 04. The transfer was effective from 1 April 2005, and was reflected in the Spring Supplementary Estimate 2005-06
Cabinet Office	- 7,500	MoD's Contribution to the running of the BBC Monitoring Service

<i>Importing Department</i>	<i>£'000</i>	<i>Purpose</i>
Department for Culture, Media and Sport	– 160	The transfer of the Pattern Room Collection The Pattern Room is a collection of historic weapons and other items accumulated over the past centuries when the Army etc made its own weapons; these have now been transferred to the Royal Armouries. This was not treated as an MOG transfer: it was too small and only covers the cost of the staff transferring.
Total	– 222,660	

Restructuring

8. Budget 2006 announced £100 million from the Reserve in 2006–07 in order to help manage the cost of restructuring of both the Armed Forces and Civilian elements of MOD.

Urgent Operational Requirement Changes

9. Some Urgent Operational Requirement (UOR) changes bring forward items of capital equipment already in the programme. In these cases, MOD accounts for the purchase against RFR2 funding in the year of delivery, but takes a corresponding reduction in the capital resource set aside for that purchase in the year that it was originally planned to be delivered. There is a reduction of £15 million in Capital DEL in the Estimate for equipment delivered under UORs in previous years.

Flexibility

10. The Estimate includes a £50 million switch from non-cash to near-cash agreed with the Treasury as a result of MoD's progress against the SR04 reform agenda.

Armed Forces Memorial

11. This relates to a grant of £1.5 million for the Armed Forces Memorial in Staffordshire, which will be funded by the proceeds from the coin celebrating the 200th anniversary of the Battle of Trafalgar.

Non Voted Items

12. Non voted items are those not voted in the Part II table of the Estimates, but are included in the GEP figures. These are:

- The Departmental Unallocated Provision. This is a part of the DEL received as a result of the Spending Review which Departments hold back to deal with unforeseen pressures in accordance with the Consolidated Budgetary Guidance issued by HMT.
- The cash release of Nuclear provisions created in previous years which will be paid this year.
- The net consumption and cost of capital charge for Royal Hospital Chelsea together with MOD's contribution to Capital additions.
- The grant to the Fleet Air Arm Museum for its running costs is regarded as a subsidy as over half its income comes from private sources. Grants to the other Museums do not meet the ONS definition and are voted.

Near Cash

13. The MOD's "near cash" budget (which is a Treasury control) is the sum of the Direct RDEL and Capital DEL (including non-voted items) for RfR1. For 2006–07 it is £28,081 million.

RFR2 Conflict Prevention

14. The Estimate includes Programmed Element of Conflict Prevention of £47 million of which £31 million is for Sub Saharan Africa and £16 million is for the rest of the world. Costs arising from operations (which are borne by the Global Conflict Prevention Pool of the Treasury Reserve) will be included in the Supplementary Estimates process, as in previous years. The Department will respond in due course to the Committee's recommendations in its report "Costs of peace-keeping in Iraq and Afghanistan: Spring Supplementary Estimates 2005–06".

RFR3 War Pension Benefit

15. RFR3 has increased by £4 million because of an increase to the pension allowance payable to widows of servicemen who died or left the service before 1 April 1973 and did not benefit from the improvements made in the MOD's Armed Forces Pension Scheme which was introduced on 1 April 1973. This increase was announced in Parliament in March 2005 and laid before Parliament in June 2005.

Items that will change in Supplementary Estimates

16. The Treasury has agreed that MOD should retain a proportion of the receipts (£250M) from the sale of shares in QinetiQ, over financial years 2006–07 and 2007–08. These funds will be drawn down in the Supplementary Estimates.

17. MOD has a fixed asset management project which is part of the Defence Resource Management Programme to “simplify and improve” financial processes across the Department. The second stage of this is the centralisation of fixed asset management under four single balance sheet owners (SBSOs) Defence Estates (DE), Defence Logistics Organisation (DLO), Defence Procurement Agency (DPA) and the Defence Communications Services Agency (DCSA), which is part of the DLO. At this stage, the budgetary implications have not been finalised, and the effect of these intra-Departmental transfers on the Estimates will be shown in the Supplementary Estimates.

The Department's Public Service Agreement

18. The Department's Public Service Agreement (PSA) for 2005–06 to 2007–08 was published in the White Paper “Spending Review 2004: Public Service Agreements 2005–08” (Cm 6238, July 2004). These are also published in the Government's Expenditure Plans 2005–06 to 2007–08.

Departmental Expenditure Limit (DEL)

19. The following table shows the DEL from 2003–04 to 2006–07 for all RFRs

	2003–04 Outturn £m	2004–05 Outturn £m	2005–06 SSE £m	2006–07 Estimate £m
Resource DEL	31,329.935	31,286.724	33,727.344	32,643.245
Capital DEL	6,073.300	6,754.293	6,798.278	6,926.660
Depreciation ¹	–6,304.863	–5,647.882	–8,168.297	–7,551.000
Total DEL	31,098.372	32,393.135	32,357.325	32,018.905

1. Depreciation, which forms part of resource DEL is excluded from total DEL, since capital DEL includes capital spending and to include depreciation of those assets would lead to double counting.
2. The figures are for voted and Non voted DEL. The Non voted figure for 2006–07 is £331.294 net of depreciation.

DEL End Year Flexibility

20. End of Year Flexibility (EYF) will be assessed following the publication of HM Treasury's Public Expenditure Outturn White Paper (PEOWP) later this year.

Administration Costs Limit

21. The Department is not subject to an Administration Costs Limit.

Provisions and Contingent Liabilities

22. Provisions for liabilities and charges have been established under the criteria of FRS12 and are based on realistic and prudent estimates of the expenditure required to settle future legal or constructive obligations that exist at the balance sheet date. Provisions are charged to the Operating Cost Statement (OCS) unless they have been capitalised as part of the cost of the underlying facility where the expenditure provides access to current and future economic benefits. In such cases the capitalised provision will be depreciated as a charge to the OCS over the remaining estimated useful economic life of the underlying asset. All long term provisions are discounted to current prices by use of HM Treasury's Test Discount Rate, which is 2.8% for the financial year 2006–07. The discount is unwound over the remaining life of the provision and shown as an interest charge in the OCS.

23. MoD's provisions cover legal claims, civilian departure costs, environmental costs restructuring and nuclear decommissioning and restoration costs. Details of the contingent liabilities are set out at Contingent Liabilities note in the Estimate.

Machinery of Government Changes

24. A Machinery of Government (MOG) change is made when the responsibility for a service transfers from one Government Department to another. The most recent one of these was in 2002–03 when the War Pensions Agency was transferred from Department of Work and Pensions. There are no MOG changes in this Estimate.

Annex 1

DEFINITION OF TERMS

1. *Direct R DEL* This is a control aggregate within the resource budget which excludes non-cash items such as depreciation, cost of capital and movement in provisions. Direct R DEL is also known as “near cash in the resource budget”.

2. *Indirect R DEL* This covers items such as depreciation cost of capital charges and movements in provisions (other than nuclear provisions), and the notional auditors' fees for the NAO. This is also known as non-cash.

3. *Total R DEL* is the sum of columns 1 and 2.

4. *AME* (Annually Managed Expenditure) covers programmes that are demand-led, such as war pensions, or exceptionally volatile in a way that could not be controlled by the department and where the programmes are so large that the department could not be expected to absorb the effects of volatility in its programme, such as movements in nuclear provisions.

5. *Non-Budget* Items of expenditure which are subject to Parliamentary but not Treasury control, and hence are outside DEL and AME.

6. *Total Net Resources* This is the sum of columns 1 to 6.

7. *Capital DEL* is for new investment and net policy lending. It includes Capital additions and disposals and also the capital repayment of loans.

8. *Capital AME* includes the capital element of the loan repayments for self financing public corporations, such as QinetiQ.

9. *Total Net Capital* This is the sum of columns 8 and 9.

2 May 2006

Memorandum from the Ministry of Defence

ESTIMATES MEMORANDUM 2006–07: ARMED FORCES RETIRED PAY AND PENSIONS

SUMMARY OF CHANGES SOUGHT IN THE ESTIMATE

1. The Armed Forces Pension Scheme Main Estimate requests provision of:

- (a) Net resources within Request for Resources 1: £4,588.662 million.
- (b) Net Cash Requirement: £1,584.369 million.

2. This Memorandum covers the Estimate for the Armed Forces Retired Pay and Pensions for 2006–07. The Scheme's spending plans for this financial year are based on the expected take up of pensions of retired personnel. The Estimate covers only the payment of pensions. The costs of administering the Scheme fall to the MOD Main Estimate. The Armed Forces Pension Scheme is a demand led service and is therefore AME; as a result there is no Spending Review settlement against which to compare it. The costs of the scheme are forecast every six months for both the current year and future years. As a result we have compared the Estimate with the latest forecast submitted to Treasury.

DETAILED EXPLANATION OF THE CHANGES

3. The Estimate for 2005–06 included non-budget expenditure of £9.93 billion relating to the increase in the value of provisions held on the Balance Sheet as a result of the change in discount rate from 3.5% to 2.8%. There will be no change in the discount rate for 2006–07. The non-budget element of the estimate is therefore not applicable to this financial year.

4. An increase of £67.956 million in receipts due to higher than anticipated SCAPE (Superannuation Contributions Adjusted for Past Experience) receipts has been included due to the introduction of revised rates of SCAPE from 1 April 2005. This change is shown as a reduction in the resources required in the table below. SCAPE replaced the old ASLC (Accrued Superannuation in Lieu of Contributions) as the basis of contributions to the scheme.

5. An increase of £85.369 million in Current Service Costs has been calculated on the level of SCAPE costs which has then been multiplied by an agreed Government Actuary Department factor, which is 1.29.

6. An increase of £23.102 million for interest on Scheme Liability has been applied due to higher than forecast Service provisions liabilities.

ANALYSIS OF CHANGES BETWEEN LATEST FORECAST AND ESTIMATE

	<i>Total AME £m</i>
Previous Forecast	4,548.147
Higher than anticipated SCAPE receipts	– 67.956
Increase in Current Service Costs and change in multiplication factor	+ 85.369
Increase for interest on Scheme Liability	+ 23.102
Revised Estimate	4,588.662

2 May 2006

APPENDIX 2

DEPARTMENTAL MINUTE FROM THE MINISTRY OF DEFENCE CONCERNING THE REPORTING OF A CONTINGENT LIABILITY FOR THE UNDERWRITING OF FUNDING FOR THE ARMED FORCES MEMORIAL

It is normal practice, when a Government department proposes to undertake a contingent liability in excess of £250,000 for which there is no specific statutory authority, for the department concerned to present to Parliament a Minute giving particulars of the liability created and explaining the circumstances; and to refrain from incurring the liability until fourteen days (exclusive of Saturdays and Sundays) after the issue of the Minute, except in cases of special urgency.

The Armed Forces Memorial, dedicated to some 16,000 members of the United Kingdom Armed Forces killed on duty or as a result of terrorist action since the end of the Second World War, is to be constructed at the National Memorial Arboretum in Staffordshire. The costs of the whole project are expected to be in the region of £6 million and the Trustees of the Armed Forces Memorial Trust are raising this money by public subscription. The Chancellor of the Exchequer announced on 13 February 2006 that the Treasury would contribute £1.5 million towards the appeal from the proceeds of the sale of Trafalgar Coins. These are non-public funds.

The concept for the memorial was first announced in the House of Commons by the then Secretary of State for Defence, on 10 November 2000. The Ministry of Defence now wishes to provide an indemnity of £3.3 million to the Trust to underwrite the costs of the project that are not yet covered by donations. This underwriting will allow the Trustees to proceed with contractual arrangements to meet the unveiling deadline of September/October 2007.

It is the Trustees' intention to meet all costs from funds raised from public subscription. Officials from the Ministry of Defence will work closely with the Trustees to ensure that the risk of the guarantee being called on is minimised. If the liability is called, provision for any payment will be sought through the normal Supply procedure. Any such payments would be recovered from future public subscriptions.

The Treasury has approved the proposal in principle. If, during the period of 14 days (exclusive of Saturdays and Sundays) beginning on the date on which this Minute is laid before Parliament, a Member signifies an objection by giving notice of a Parliamentary Question or by otherwise raising the matter in Parliament, final approval to proceed with incurring the liability will be withheld pending an examination of the objection.

22 May 2006

APPENDIX 3

Further Memorandum from the Ministry of Defence

MAIN ESTIMATES 2006–07

(i) *The Committee's report on the Spring Supplementary Estimate for 2005–06 expressed concern at the level of contingency included in the request for resources. We are unable to identify from the Memorandum covering the Main Estimate whether or not there are any contingencies included within the Main Estimate. Please could you provide details of any contingencies in the Main Estimate, both by amount and by sub-head, and explain how they were arrived at? How do any contingencies relate to the Departmental Unallocated Provision of £470 million and are there any plans yet as to how the unallocated provision will be spent?*

There are no contingencies included within the Main Estimate. Should we need to access the Departmental Unallocated Provision, we will seek Parliamentary authority to do so in Supplementary Estimates.

(ii) *The Memorandum covering the MoD's Main Estimate does not include any information on the levels of End Year Flexibility that the MoD is carrying. Although we recognise that the use of EYF is reserved for Supplementary Estimates, the Committee would like an update on the latest estimate for EYF which we anticipate will have changed slightly from those presented alongside the Winter Supplementary Estimate as a result of 2005–06 actual outturn figures. Are there any plans for utilising the stock of EYF during 2006–07?*

End of Year Flexibility will be assessed following the publication of HM Treasury's Public Expenditure Outturn White Paper later this year, informed by the actual 2005–06 outturn in the audited accounts.

(iii) *The Memorandum covering the MoD's Main Estimate shows (paragraph 4) some restructuring taking place, combining the Top Level Budget holders for Commander-in-Chief Fleet and 2nd Sea Lord/Commander-in-Chief Naval Home Command. The Committee was briefed on this during the visit to Fleet Command but would appreciate a short note on the operational impact of this merger of roles and the efficiency savings which the merger will generate.*

The reason for the merger of the Commander-in-Chief Fleet's and the Second Sea Lord's headquarters was to ensure that the Navy manages itself in the most cost-effective and efficient way possible, thereby maximising the resources available for the delivery of operational capability. The new unified headquarters and single top level budget came into being on 1 April 2006 and will generate over £10 million of efficiencies by April 2008.

(iv) *The Memorandum covering the Main Estimate also indicates (paragraph 5) that further restructuring is currently underway to consolidate the MoD's assets under single balance sheet owners. Again, what will be the operational impact of this restructuring and what efficiency savings will it generate?*

As part of the review of the MOD Finance Function conducted in 2004, known as "Simplify and Improve", we considered whether current budgetary accountabilities matched decision-making responsibilities. We concluded that because key decisions about the procurement of new equipment and out of service dates were taken by the Centre of the Department rather than by the Top Level Budget Holders there was no management benefit in these assets appearing on the balance sheets of these budget holders. It was therefore decided that all fixed assets would be transferred to Single Balance Sheet Owners (SBSOs), who would manage the financial consequences of asset ownership. This has no operational impact and will not, in itself, generate efficiency savings, but it does significantly simplify our financial processes.

(v) *How much of the £100 million additional resources announced for the MoD in the Budget 2006 will be spent effecting this restructuring?*

The purpose of the £100 million additional resources made available to the Department from the Reserve in 2006–07 is to help manage the up-front costs of the programme of Civilian and Military manpower draw-down and restructuring that was first announced in the "Delivering Security in a Changing World: Future Capabilities" Command Paper of 2004. The aim of this programme is to assist the delivery of efficiency improvements across Defence and to modernise the way the Armed Forces and Defence are organised, equipped and supported. The additional resources are not intended to meet any costs associated with the consolidation of MoD assets under single balance sheet owners or the creation of the single Fleet Top Level Budget from the merger of the Commander-in-Chief Fleet and 2nd Sea Lord budget areas.

(vi) *There has been a 24% increase (£647 million) in sub-head I (Central) within RfR1 compared with the 2005–06 provision. Please could you provide an explanation for the increase?*

The increase in the Central TLB is within Indirect Resource Departmental Expenditure Limit (DEL). As noted above we are planning to transfer Fixed Assets to Single Balance Sheet Owners later in the year. Until the SBSOs have assumed responsibility for the assets we shall not have a definitive view of the final allocation between TLBs. We plan to adjust the inter-TLB allocations and seek Parliamentary approval through Supplementary Estimates.

(vii) *Paragraph 3 in the Introduction to the Main Estimate mentions a change in the classification of On-Balance Sheet PFI contracts. Could you explain why the change has occurred and what impact this change will have on the future funding requirements of the MoD?*

This is the result of changes in the budgeting guidance issued by HM Treasury (which is available on the Treasury's website). Departments were previously required to split the recording of payments on PFI deals so that the interest payable below 3.5% was charged to non-budget (not within the Departmental Expenditure Limits (DEL)) and that over 3.5% was scored to Direct Resource DEL. The new arrangements require that the full amount of interest is charged to Direct Resource DEL. The cost of capital credit was in Non Budget, and it will now be within Indirect Resource DEL. This technical accounting change simplifies the recording of transactions: Treasury has adjusted Departmental DELs accordingly and there is thus no impact on future funding requirements.

(viii) *Non-Budget costs within RfR1 in the 2006–07 Main Estimate are around £12 million and are significantly lower than those in 2005–06 which exceeded £2.5 billion. Please can you explain why this difference has arisen?*

This change arises because the discount rate for provisions reduced from 3.5% real to 2.2% real with effect from 1 April 2005, and as a result the Non Budget Estimate in 2005–06 was significantly larger than usual. When provisions for future liabilities are recorded on the balance sheet, they are discounted (reduced) using HM Treasury rates to reflect the present value of future payments. If the discount factor decreases, the present value on the balance sheet will increase, and this corresponding entry is charged to the operating cost statement in Non Budget. The Non Budget Estimate in 2005–06 comprised £2,328 million for the discount rate change, which is not required in 2006–07, £18 million for the PFI interest and cost of capital which now lies within Departmental Expenditure Limits and Annually Managed Expenditure and £13 million for Grants in Aid. The only item in Non Budget in 2006–07 is the Grants in Aid.

(ix) *Capital non-operating appropriations-in-aid are included within the 2006–07 Main Estimate at £21.5 million. This compares to the 2005–06 provision of £607 million. Within the £21.5 million total only £7.2 million relates to the sale of assets. The Committee would like a breakdown of the assets to be sold in the year and an explanation of why the MoD's asset disposal strategy for the year is so limited.*

We made an oversight in not reflecting the totality of the planned estate disposal programme in Main Estimates. For reasons of commercial sensitivity we do not wish to provide a detailed breakdown of individual anticipated receipts. Major disposals this year will include Queensgate, Farnborough, Holton Hospital, Dean Hill, West Rainham, and Drummond Barracks. Overall, however, we expect the Estate disposals figure to be in excess of £150 million. We shall update the figures at Winter Supplementaries.

(x) *There are two new contingent liabilities in the 2006–07 Main Estimate relating to the "Provision of MoD support services to the Iraqi Ministry of Transport in opening Basra Airport" and the "Non-Insurance of the Rolls Royce Core Factory and associated Neptune Test reactor facility for third party risks". Please could you provide more information about the nature of these contingent liabilities and explain why they are unquantifiable?*

The contingent liability relating to the provision of MOD support services to the Iraqi Ministry of Transport in opening Basra Airport was reported to Parliament by Departmental Minute on 2 December 2004. MOD will support the commercialisation of Basra Airport in the provision of the following services: Air Traffic Control—Communications Support—Fire and Crash Rescue. These services will continue to be provided to the Multi National Division (South East) in addition to supporting commercial operations. The potential contingent liability would arise in the event of an aviation accident. Because of the broad and potentially unbounded nature of aviation accidents the potential costs are unquantifiable.

The contingent liability relating to the non-insurance of the Rolls Royce Core Factory and associated Neptune Test reactor for third party risks was reported to Parliament by Departmental Minute on 11 March 2004. MOD proposes to extend the existing contingent liability in respect of the submarine reactor fuel Core factory and associated Neptune test reactor that are operated exclusively for Defence by Rolls Royce. The existing scope of the Crown indemnity within procurement contracts would be extended from risks to Rolls Royce facilities and workforce only, to cover all third party liabilities (damage to property and injury to persons outside the nuclear site). The existing scope of Crown indemnity for the facility and workforce and

the £140 million cap to insurers' liability for third party claims means that a significant proportion of the financial risk is already held by the MOD. Careful appraisal of the risks has been undertaken to support the investment appraisal. The chance of a significant nuclear accident is so remote that expenditure to purchase commercial insurance does not represent value for money.

Further information on both of these liabilities is provided in the Departmental Minute.

In both cases the cost to the Department would depend on the severity of the incident. There are so many different scenarios that could lead to the liability being realised that the potential costs are unquantifiable.

(xi) *We notice there has been a small change in the format of the notes to the Main Estimate which reduces the information available to the Committee on appropriations-in-aid. Could you provide a breakdown of the £1,365,830,000 on page 308 relating to the sale of goods and services in order to enable a comparison to the prior year's provision?*

The following table shows a breakdown of the appropriations-in-aid, in the same level of detail as previous Estimates.

	2006–07 £000s
Income from supplies and services	1,026,477
Loan and rental income	265,369
Interest Received	94
Other Income	73,890
Sale of goods and services	1,365,830
Trading Funds dividends (includes interest previously reported under interest received)	25,546
Total	1,391,376

(xii) *There remains in the MoD's Main Estimate a contingent liability to top up the QinetiQ pension fund, the need for which was to be assessed when the Government's remaining stake in QinetiQ was sold. QinetiQ was floated on the London Stock Exchange in February 2006 at which point the Committee would expect to see the liability either settled or extinguished. Newspaper reports suggest QinetiQ is indeed intending to call on the entire £45 million commitment and retain a further £45 million raised from share sales to boost the pension fund further. If QinetiQ has publicly expressed its intention to call on the MoD's £45 million commitment why does the liability still remain contingent? Has it not crystallised? Does the £45 million QinetiQ is planning to retain from share sales reduce the amount available for repayment to the MoD? Given that the pension fund is likely to still be in deficit following the £90 million cash injection, has the MoD made any further commitments with regard to the pension fund in future?*

The contingent liability of £45 million in respect of the QinetiQ pension fund was paid at the end of March 2006, just after the completion of the Initial Public Offering (IPO) of shares. Although Main Estimates were not published until May this year, much of the supporting data was prepared before this payment was made and did not therefore reflect the fact that the liability would be discharged by the time of publication. The position will be corrected in Winter Supplementaries. Following the IPO, MOD retained a 19.3% stake in QinetiQ, but has no further commitment or liability in relation to the pension fund.

(xiii) *The Memorandum covering the MoD's Main Estimate makes reference (paragraph 11) to the Armed Forces Memorial—"a grant of £1.5 million for the Armed Forces Memorial in Staffordshire, which will be funded by the proceeds from the coin celebrating the 200th anniversary of the Battle of Trafalgar". On 22 May the MoD laid a copy of a Departmental Minute (attached) concerning "the reporting of a contingent liability for the underwriting for the Armed Forces Memorial". The costs of the Armed Forces Memorial project is expected to be in the region of £6 million. The MoD wishes to provide an indemnity of £3.3 million to the Armed Forces Memorial Fund Trust to underwrite the costs of the projects that are not yet covered by donations. The Minute notes that it is the Trustees' intention to meet all costs from funds from public subscription and that officials from the MoD will work with the Trustees to ensure that the risk of the guarantee being called on is minimised. In what ways will the MoD ensure that the risk is minimised?*

The Minute states that "The Chancellor of the Exchequer announced on 13 February 2006 that the Treasury would contribute £1.5 million towards the appeal from the proceeds of the sale of Trafalgar Coins. These are non-public funds". Why is this contribution from the Treasury considered non-public funds?

The Committee staff were informed that the usual 14 day's notice was not being given. Please explain why, and why this is not explained in the Minute.

The Armed Forces Memorial Trustees have submitted their fundraising business plan to the Department. This is being scrutinised for realism and officials will liaise regularly with the Trust to monitor progress against the plan. When the Treasury approved the £1.5 million donation they asked us to make clear that it is not funded via the defence budget but from the proceeds of the sale of a coin. They have since advised

that cash from coin sales is paid to the Consolidated Fund and is available to finance public spending. The £1.5 million to fund the Armed Forces Memorial has been provided from the Consolidated Fund and can therefore be regarded as public money. Prior to the formal submission of the Departmental Minute the Parliamentary Clerk had discussed informally with the Committee Clerk the possibility that the full 14 days notice might need to be reduced. In the event it was concluded that the full notice period would be acceptable and no reduction was therefore required in the Minute.

(xiv) The Committee understands that negotiations for the next Comprehensive Spending Review are currently underway and that as well as agreeing budgets for the next three years with Departments, this will involve setting new PSA targets for the three year period. Please could you forward details of the MoD's draft PSA targets and an explanation of where changes to targets or new targets are proposed.

Discussions on our approach to a PSA covering the CSR07 period are still at a very early stage. We have not yet begun to discuss in detail with the Treasury the coverage or level of individual targets and there are no drafts at this stage.

9 March 2006

