



House of Commons  
Committee of Public Accounts

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# Ministry of Defence: Major Projects Report 2009

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Twenty-third Report of Session  
2009–10

*Report, together with formal minutes, oral and  
written evidence*

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## The Committee of Public Accounts

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### Publication

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### Committee staff

The current staff of the Committee is Sian Woodward (Clerk), Lori Verwaerde (Senior Committee Assistant), Pam Morris and Jane Lauder (Committee Assistants) and Alex Paterson (Media Officer).

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# Contents

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<b>Report</b>	<i>Page</i>
Summary	3
Conclusions and recommendations	5
<b>1 Controlling spending through tighter governance arrangements</b>	<b>7</b>
<b>2 Improving the Department's skills in cost estimation</b>	<b>9</b>
<b>3 Understanding and managing risk</b>	<b>10</b>
<b>Formal Minutes</b>	<b>12</b>
<b>Witnesses</b>	<b>13</b>
<b>List of written evidence</b>	<b>13</b>
<b>List of Reports from the Committee of Public Accounts 2009–10</b>	<b>14</b>



## Summary

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The Major Projects Report 2009 is the latest in a long running series of reports examining the record of the Ministry of Defence (the Department) in meeting cost, time and performance targets for its top military equipment projects which are expected to cost more than £60 billion.

Our hearing identified the serious consequences of failings in the Department's governance and budgetary processes. Even using the Department's own, over-optimistic estimates the defence budget is unaffordable by some £6 billion. The exact size of the gap is dependent on the assumptions one makes about future funding, but the gap could easily be £36 billion and potentially even more.

Intentional decisions to delay some projects have increased total procurement costs and represent economies of the short term, and overall are poor value for money on the specific projects affected. The decisions were taken by the Department as part of a wider package to try to make the defence programme affordable over the next few years. They account for two thirds of the £1 billion of cost increases on projects in the last year. Crucially, they mean the Armed Forces will not get the operational benefits of new capabilities as quickly as expected and some equipments will only be delivered in reduced numbers.

The decisions to delay projects, change requirements and reduce the numbers of equipments being procured adversely affect the Department's ability to secure value for money from its commercial partners. Yet the Department continues to do so. The Department is in the strongest negotiating position with industry before it places a contract. Slowing projects down once started almost inevitably increases their costs and takes pressure off contractors to become more efficient.

After years of reporting on the poor performance of individual projects, we note that this year there are some tentative signs that projects are better managing the costs over which they have control. In practice, the programming decisions taken to deliberately slip projects make it difficult to assess the performance of individual projects and we will be looking for evidence that the improvements can be sustained in future years.

On the basis of the annual report from the Comptroller and Auditor General,<sup>1</sup> we examined whether the Department's governance and budgeting arrangements were fit for purpose and whether it understood the serious implications of re-prioritising projects after committing to them.

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1 C&AG's Report, Session 2009–10, *Ministry of Defence: Major Projects Report 2009*, HC 85



## Conclusions and recommendations

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- 1. The defence budget is unaffordable by between £6 billion and £36 billion. The deficit is a reflection of shortcomings in the Department's governance and budgeting arrangements.** The implications of the failings are not just about increasing costs and poor value for money on individual projects but, vitally, mean the Armed Forces will not get the operational benefits of new capabilities as quickly as expected and some equipments will only be delivered in reduced numbers. The Defence Green Paper and the Strategy for Acquisition Reform,<sup>2</sup> both published in February 2010, are a start at addressing the issues but do not tackle the fundamental unaffordability of the defence budget. Looking forward, the Department will undoubtedly need to take difficult decisions, including possibly cancelling projects.
- 2. HM Treasury did not act sufficiently quickly to challenge the growing unaffordability of the defence budget.** The Treasury should seek greater assurance over the affordability of new projects in the context of the overall defence budget. The Treasury should also work with the Department to agree how the expertise available in both organisations can be harnessed to work together to ensure future defence equipment plans are constructed and managed on a realistic basis.
- 3. In future, the Department and HM Treasury will agree a 10 year planning horizon for the Equipment Plan. This is a step in the right direction but by itself will not be enough.** The Department must learn from past experience to ensure its future equipment planning reflects the risk that cost increases in other, less flexible elements of the defence budget such as pay, pensions and PFI deals may 'squeeze' the funding available for equipment.
- 4. The Department hasn't done enough to understand what effect changes in the availability of funding, cost growth on existing projects, or urgent new demands may have on the future equipment budget.** The Department should analyse the effects of changes in funding assumptions and combine this with an analysis of its past track record to ensure there is sufficient contingency in the Equipment Plan to deal with possible cost growth and meet emerging operational needs.
- 5. The Department does not have good information on the overall costs and risks of its programmes.** The Department should develop common measures of risk across its top 50 projects, which should include assessments of its commercial skills, the maturity of new technology, and knowledge of the systems used to integrate equipments. Taking into account other key variables (such as defence sector inflation and exposure to exchange rates) these assessments should then be aggregated so that the Department can take a balanced view on the scale of the risks to the delivery of military capability in its portfolio of equipment projects.

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<sup>2</sup> Ministry of Defence Green Paper, *Adaptability and Partnership: Issues for a Strategic Defence Review*, 3 February 2010, (Cm 7794); Ministry of Defence Report, *The Defence Strategy for Acquisition Reform*, 2 February 2010, (Cm 7796)

6. **Delaying projects once they have started increases costs, postpones the delivery of military capability and puts the Department at a disadvantage as it tries to secure value from its commercial partners.** In future the Department must ensure that decisions to accelerate or slow down projects, or change the numbers or capabilities of equipments, are supported by quantified operational and financial analyses to enable the full costs and benefits to be identified and compared on a like-for-like basis.

# 1 Controlling spending through tighter governance arrangements

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1. The Major Projects Report 2009 examines the Ministry of Defence's (the Department) progress in meeting cost, time and performance targets for its 15 top-spending military equipment projects over the past year, representing more than £60 billion in forecast spend. In the last year, the cost of these projects has increased by a further £1.2 billion, which represents over one-quarter of the total cost growth of £4.5 billion since project development began. Project delays rose by 93 months in-year—and total slippage per project now averages 24 months.<sup>3</sup>

2. Progress on individual equipment projects has been overshadowed this year by fundamental Departmental failings in managing the overall affordability of the defence budget.<sup>4</sup> Estimates of the gap between planned budgets and forecast spend are highly dependent on future funding agreed with the Treasury.<sup>5</sup> The Department has calculated that if funding were to grow by 2.7% year-on-year,<sup>6</sup> the deficit would be £6 billion after 10 years.<sup>7</sup> The National Audit Office has calculated that if cash spending on defence remains flat then the deficit will rise to £36 billion.<sup>8</sup> But based on a more pessimistic assumption of a 4% reduction year-on-year for the next five years, should other budgets such as health be ring-fenced, then the budget deficit could be as high as £80 billion.<sup>9</sup>

3. The Department's governance arrangements were not strong enough to prevent this serious imbalance between planned spending and the defence budget developing,<sup>10</sup> and have led to the Department taking some short-term savings measures on projects which reduce their overall value for money.<sup>11</sup> For example, slipping the first Queen Elizabeth carrier by one year has raised net costs by £674 million, and postponing the Astute Class submarines saves £139 million over the next four years but ultimately increases costs by £539 million.<sup>12</sup> It is an indictment of the Department's governance and budgetary arrangements that it has got itself into such a mess that, in their own words, these decisions represent the 'least bad' option left open to them.<sup>13</sup>

4. The Department has also been forced to make cuts to other military capabilities to balance its budget,<sup>14</sup> and the Committee remains concerned that these have been made in

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3 Q 10; C&AG's Report, paras 8 and 9

4 Qq 1, 30 and 115

5 Q 29

6 Qq 60–68

7 Qq 71–73; Known as 'Flat Real'

8 Qq 73–97; Known as 'Flat Cash'

9 Qq 3, 80–81 and 126

10 Q 127

11 Qq 1 and 86

12 Qq 44, 81–84; C&AG's Report, para 4

13 Qq 5 and 27–28

14 Qq 21 and 96

an arbitrary fashion without proper analysis.<sup>15</sup> To save money only 30 Merlin helicopters will now be upgraded to a new standard, and the number of Future Lynx helicopters has been cut by 23% and planned flying hours reduced by one-third, without any quantified operational analysis of the military impact of these measures.<sup>16</sup> The Committee detects a worrying trend: previous Departmental witnesses have told us they required 12 Type 45 Destroyers—now they tell us they can do what they need with six. Similarly, Nimrod numbers have fallen from 18 to six and yet the Department claims it can still make do. Either the original estimate is extraordinarily wrong or there has to be a loss in capability, yet the Department continues to cut equipment numbers without a proper assessment of the operational impact.<sup>17</sup>

5. The Treasury has a role to play in challenging the Department's budgeting assumptions and it told us it had always known about the imbalance in funding.<sup>18</sup> The Treasury approach of focusing purely on whether the Department's books were balanced in each year ignored the long-term affordability of the programme.<sup>19</sup>

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15 Qq 93–95

16 Qq 94–97; C&AG's Report, para 4

17 Q 20

18 Qq 31–34, 43 and 78

19 Qq 12 and 34–35

## 2 Improving the Department's skills in cost estimation

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6. Although the Department and Treasury have recently worked to improve cost estimating by agreeing a rolling 10-year planning horizon, pressure on the Equipment Plan is significantly affected by wider defence budget pressures.<sup>20</sup> These include: Armed Forces' pay, pensions, receipts from Defence Estates, adverse movements in foreign exchange, and pressure to shift funds to support current operations.<sup>21</sup> For example, the Department noted that successive Armed Forces' pay reviews had recommended pay rises that exceeded the level of inflation built into the Comprehensive Spending Review settlement, adding 'several hundred million' in costs per year over the past three years.<sup>22</sup> Foreign exchange movements had added a further £1.3 billion over four years.<sup>23</sup>

7. To find the money to cover these cost increases, the Department has deliberately delayed equipment projects to generate short-term savings, even though such delays invariably result in poor value for money.<sup>24</sup> Longer term, given the wider economic position, the funding provided for defence as a whole, including the slice allocated for equipment acquisition, will undoubtedly be under considerable pressure. The Department told us it would model the implications of a range of budget settlements over a 10-year horizon so that future decisions were carefully planned, rather than the knee-jerk reactions of late.<sup>25</sup>

8. Critically, the Department does not have any contingency funding in place within its budget to address either external pressures or cost growth from within the Equipment Plan. Currently, projects are budgeted on the 'most likely' cost (the expected cost of the project) and not their 'not to exceed cost' (the highest cost estimate approved). A recent report showed average project costs of 40% more than their 'not to exceed' cost by the time they are completed, putting the overall affordability of the Equipment Plan at risk.<sup>26</sup>

9. The Department acknowledged that its historic over-optimism on project costs has contributed to cost growth. This trend has been so marked that, of the projects in this year's Major Projects Report, the total cost over-run is in excess of £4.5 billion—an average of over £300 million per project. A dedicated cost estimation team is being established to support all acquisition work, and it is critical that its work is both independent and authoritative.<sup>27</sup>

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20 Qq 16 and 59

21 Qq 1–2 and 36; C&AG's Report, para 7

22 Qq 1, 13 and 14

23 Qq 2 and 25

24 Qq 1 and 104–106

25 Q 6

26 *Review of Acquisition for the Secretary of State for Defence: An independent report by Bernard Gray*, October 2009, page 7

27 Qq 116 and 121–124

## 3 Understanding and managing risk

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10. The Department lacks a good knowledge of risk on individual equipment acquisitions and across the portfolio of projects in the Equipment Plan. Frequently, projects proceed without a rigorous assessment of the risks arising from: how well understood the technologies being applied are; whether there are potential compatibility problems with other equipments; if the commercial arrangements will incentivise industry; and whether the right project management skills are available in the Department and industry to deliver the project.<sup>28</sup>

11. Regular, objective assessments of the likelihood of these different risks materialising would enable the Department to measure, compare and communicate the extent of the risks affecting individual projects and to better understand where there are common risks which could affect, for example, the portfolio of projects the Department has with an individual contractor. The assessments would also direct where more work is required to reduce risk, or where the Department needs to start trading off time, cost and performance against each other.<sup>29</sup>

12. Early adoption of these assessments in each project's life, and at portfolio level, will help ensure that the Department prioritises and directs scarce resources effectively to reduce or eliminate risk before both the initial and main investment decisions. This is a fundamental prerequisite to achieving a balanced and stable Defence budget over the long-term.<sup>30</sup>

13. The Department accepts that delaying projects after contracts have been signed inevitably results in increased costs to the taxpayer, delays in delivery and possible capability gaps.<sup>31</sup> Changing timetables and requirements before contracts are agreed is an inherent part of negotiation. Trading between cost, time and performance, supported by robust risk analysis and clear operational requirements, is a sign of healthy project management. By comparison, substantially changing contracts after they have been signed inevitably erodes value for money, and delays or creates gaps in military capability. Specifically, costs increase for three principal reasons:

- **Sustaining industrial capacity.** Industry's fixed costs, for example, the employment of design teams at shipyards, have to be sustained over a longer period of time. Invariably, it is the Department that bears the cost when this period of time is extended;<sup>32</sup>

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28 *Review of Acquisition for the Secretary of State for Defence: An independent report by Bernard Gray*, October 2009, pages 137–141

29 Qq 118–119

30 Qq 127 and 128

31 Qq 3, 5 and 117

32 *Review of Acquisition for the Secretary of State for Defence: An independent report by Bernard Gray*, October 2009, pages 135–136, Appendix G

- **Reducing efficiencies.** Obligations on contractors to operate efficiently are greatly reduced as industrial partners are able to apportion cost increases to the Department's decision to slow down the build of the equipment,<sup>33</sup> and
- **Changing requirements.** Opportunities for industrial partners to lower costs are reduced by the unpredictability and changing nature of the project and planned efficiencies are rendered impotent by constant changes to requirements.<sup>34</sup>

14. As a case in point, the Department was apparently unaware in summer 2008 of the gap between the planned defence budget and forecast spend when the multi-billion pound Queen Elizabeth Class aircraft carrier contract was signed.<sup>35</sup> Yet only seven months later the Department chose to delay the whole project, adding £674 million to forecast costs.<sup>36</sup> Had the Department delayed signature of the carrier contract until they had adjusted the spending profile to make the project affordable, then their contractual position would have been far stronger than it subsequently became after contract signature.<sup>37</sup> If the Department had then stuck to an agreed plan it would have given industry a clearer incentive to introduce more efficient ways of working in the medium term, and ensured that the Department were better able to hold commercial partners to account in the longer term.<sup>38</sup>

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33 Qq 3, 36, 40 and 90

34 *Review of Acquisition for the Secretary of State for Defence: An independent report by Bernard Gray*, October 2009, pages 142–143, Appendix G

35 Q 120

36 Qq 87–89

37 Qq 3, 5 and 106

38 Q 90

# Formal Minutes

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**Monday 15 March 2010**

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon  
Mr Douglas Carswell

Rt Hon David Curry  
Nigel Griffiths

Draft Report (*Ministry of Defence: Major Projects Report 2009*), proposed by the Chair, brought up and read.

*Ordered*, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 14 read and agreed to.

Conclusions and recommendations 1 to 6 read and agreed to.

*Resolved*, That the Report be the Twenty-third Report of the Committee to the House.

*Ordered*, That the Chair make the Report to the House.

*Ordered*, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Wednesday 17 March at 3.30 pm]

## Witnesses

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**Wednesday 27 January 2010**

*Page*

**Sir Bill Jeffrey KCB**, Permanent Under Secretary of State for Defence, **General Sir Kevin O'Donoghue KCB CBE**, Chief of Defence Materiel and **Vice Admiral Paul Lambert CB**, Deputy Chief of Defence Staff (Capability), Ministry of Defence

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## List of written evidence

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Ministry of Defence

Ev 16

## List of Reports from the Committee of Public Accounts 2009–10

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First Report	A second progress update on the administration of the Single Payments Scheme by the Rural Payments Agency	HC 98
Second Report	HM Revenue and Customs: Improving the Processing and Collection of Tax: Income Tax, Corporation Tax, Stamp Duty Land Tax and Tax Credits	HC 97
Third Report	Financial Management in the Foreign and Commonwealth Office	HC 164
Fourth Report	Highways Agency: Contracting for Highways Maintenance	HC 188
Fifth Report	Promoting Participation with the Historic Environment	HC 189
Sixth Report	Train to Gain: Developing the skills of the workforce	HC 248
Seventh Report	Young peoples sexual health: the National Chlamydia Screening Programme	HC 283
Eighth Report	Department for International Development: Aid to Malawi	HC 282
Ninth Report	The procurement of legal aid in England and Wales by the Legal Services Commission	HC 322
Tenth Report	Services for people with rheumatoid arthritis	HC 46
Eleventh Report	HM Revenue and Customs: Dealing with the tax obligations of older people	HC 141
Twelfth Report	Maintaining financial stability across the United Kingdom's banking system	HC 190
Thirteenth Report	Excess Votes 2008–09	HC 360
Fourteenth Report	Department for Transport: The failure of Metronet	HC 390
Fifteenth Report	Equality and Human Rights Commission	HC 124
Sixteenth Report	Regenerating the English Coalfields	HC 247
Seventeenth Report	Department for Business, Innovation and Skills: Venture capital support to small businesses	HC 271
Eighteenth Report	Vehicle and Operator Services Agency: Enforcement of regulations on commercial vehicles	HC 284
Nineteenth Report	Improving Dementia Services in England—an Interim Report	HC 321
Twentieth Report	Department for Work and Pensions: Management of Benefit Overpayment Debt	HC 444
Twenty-first Report	The Decent Homes Programme	HC 350
Twenty-third Report	Ministry of Defence: Major Projects Report 2009	HC 338

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# Oral evidence

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## Taken before the Public Accounts Committee on Wednesday 27 January 2010

Members present

Mr Edward Leigh, in the Chair

Mr Richard Bacon  
Mr Douglas Carswell  
Mr David Curry  
Mr Ian Davidson

Nigel Griffiths  
Mr Austin Mitchell  
Dr John Pugh

**Mr Amyas Morse**, Comptroller and Auditor General, **Mr Robert Prideaux**, Director, Parliamentary Relations, and **Mr Tim Banfield**, Director, National Audit Office, gave evidence.

**Mr Marius Gallaher**, Alternate Treasury Officer of Accounts, HM Treasury, gave evidence.

### REPORT BY THE COMPTROLLER AND AUDITOR GENERAL THE MAJOR PROJECTS REPORT 2009 (HC 85-I and HC 85-II)

*Witnesses:* **Sir Bill Jeffrey KCB**, Permanent Under Secretary of State for Defence, **General Sir Kevin O'Donoghue KCB CBE**, Chief of Defence Materiel and **Vice Admiral Paul Lambert CB**, Deputy Chief of Defence Staff (Capability), Ministry of Defence, gave evidence.

**Q1 Chairman:** Good afternoon and welcome to the Committee of Public Accounts where today we are considering the Comptroller and Auditor General's Report on Major Projects Report 2009. We welcome back to our Committee Sir Bill Jeffrey, the Department's Accounting Officer, General Sir Kevin O'Donoghue, who is Chief of Defence Materiel and Vice Admiral Paul Lambert, who is Deputy Chief of Defence Staff for Capability. You are all very welcome. Obviously this is a very important hearing and a serious state of affairs which we are trying to address in the MoD. Obviously, Sir Bill, progress has been made on addressing cost overruns on individual projects—and I say straight away that I pay tribute to that, although more needs to be done to tackle delays. However, all this good work for which, of course, we have been calling for many years is being undermined by the corporate decisions to address the serious imbalance between the defence budget and planned spending. Sir Bill, my first question to you is why is your Departmental budget in such a mess that you have had to push back the completion dates of projects solely for short-term budget considerations, and this actually ends up costing us, the taxpayer, a lot more money in the long-run?

**Sir Bill Jeffrey:** Can I start, Chairman, by saying that I greatly appreciate what you have said about the NAO's comments on project performance because I do take some comfort—although I do not claim that we are there yet by any means—in the extent to which this Report points to improved project management performance, and I am grateful for that. Why has the budget been as hard to manage as it has been? There is a variety of reasons for that. We started in 2007 with the Spending Review outcome

which provided for small—around 1% a year if one excluded the future deterrent, real term growth in the Defence Programme. In the year since then we have seen a range of persistent financial pressures and the position, I have to say, has been exceptionally tight each year. I will mention five if the Committee will bear with me, just to set a bit of context for this hearing. One is the Equipment Programme itself because we have undoubtedly inherited a number of commitments to major projects, of which this Committee is well aware, which come to fruition over the next few years. We have seen a rise in the unit cost of what we acquire. I would not myself use the phrase “defence inflation” but as technology gets more advanced then when buying the numbers of pieces of equipment that we often do we get fewer of them for the same amount of money; that is the same as the Americans experience and others as well. And we have seen some unforeseen growth in the cost of individual Equipment Programmes. But in addition to that, in the rest of the defence budget we have had successive Armed Forces' Pay Review Reports which have recommended settlements which exceeded the assumed level of inflation in our Spending Review Settlement and these in themselves the Government has been glad to accept because our Armed Services people deserve what they get; but they have added pressure of several hundred million a year over the last three years to the budget. Thirdly, I would mention pensions. Like every other section of society our people are living longer—

**Q2 Chairman:** You will have to be a bit brisker because people are time limited in this Committee, and you have the whole hearing in which to get out your answers.

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 Ministry of Defence
 

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**Sir Bill Jeffrey:** I will be brisk; I do apologise, Chairman. We have seen substantial cost pressure from that source. Foreign exchange—like the Foreign Office, although less well publicised, we have seen very big additions. In the 2009 Planning Round we had to look at £1.3 billion's worth of cost pressure over four years, simply because the pound would buy less than it would before. Finally, estate sales; we have built into our figures an assumption that we would sell more of the defence estate than is proving possible.

**Q3 Chairman:** I am sorry, Sir Bill, but I do not find your answer entirely convincing because the whole tone of it is that we have a problem with things like exchange rates, but actually we are in a crisis, are we not? Even if we accept the MoD assumption, which is of a 2.7% increase in a year, that leaves you £6 billion in the red after ten years. If we believe the NAO and we look at the more likely scenario of a flat cash environment budget you are left with £36 billion deficit. If we believe the think-tanks who tell us that after the General Election because other budgets, such as health, are ring-fenced that you might face a 5% reduction over three years, that leaves you with an £80 billion black hole. So this is an extremely serious situation. Do you accept that actually delaying projects after contracts inevitably results in increased cost to the taxpayer, delays in delivery and possible capability gaps? And actually, where you have the power, Sir Bill, is before you sign the contract. What you are doing is delaying projects after you sign the contract and this is a gift to the contractors at our expense?

**Sir Bill Jeffrey:** I accept that last part of your question without hesitation, Chairman, because, to take the obvious example, the slippage in the Carrier Programme is not something we would have chosen to do and it had the consequences that the NAO Report brings out and to which you alluded. The question I was trying to answer before was: what has created the cost pressure in the last few years, and the answer I gave is intended to answer that.

**Q4 Chairman:** What has created the cost pressure, Sir Bill, is that you are agreeing to too many projects that you cannot afford; that is the reality, is it not?

**Sir Bill Jeffrey:** But to respond to the second part of your question, I certainly accept that as we look forward there are very significant affordability issues in the defence budget, which the defence review, to which all three major parties are now committed, will need to address in the period after the Election. Just how large they are depends greatly on the assumption that one makes about the future of the defence budget. If one assumes that it continues to stay broadly constant in real terms then the figure of £6 billion is one that I would certainly recognise over ten years. The £36 billion figure in the NAO Report makes a different assumption, which is that the defence budget carries on reducing in real terms for the whole of ten years and stays exactly flat in cash terms. So I do not think that one can be at all sure of

what the dimensions of the problem are, but I am quite clear that it is a problem, and in that sense I agree with this.

**Q5 Chairman:** And the answer to my particular question that delaying projects after the signing of a contract inevitably leads to increased costs in the long-term?

**Sir Bill Jeffrey:** I accept that but in the situation which we faced a couple of years ago the Government felt that that was the least bad option to take.

**Q6 Chairman:** For instance, you have mentioned the carrier. Why did you change or delay the first aircraft carrier only seven months after agreeing the contract with industry? Just by that one decision you added £674 million to cost. This suggests to me that your reaction is not planned, it is knee-jerk.

**Sir Bill Jeffrey:** It was the product of a pretty careful examination of the whole of the Equipment Programme, which identified where the variable spend was and a significant proportion of the variable spend in the following few years, which in the system in which we were operating was the period on which we had to concentrate, was on the carrier. It certainly was not a decision that we would have wished to take. We also took into account the capability dimension of it and the fact that first of all there were other capabilities that ministers regarded as more urgent, including ones that were directly relevant to current operations; secondly, that in terms of the delivery of the carrier strike capability a year or so's delay was less impactful than other possible measures would have been elsewhere.

**Q7 Chairman:** Would it not have been more courageous just to cancel the entire programme?

**Sir Bill Jeffrey:** That is a question that you had better address to ministers, I think. It was an option but it was not an option that was taken. I think it also bears on something which was touched on in the Report, Chairman, which is that we were managing through this period of acute financial pressure without the benefit of a Strategic Defence Review, and more radical measures of the kind you have just mentioned are almost by definition measures that one would expect to see as a consequence of a Defence Review rather than prior to one.

**Q8 Chairman:** It does not help that all your Heads of Service are fighting in public, does it?

**Sir Bill Jeffrey:** I would not accept that characterisation. As we approach the Defence Review there is undoubtedly a public debate beginning and in one or two comments recently Service Chiefs have made contributions to that, which I think, frankly, have been presented in more colourful terms than they were intended to be.

**Q9 Chairman:** General, are you exasperated that all your good work that you undoubtedly made at the project level to control costs is being undone by such appalling budgetary decisions?

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**Ministry of Defence**


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**General Sir Kevin O'Donoghue:** I get given a set of requirements; I get given a budget and I buy things, and I endeavour to get them in to performance, cost and time. That is my job.

**Q10 Chairman:** But you cannot disguise, can you, that although you have improved cost control you still have an average delay of two years per project.

**General Sir Kevin O'Donoghue:** To be fair, some of that is outwith our control—A400M is a very good example. It is a collaborative project and you will see that overall it is a six-year delay and one year of that was the Germans taking a year to sign the MoU, for example. There are a number of delays in there that were programmed in as delays—and the Carriers you have mentioned—and some are collaborative projects which are outwith my control. I accept that there are some technical reasons, technical issues where we have a delay. That is in within my gift to do something about and that is what we have tried to concentrate on and get a grip on.

**Q11 Chairman:** I found your first answer a bit unconvincing, General. You shrugged your shoulders and said, “Not my job—I just have to get on with life.” That is basically it, is it not? You are passing the buck.

**General Sir Kevin O'Donoghue:** It is not my job to make decisions which are the prerogative of ministers.

**Q12 Chairman:** Can I ask the Treasury what is happening here? You have a fundamental responsibility for overseeing this Department to ensure that its budget is in some kind of balance. What have you been doing? You have a team overseeing the MoD; you presumably could have insisted on a programme being cancelled but what have you been doing all this time? How can you let this state of affairs carry on with a great department of state?

**Mr Gallaher:** I think that in the Treasury we take a balanced view on the needs of the Ministry of Defence and also on the needs of the taxpayer and getting the best product for resources that we can afford to make. We do not actually wish to second-guess the Ministry of Defence's requirements and needs but, at the same time, we have to balance that with what is affordable.

**Q13 Mr Curry:** Sir Bill, there is something that one notices right throughout the public sector, that huge amounts of additional resources usually end up in pay. You have rightly mentioned the Armed Services and you can say that they deserve it. When we had a GP contract; huge amounts of additional money were hurled at GPs for doing not a shred of extra work and, in some cases, rather less work when it comes to out of hours. When student fees were set at £3,000 lecturers' pay rose by 8% in real terms, so a huge amount of that did not benefit students at all, it went straight into the lecturers' salaries. What is it that means that so often these increases end up in the pay packets rather than perhaps in Equipment Programmes?

**Sir Bill Jeffrey:** In mentioning pay, Mr Curry, I was simply trying to put in context the financial pressure under which we have been operating in the last few years. The particular case of the Armed Forces is, like a number of other public sector bodies, the subject of recommendations from an independent pay review body.

**Q14 Mr Curry:** I appreciate that but the phenomenon exists, does it not?

**Sir Bill Jeffrey:** The phenomenon clearly does exist and in my view entirely understandably and, indeed, laudably, given the contribution our Armed Forces make to our national life, ministers have over the last few years chosen to accept the AFPRB's recommendations—I simply observe that.

**Q15 Mr Curry:** But never spell out that the consequences of that are that the pain has to be felt elsewhere, perhaps in the equipment that those very same soldiers might want to use? For example, the former Defence Secretary giving evidence to the Chilcot Inquiry described the Future Rapid Effects Programme as a “total shambles”, just this last week.

**Sir Bill Jeffrey:** He did. I do not know to what extent the Committee wants to get into the Future Rapid Effects Programme?

**Chairman:** Could everyone speak up, please? It is a very large room with poor acoustics.

**Q16 Mr Curry:** Let me rephrase the question. Bernard Gray did his report and Lord Drayson is going to reveal his ruminations quite shortly. What would you expect to be different as a result of the work that Mr Gray did? If you were sitting here two or three years down the line what would you expect to say was different about the way that procurement takes place?

**Sir Bill Jeffrey:** Bernard Gray paid attention, as one would expect him to, to the basic issues of project management skills with which we have been grappling in recent years and he made some recommendations about these, and General Sir Kevin is following up on aspects of that. The area on which he did focus attention was the one that the Chairman started with, which is how can we manage the overall Equipment Programme better; how can we vouch for its affordability more confidently; how can we be clear within the organisation about exactly who is responsible for what? The changes that Lord Drayson's work will lead to and which will be published alongside the Green Paper quite soon now, were indeed foreshadowed by the Defence Secretary when he published Bernard Gray's Report. They include a commitment to have Defence Reviews once in every Parliament; a ten-year indicative programme against which we will be able to manage the Equipment Programme; the establishment of an internal committee, which I will chair, which will be charged with vouching for the Programme's affordability year by year; and, crucially, the annual publication of an assessment of the Equipment Programme's affordability against that ten-year line. These are the kinds of measures

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 Ministry of Defence
 

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that I certainly think have the potential, in addition to the kind of re-examination of the whole budget that the Defence Review will need to undertake, to bring the Programme into better balance than it has been in recent years.

**Q17 Mr Curry:** I can see the logic in that but you say a review in every Parliament. Parliament lasts an average of four years. From the conceptualisation of a project to it taking off or being launched or whatever is several Parliaments, is it not? It is bound to be several Parliaments. How easy is it going to be to design Equipment Programmes, particularly collaborative Equipment Programmes, when everybody knows there is going to be a four-yearly review? Is it not going to be rather difficult? How do you square that circle of being able to develop programmes which are by definition complex and long with the permanent threat of a Defence Review?

**Sir Bill Jeffrey:** That is exactly the argument that there has been around whether to have regular Defence Reviews or not. The Americans have a fixed four-yearly review which corresponds to the Presidential term. We cannot be as confident about the length of a Parliament and there is undoubtedly a risk—

**Q18 Mr Curry:** You can be confident it is not going to be more than five years, can you not?

**Sir Bill Jeffrey:** We can.

**Q19 Mr Curry:** Not unless Sir Kevin leads a coup!

**Sir Bill Jeffrey:** Which I do not think, knowing him as I do, is very likely! The argument around whether to have regular Defence Reviews has always been would it mean that important programmes were imprisoned in judgments about the next Defence Review. I think the advantage—and the reason I am pleased that your Party as well as the present governing Party has committed to it—is that it removes alibis for avoiding difficult decisions and provides an opportunity in which one can look not just at the margins but at the core of the Defence Programme.

**Q20 Mr Curry:** Let me put something to you which always makes me slightly queasy. We were always told that we needed four Trident submarines. I actually did not vote for the renewal of it as a matter of fact—I would be happy to have zero—but we are now told that we could probably manage with three. We were told we needed 12, I remember, Type 45 Destroyers, and we are now told that we can do what we need with six of them. Nimrods were going to be 18, if I can recall, and now we are saying we can probably get by with 12. Am I right to feel that either somebody has the original arithmetic extraordinarily wrong or there has to be a lost capability in that?

**Sir Bill Jeffrey:** I think the programmes you mentioned are different cases.

**Q21 Mr Curry:** It is money at the end of the day, really.

**Sir Bill Jeffrey:** It is money but to take the programmes you mentioned, in the successor deterrent case we will look at whether the capability can be provided with three boats rather than four. On the face of it it seems rather unlikely, but the basic requirement is to provide what is known in the trade as continuous at-sea deterrence, and we will provide as many as it takes to meet that requirement. But in other spheres it is undoubtedly the case that more units of equipment represent greater capability and it is a less absolute judgment. To answer your question, it is undoubtedly the case that broadly speaking if you reduce numbers, as we have done in some of these big programmes, you have less capability.

**Q22 Mr Curry:** If a minister said, “Look, chaps, we are a medium-sized country and all this nonsense about punching above weight means that we spend above our means; we need to come to terms with what we can really afford and just put it straight,” that would be a more honest way to do it, would it not, instead of saying, “Actually we can do exactly the same job with much less kit”?

**Sir Bill Jeffrey:** That is, I believe—and I think many senior politicians believe this as well—precisely the kind of issue that the defence review that we will need to address.

**Q23 Mr Curry:** Can we look at the dear old Airbus? Of course, the Chief Executive of Airbus has said that actually the fate of the whole company might depend upon this military project. So we are not just talking about a defence capability; we may well be talking about one of the emblematic European projects. Where are we on this? I know that it is pretty critical. Are we going to go ahead with it or is it going to be like the Typhoon where we wish like hell that we had not tied everybody up so much on the ground that they would be likely to want to worm their way out of it, when actually it is we who want to worm our way out of it?

**Sir Bill Jeffrey:** The A400M project I would say immediately has been a disappointment to us. As the NAO Report observes, the company themselves have acknowledged that they under-estimated the complexity of the challenge of delivering an aircraft to that specification for the various partner nations. There are a number of discussions going on now which are at quite a delicate stage commercially and I would prefer not to, in open session, get very far into these.

**Q24 Mr Curry:** How much freedom would there be in a Defence Review given that it is a collaborative project with implications which go beyond pure defence implications really?

**Sir Bill Jeffrey:** A Defence Review will need to consider air transport, as it will need to consider every other significant capability. There is the freedom—and it is at a price—to walk away from the A400M Project. We are in many respects reluctant to do so, although we do not by any means rule it out, because we need the capability. And because of the very substantial slippage in the A400M we have had

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 Ministry of Defence
 

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to think hard and quickly about other ways in which we can provide air transport capability over the next few years including, in the statement that the Secretary of State made before Christmas, the acquisition of another C-17.

**Q25 Mr Curry:** And of course there has been quite a sharp recent decline in the pound as well.

**Sir Bill Jeffrey:** There has. I did not want to make too much of it but that is why I highlighted the currency issue in my opening presentation.

**Mr Curry:** You were quite right to do so.

**Q26 Mr Mitchell:** The main criticism seems to me that your governance arrangements with the Department were not fit for purpose to help you live within your means. Would that be a correct impression?

**Sir Bill Jeffrey:** I would not express it in quite that way. I think we have always had the means to manage the Equipment Programme. It has in particular been a responsibility of the post that Admiral Lambert now occupies, and in our annual planning rounds at departmental level we have addressed the Equipment Programme year by year. What I conclude from recent experience and from Mr Gray's Report in particular is that we should strengthen these arrangements, which is why we are introducing a sub-committee of our Defence Board, which I will chair with the Chief of the Defence Staff, the Vice Chief and my Deputy and the Finance Director to address the central issue of the affordability of the Equipment Programme on a regular basis.

**Q27 Mr Mitchell:** The way that the NAO expresses it is that unless the Department addresses its underlying budgetary and governance issues it will not consistently deliver value for money for the taxpayer—this is page 4, paragraph 3—or encourage commercial partners to operate effectively. Are these new arrangements going to achieve that?

**Sir Bill Jeffrey:** I would accept that judgment. I would say that we are addressing the governance issue in the way I described and that the fundamental question about what constitutes an affordable Defence Programme within the share of the nation's resources that we are likely to have is one that can only be addressed through the post-election Defence Review.

**Q28 Mr Mitchell:** The fundamental question, as my mother would put it, is that your eyes are bigger than your belly.

**Sir Bill Jeffrey:** I am sure that is the case.

**Q29 Mr Mitchell:** My mother would be very grateful—she is dead unfortunately. Why does the Investment Approvals Board not consider the affordability of the overall Equipment Programme you are embarking on when it approves each individual major investment? Why does it not look at the overall position?

**Sir Bill Jeffrey:** It does need to vouch for affordability and one of the changes we are making is that the sub-committee of the board that I will chair will set the conditions for affordability and make it clear what is affordable and what is not so that the Investment Approvals Board has an easier task. One of the underlying problems in this is judging what is affordable and what is not beyond the lifetime of the current Spending Review. We do not know for sure—or, indeed, at all—what the Defence Budget will be at the moment after 2010-11. So asserting that something is unaffordable, notwithstanding the figures in the NAO's Report, is not as straightforward as it might seem.

**Q30 Mr Mitchell:** Because you are not able to resolve this issue in the Department it now has to be left for a Defence Review, which, in a sense is too late because you have entered into all the commitments. This is effectively what paragraph 2 on page 4 says, that the decisions did not and could not resolve the underlying issue of affordability which would need to be addressed by the Department, working with Treasury, as part of the Strategic Defence Review which is expected after the General Election. So, effectively because you do not have the effective machinery within the Department it now has to be left for a national decision taken at a later date, by which stage costs have built up.

**Sir Bill Jeffrey:** I would not myself present it in that way, Mr Mitchell. I think what we have been doing in the last few years, as we must, is two things. One is to look to the extent that we could to shift money into projects that were operationally relevant to our current operations in Afghanistan and, before that, in Iraq. But the other—and it is my concern as Accounting Officer and this Committee's concern—has been to live within our budget. We have taken steps to do that. Some of them, as this Report illustrates, are suboptimal steps but we have done so. The underlying pressures within our budgets are ones which, as the NAO indicates, can only be resolved conclusively through the kind of Defence Review that is now planned by both Parties.

**Q31 Mr Mitchell:** Can I just ask the Treasury, given the fact that it is your objective to control spending and to ensure that it is managed effectively, when was the Treasury aware of the gap between the planned budget in the Ministry of Defence and the forecast spend?

**Mr Gallaher:** We have always realised that there is a different inflation rate within defence.

**Q32 Mr Mitchell:** But that has gone on for a long time.

**Mr Gallaher:** Also, we get a greater capability from the extra expenditure that we incur. But we also have to balance it with other priorities facing our nation and we will not detract from helping—

**Q33 Mr Mitchell:** That does not answer the question. When did you become aware of this gap and that their eyes had been too big for their belly?

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 Ministry of Defence
 

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**Mr Gallaher:** I think we have always been in close contact with the Ministry of Defence and we know when there are problems and issues—we will always know about them.

**Q34 Mr Mitchell:** But when did you become aware?

**Mr Gallaher:** I think we are always aware.

**Sir Bill Jeffrey:** I could answer that question, Mr Mitchell, because in some ways it is our expenditure colleagues in the Treasury who deal with this day by day rather than the Treasury Officer of Accounts. We are transparent with the Treasury about our year by year position and our colleagues who are responsible for controlling our expenditure have pretty full visibility of the position.

**Q35 Mr Mitchell:** Then the question to the Treasury becomes: why did you not do something about it?

**Mr Gallaher:** We do do something about it; we do balance the books. We try to listen to what the Ministry of Defence's priorities are and what their concerns are and we take that into account in the overall scheme of spending. We cannot just ignore the other priorities that we face as a nation.

**Q36 Mr Mitchell:** One of the problems, as you have said, is that the rate of inflation on defence projects is high and it is higher still if you delay the projects, which means putting money into the pockets of the contractors without a visible return. Are we in a situation where the Department can either afford these big projects or it can fight wars and give the troops proper equipment? Are those two incompatible situations? If you are going to have the projects you cannot fight the wars and if you are going to fight the wars you cannot have the projects?

**Sir Bill Jeffrey:** The reconciliation of these two requirements is part of the challenge we face. We have certainly over the last few years been heavily engaged operationally. The additional costs of that engagement have been met by the Treasury from the Reserve, but managing our core programme in such a way that we meet the cost pressures that I described at the beginning of the hearing, while simultaneously, as our ministers have very understandably wanted to, devoting more of it to the kinds of capabilities that are highly relevant to these operations, is one of the challenges that we have had to work through.

**Q37 Mr Mitchell:** How far would I be right in my prejudice, which is feeling that the projects are preparing for the wrong war? In other words, here are highly technical and expensive programmes to fight a war that we are no longer going to fight against a technologically advanced power, whereas we are fighting wars in Afghanistan in the burning bush.

**Sir Bill Jeffrey:** It is certainly one of the conundrums of defence planning that many of our investments are over long periods of time.

**Q38 Mr Mitchell:** Is this a question of the mentality of the Department—the mentality is we are going to fight this kind of war—whereas in actual fact we are

fighting another kind of war and therefore we are going to invest in high technology stuff for the kind of war that is in their heads?

**Sir Bill Jeffrey:** It is inevitably a balance. We would be making a mistake—and this will be an issue for the next Defence Review—if we simply stopped our military capabilities on the assumption that we will carry on doing nothing but what we have been doing recently. We have to prepare for other kinds of conflict and the challenge that the next Defence Review—as its predecessors did—will have to address is how does one strike the best balance between the longer term kinds of capabilities, which tend to be big equipment and what the Americans call “irregular warfare” which characterises much of what we are doing now.

**Q39 Mr Mitchell:** At the end of the day, with the Defence Review, something is going to have to give, is it not? Some projects are going to be scrapped. Is it possible to give us a list of the costs of cancellation of each of these projects?

**Sir Bill Jeffrey:** We could certainly try to provide the Committee with some information of that kind but the various industrial and commercial considerations that affect individual projects make it in some cases quite a hard assessment to make. But if the Committee would welcome some indication of that kind we can see what we could provide.

**Mr Mitchell:** We would be grateful if you could give us what list you can give. I would be grateful anyway, I do not know whether the Committee would be!

**Chairman:** We will have a note on that.<sup>1</sup>

**Q40 Mr Mitchell:** And a list of the costs of delay. Effectively it will be further delay, will it not? How much money are we shoving into the pockets of contractors because the project is delayed?

**Sir Bill Jeffrey:** The Report before us today gives us an indication of the cost consequences of some of the decisions to delay that were taken a year or so ago. The difficulty about speculating about cancelling other projects is that first of all it gives rise to a belief that we are just about to do so; secondly, that sometimes there are quite sensitive commercial considerations around them.

**Q41 Mr Mitchell:** I appreciate that, but do you have a list in the Department of junkability?

**Sir Bill Jeffrey:** A list of?

**Mr Mitchell:** Junkability—which projects could go? Let us not call it junkability, that is naughty; call it a list of priorities of things you must keep and things that could go. Have you drawn up such a list?

**Chairman:** He has a list but it is too sensitive for us to see it.

**Q42 Mr Mitchell:** I am asking if he has drawn it up.

**Sir Bill Jeffrey:** I was not saying that, Chairman. If things were junkable I tend to think that we would have junked them already. Addressing among the many high profile projects for which we are responsible where the highest priority is and where

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 Ministry of Defence
 

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the lowest priority is is very much the business of the Defence Review which we have spent some of this hearing discussing.

**Q43 Chairman:** I must just complete a line of questioning that Mr Mitchell was asking the Treasury. So we now know from the answer you gave, Treasury, that you have been aware of this imbalance for some time. I wanted to ask you what set of measures you have now put in place to redress this; but I accept that you do not deal with this day to day and so I think it is only fair that I ask Sir Bill this question. The Treasury being aware of the imbalance, what set of measures are they now putting in place to address this imbalance?

**Sir Bill Jeffrey:** We and the Treasury have discussed these issues throughout. I think that they have understood the dilemmas we faced in reaching decisions about where to take cost out of the Programme; and, as the Treasury Officer of Accounts has said, I have not sought to second-guess these judgments. Their main contribution to attempting to address this issue has been to agree in the last few months to an indicative planning horizon for equipment expenditure over the next ten years. I would not underestimate the importance of that because the key word is “planning”. We do plan the Equipment Programme over ten years, and indeed longer, but until we have such a run of figures which the Treasury stand over it is very difficult to judge whether that programme is affordable or not.

**Q44 Mr Carswell:** Sir Bill, the Report suggests that it is delays that tend to drive up costs and there is certainly a correlation between delays and cost increases. I want to ask you a series of questions to see whether the relationship between delay and cost increases was causal or something else. The A400M. I am sure you are going to say that you are not allowed to tell me but I will ask anyway: what is the latest expected cost per plane?

**General Sir Kevin O’Donoghue:** I would be very happy to talk to the Committee about A400M in confidence at the end, if that was acceptable.

**Q45 Mr Carswell:** Could you tell me what the cost is—it is the Committee of Public Accounts?

**General Sir Kevin O’Donoghue:** No, I really cannot publicly.

**Q46 Mr Carswell:** We can always go into private session at the end.

**General Sir Kevin O’Donoghue:** That is what I am suggesting. There was a ministerial meeting yesterday in Berlin. We are right in the middle of very detailed—

**Q47 Mr Carswell:** I believe it is north of £100 million. Could you tell me, Sir Bill, why did we not just buy the C-17, which would cost £70 million—we know that—and it would be bigger?

**Sir Bill Jeffrey:** We are acquiring C-17s; we committed to a seventh C-17 shortly before Christmas.

**Q48 Mr Carswell:** Because of non-delivery of the A400M.

**Sir Bill Jeffrey:** As far as the A400M is concerned it is a project for which we have various contractual and other commitments; therefore, we are negotiating in good faith in the way that the CDM has described. But, as he is, I am reluctant to get into commercially sensitive detail about the A400M project.

**Chairman:** If there is anything that you want to tell us in private, just park that to the end of the session.

**Mr Carswell:** For the record, I do not want to be bound; I am here to hold the Ministry of Defence to account and I do not wish to be bound by off-the-record briefings.

**Chairman:** Under the rules of the Committee.

**Q49 Mr Carswell:** So you cannot tell us how much for the A400M—and you cited contractual obligations as your reason for not going with the C-17. The Future Lynx. In December 2007 the minister refused to say how much that would cost; in January 2008 you revealed that it would be about £1 billion for 70. In July 2009 we were told it would be £1.7 billion—that is £0.7 billion more—and I now understand that it is something like £1.9 billion. The unit cost of these helicopters has increased because the number ordered has gone down, as the Report shows. We could have bought a combination of UH72s and MH60s for something like half the cost; why did we not?

**Vice Admiral Lambert:** There is a combination of reasons and one of the things we do need to look at when we are looking at the Equipment Programme is what the impact is on the other lines of development. The requirement for Future Lynx and its run-on of the older Lynx means that we can use similar training methods, we can use the same infrastructure, et cetera, et cetera, and so the requirement for Lynx across the piece, from both land and maritime does give a utility there which is met by the Future Lynx requirement.

**Q50 Mr Carswell:** I am not sure I understand that. Is it your view that it is good value for money for us to spend £27 million on a helicopter, which we could have bought for half the cost elsewhere?

**Vice Admiral Lambert:** Many of the costs—and I do not know if CDM wants to come in here—that you see as indicative costs we have looked at and there is often a number of modifications we need to do, and other things, and it is quite often that the indicative cost that one sees as a headline cost are not the same costs as we pay at the end of the day in the programme.

**Q51 Mr Carswell:** It is often said that one of the reasons why we went ahead with Future Lynx is sovereignty of supply. Can you tell me in which country the Allison motors that go into Rolls Royce engines are made?

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 Ministry of Defence
 

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**General Sir Kevin O'Donoghue:** No, I cannot.

**Q52 Mr Carswell:** Let me suggest that if we had bought Sikorsky we would have been dependent on one country but by buying Future Lynx we are dependent on two. I am surprised that you did not know that.

**General Sir Kevin O'Donoghue:** I am surprised that the Rolls Royce engines are not made in the UK, if that is what you are suggesting.

**Q53 Mr Carswell:** Allison, the contractor, is US-based. Sir Bill, is it your personal, professional and ethical judgment that it is acceptable for the former head of the MoD, your predecessor, who as Permanent Under Secretary was Permanent Under Secretary at a time when rival bids were in effect excluded, now sits on the board of a company that was given a £1.9 billion contract. Do you think that is ethically acceptable?

**Sir Bill Jeffrey:** I have no reason to doubt the ethics of my predecessor. I am a bit surprised that this Committee wants to get into that.

**Mr Carswell:** Can you see why some people might be a bit concerned about that? This is, after all, a Committee of Public Accounts.

**Chairman:** It is not really about major projects. You can answer if you want.

**Q54 Mr Carswell:** Future Lynx is a major project.

**Sir Bill Jeffrey:** I very much regret what is in effect a personal attack on my predecessor.

**Chairman:** We now have a division, and so I am afraid, Sir Bill, we will have to go and vote and we will come back as soon as we can—in about eight minutes' time or less, if we can. I am sorry to delay you.

*The Committee suspended from 4.13 pm to 4.18 pm for a division in the House.*

**Chairman:** We are quorate; Douglas Carswell is asking questions.

**Q55 Mr Carswell:** As I was saying, it is not a personal attack on anyone. As a Member of the Committee of Public Accounts I am looking to ensure that we get good value for money and that the MoD is good at turning our tax pounds into the equipment we need. Let me put it another way: will you look to put in place steps to ensure that the revolving door between those who work at the MoD and those who work for big contractors means that we get good value for money rather than poor value for money?

**Sir Bill Jeffrey:** The specific issue of civil servants and indeed military people taking up posts when they leave Government is quite a long way from the subject matter of this examination, but is one that is dealt with by the Advisory Committee to the Prime Minister that deals with these matters. What I took you to be saying, Mr Carswell, was that there is some question about the integrity of my predecessor and I

do resist that because it is, if I may say so, an unfair allegation to make. Again, it seemed, Chairman, some way from the subject matter of the MPR.

**Q56 Mr Carswell:** In any market where the supply is constrained the seller sets the terms of the trade. Do you think that perhaps one way of ensuring that there are fewer delays and fewer cost increases would be to remove some of the constraints on supply and perhaps allow General Sir Kevin or others a more off the shelf, less protectionist way of spending the money?

**Sir Bill Jeffrey:** I think one of the significant developments in defence procurement over, I would say, certainly the few years that I have been in this post but it goes further back than that, is to move away from an either/or; that one either competes everything internationally as well as domestically, or one is protectionist and insists that the requirements be met from within our own country. What we have increasingly moved towards—and it was set out very clearly in the Defence Industrial Strategy—is an approach in which the procurement approach is tailored to the individual case. In some cases there is an evident need to look to the internal market because of considerations of operational sovereignty, or because there is in effect only one supplier. In these cases we have to be relentless in getting in amongst that supplier, understanding the cost structure and establishing demanding partnerships. In others there is a lively international market and we ought to go to it to get the best deal we can.

**Q57 Mr Carswell:** Two more questions—if I have time for them, please—and it is tangential to the Report, but I will try my luck with the Chairman. Urgent Operational Requirements are more and more used. Would I be right in thinking that that is because Urgent Operational Requirements allow you to go out and buy what you want rather than what you are constrained to do by the Defence Industrial Strategy?

**Sir Bill Jeffrey:** General Sir Kevin may want to come in but it is not that; the definition of the Urgent Operational Requirements is in a sense what it says on the tin. The experience of actually being engaged militarily is that the enemy, as they say in military circles, has a vote. We learn through the campaign; we discover that equipment that we may well not have in our core programme is actually required. A very good example, to which we have responded more quickly than we are sometimes given credit for, is protected armoured vehicles and we use the Urgent Operational Requirements process with the Treasury's agreement to acquire these sorts of equipment. And we do so very quickly; it is not the standard equipment procurement process. I think that the teams concerned deserve great credit for the speed with which we do respond to these requirements.

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**Ministry of Defence**


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**Q58 Mr Carswell:** I would put on record that I repeat that I am not questioning anyone's integrity in the MoD. A final question, if I could get away with it. How much are you giving BAE for Mantis and why do you not just go General Atomics?

**General Sir Kevin O'Donoghue:** The reason we do not just go to General Atomics I would suggest is because that is a skill that we need to retain in this country. We must retain the ability to produce air vehicles of the future. We could debate whether they are going to be manned or unmanned; I suspect they will be unmanned in the future. But I think it would be a mistake to lose that capability just by going to General Atomics. Whether we do retain our sovereignty in conjunction with our European allies or not I think is a question—whether we join with the United States. If we lose that capability completely we will lose the skill-sets and we will lose the infrastructure and we will never be able to get it back. So I do think that we need to keep this going.

**Vice Admiral Lambert:** And we may not be able to run the Urgent Operational Requirements that we would want to in the future.

**Q59 Chairman:** Sir Bill, you told me earlier that the Treasury had given you a ten-year indicative programme. Can you tell me what the rate of growth is in that programme?

**Sir Bill Jeffrey:** I may have inadvertently misled you, Chairman. What we have agreed to in principle is that we should have such a ten-year planning line and the intention is that it should be one of the products of the Defence Review after the election.

**Q60 Mr Bacon:** To start with, I would just like to go back to this gap, where the Chairman started, Sir Bill. As I understand it, the gap in terms of the procurement budget in ten years' time will be £6 billion if the MoD assumption of 2.7% growth in the budget is maintained for each of the next ten years. Then in ten years' time the gap would be £6 billion; is that right? That predates my next question.

**Sir Bill Jeffrey:** Not quite, is the answer to that question. First of all, these figures relate to the whole Defence Programme and not just to the Equipment Programme.

**Q61 Mr Bacon:** When you say the whole Defence Programme, you mean the whole defence budget?

**Sir Bill Jeffrey:** Yes.

**Q62 Mr Bacon:** So if I take the defence budget and I grow it by 2.7% for ten years—2.7% each year—I get to a number which is £6 billion less than you would need to fulfil your procurement requirements?

**Sir Bill Jeffrey:** Which brings me to the second point I was going to make.

**Q63 Mr Bacon:** Sorry, is that right?

**Sir Bill Jeffrey:** Only if by 2.7% growth you mean an addition to the cash figure each year by 2.7%.

**Q64 Mr Bacon:** It is probably best to ask the National Audit Office about this.

**Sir Bill Jeffrey:** We are not talking about real terms growth.

**Q65 Mr Bacon:** Let me just clarify this with Mr Banfield. What is the number that grows by 2.7% each year and in ten years' time results in a £6 billion shortfall?

**Mr Banfield:** It is an increase of 2.7% each year cumulatively.

**Q66 Mr Bacon:** In the?

**Sir Bill Jeffrey:** In the cash figure.

**Mr Banfield:** Yes.

**Q67 Mr Bacon:** In the cash figure of the entire defence budget?

**Mr Banfield:** Yes. So we go from the end of the current Spending Round—

**Q68 Mr Bacon:** If I grow that at 2.7% for ten years I end up with a number which is £6 billion less than required for?

**Mr Banfield:** For the defence budget.

**Q69 Mr Bacon:** For the procurement bit or for the whole thing?

**Mr Banfield:** For the whole thing.

**Q70 Mr Bacon:** And if it is flat then I am £36 billion adrift?

**Mr Banfield:** Yes.

**Q71 Mr Bacon:** Sir Bill, 2.7% growth is 27 times larger than the current growth of the economy, which is 0.1% we heard yesterday. So you are not going to get 2.7% per year for the next ten years, obviously. What are you going to do?

**Sir Bill Jeffrey:** This is why rather tiresomely I drew out the point that we were talking about a 2.7% cash increase. It is not a real terms increase. That base assumption, which I agree is questionable given the general economic conditions, simply assumes that there is a general provision for inflation in the underlying provision each year; in other words, that the defence budget does not grow in real terms at all. That compares, for example, with the last ten years in which it has grown, in real terms in addition to inflation, by about 1% per year or so—a little more than that in some years. So in the jargon that we tend to use internally that scenario is "flat real". It means that you preserve the purchasing power on a very general assumption about inflation.

**Q72 Mr Bacon:** The 2.7 is flat real?

**Sir Bill Jeffrey:** Yes. It also means, incidentally, that the Defence Programme—

**Q73 Mr Bacon:** I am sorry, my question is: given that you are not going to get that—and it is blindingly obvious that you are not going to get that because even flat to real, 2.7% is 27 times larger than the present growth of the economy, as of the announcement yesterday—what are you going to do?

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 Ministry of Defence
 

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**Sir Bill Jeffrey:** Ten years is a lengthy period and the alternative assumption that the NAO Report offers, which is so-called flat cash—in other words, we reduce year by year the size of the Defence Programme by a couple of percentage points or so, between 2% and 3%.

**Q74 Mr Bacon:** Hang on. Mr Banfield, I understand flat cash to mean the money they have now they continue to get in cash and no more—it is what is used to be called cash limits in the early 1990s; is that right? So that means that you have the same amount of money that you had but because of defence inflation and stuff you end up practically having to cut things.

**Sir Bill Jeffrey:** Not because of defence inflation, because of general inflation.

**Q75 Mr Bacon:** Because of inflation anyway, which we hear is worse than—

**Sir Bill Jeffrey:** The £36 billion—and the Comptroller and Auditor General knows that I would have preferred it not to be cited in this Report—

**Q76 Mr Bacon:** I bet you would!

**Sir Bill Jeffrey:** --- because it makes a pretty arbitrary assumption about a very long period. The £36 billion assumes that—

**Q77 Mr Bacon:** Hang on a minute! You would have preferred it not to have been cited because it makes an arbitrary assumption about a pretty long period. What it actually does, surely, which is what you are uncomfortable about, is that it holds your feet to the fire and says, “Here are the consequences of your present spending decisions, either if spending remains where it is now or if it does not even grow in line with inflation.” That is all it does; and that is useful information for Parliament and the public to have.

**Sir Bill Jeffrey:** One could speculate about—

**Q78 Mr Bacon:** What you have been doing for years is robbing Peter to pay Paul and ducking and hiding and weaving with apparently the connivance of the Treasury, because the Treasury seems to have been *au fait* with what you have been doing, and the thing that this Report has done, and which caused such a stir when it was published, is made things clear. That is all it has done, has it not?

**Sir Bill Jeffrey:** My only point, Mr Bacon, is that the £36 billion figure assumes that year by year for the next ten years the real purchasing power of the defence budget reduces by between 2% and 3% and there is no provision at all for general inflation, pay increases—nothing. I do not know whether that is a realistic assumption or not, but to work round to the answer to your original question: what we do is we have a Defence Review.

**Q79 Mr Bacon:** It just describes the extremes, the two bookends, the parameters—

**Sir Bill Jeffrey:** Precisely.

**Mr Bacon:** And that is actually useful information. Obviously nobody expects it to be £36 billion because you will take decisions which will mean that it will not. But it describes in a way that I think is quite helpful for the general public and for debate and for Parliament the universe within which you are operating. But the fact that you did not want it to be cited I think tells us a lot about the way you have been doing business for years and years.

**Q80 Chairman:** The Comptroller and Auditor General would like to comment.

**Mr Morse:** First, in our Report we characterised it as an illustration, not a prediction. I think that is right, is it not?

**Mr Banfield:** Yes.

**Mr Morse:** Secondly, I do not regard it as by any means the extreme end of what we could have put in the Report had we wished to be alarmist, to be quite frank. Because if you actually look at public comments made by a number of bodies about what they would expect to happen over the next four years, if there was a much more severe regime in only the next four years the rate of subsequent growth in the budget required to retrieve that would be in double digits, and that is quite an unlikely event. So we took a view, understanding—and we had long discussions with the Department about it—the implications that in the interests of reality it was necessary to produce some actual concrete number to illustrate the scale that we were potentially talking about.

**Q81 Mr Bacon:** That is a very interesting phrase, Comptroller and Auditor General—“in the interests of reality”. I am glad that the NAO has published this figure; it is reality which the MoD has been hiding from for a long time, is it not? Ducking and weaving and if there is a problem with an Equipment Programme that is supposed to take eight years you suddenly say, “We will just have it take nine years” as if somehow time is a free given. I find these figures absolutely staggering. I was at a breakfast yesterday and John Hutton, who used to be Defence Secretary was speaking, and one of the things he said was that in the public sector ministers and civil servants often talk about £200 million as if it is just a small sum of money that is neither here nor there. “It is not,” he said; and he is right. But we are talking here about £674 million which are net cost increases, according to this Report on page 5, purely attributable to the decision to delay. Not bad management, bad project management or anything else. Could you explain to me the nature of this net increase of £674 million? Is that mainly extra payments that you are being required under the contract to make to the contractor because they are going to have their shipyard tied up for a year longer than they thought of and, and, and, or what?

**Sir Bill Jeffrey:** It is broadly payments of that sort and because the expenditure will be incurred over a longer period there is a substantial element of inflation in it as well. The General might want to comment.

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 Ministry of Defence
 

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**General Sir Kevin O'Donoghue:** That is correct.

**Q82 Mr Bacon:** A “substantial element of inflation”; how much inflation? It is only one year extra, is it not? Or how many years extra is it? The decision to slow the rate of manufacture of the Queen Elizabeth Class aircraft carriers is leading to this net increase of £674 million; that is a decision to slow the rate of manufacture by how many years?

**Sir Bill Jeffrey:** Between one and two years.

**Q83 Mr Bacon:** So between 12 and 24 months. So when you say “substantial extra inflation”?

**General Sir Kevin O'Donoghue:** £250 million<sup>2</sup>.

**Q84 Mr Bacon:** Of extra inflation?

**General Sir Kevin O'Donoghue:** Of extra inflation over the two years.

**Q85 Mr Bacon:** Really? What is the total cost of the aircraft carriers?

**General Sir Kevin O'Donoghue:** £5.3 billion.

**Sir Bill Jeffrey:** Somewhat in excess of £5 billion.

**Q86 Mr Bacon:** 250 divided by £5 billion gives you 5%, so you are assuming 2.5% inflation per year for two years on all your costs, in addition to the extra payments you have to make to the manufacturer; is that right?

**Sir Bill Jeffrey:** To be clear, Mr Bacon. I am not for a moment—and I hope it was clear from my answers to earlier questions—arguing that this was a decision we would have made in any other circumstances. It is a decision which ministers took, presented with a range of options . . .

**Q87 Mr Bacon:** Can you just remind us when was the decision taken to slow the rate of manufacture.

**Sir Bill Jeffrey:** It was taken in the latter part of 2008.

**Q88 Mr Bacon:** I know that it was seven months after the contract was signed but exactly when was the decision taken?

**Sir Bill Jeffrey:** The latter part of 2008.

**Q89 Mr Bacon:** The credit crunch started in September. Northern Rock, which this Committee took evidence on, was September 2007. It was very clear there was a problem by much earlier in 2008 than December 2008. It was clear that tax revenues were dropping off the cliff by much earlier than that. What I find difficult to understand is why you signed the contract to commit you to this stuff and then, only seven months later, you commit yourself to a slowing down which will cost you an extra £674 million. The education budget for the county of Norfolk—not just my constituency but for the whole of the county of Norfolk—is £434 million for a year. This is more than that. It would pay for all of that for a couple of years or a year and a half. If you add on the Astute, the extra cost delays from that, it would pay for all the education of all the children in Norfolk for two and a half years. These are

staggering sums of money and you almost do it casually. How can you sign a contract and, only seven months later, reach a decision with such calamitous consequences for the public purse? I realise it was because ministers decided to but you are advising ministers.

**Sir Bill Jeffrey:** This was certainly not remotely something that was done casually. It was the considered reaction to the kinds of budgetary pressures I described earlier in the session, in a situation in which the options which would have had a more damaging effect on longer-term military capability were extremely unattractive to ministers, for obvious reasons; particularly given that we had not had a Defence Review for some time and in which there was also a strong and understandable desire to redirect resources towards more operationally relevant priorities. Presented with a range of ways in which we could take cost out of the programme, ministers at that time decided that, sub-optimal as it is, for all the reasons we are discussing this afternoon, delaying the carrier was least bad.

**Q90 Chairman:** Sir Kevin, put it this way: if you change the period of the contract, does this not undermine your ability to protect the MoD's interests?

**General Sir Kevin O'Donoghue:** It makes it more difficult to hold the contractors feet to the floor.

**Q91 Chairman:** If so, why have you not personally resisted these decisions?

**General Sir Kevin O'Donoghue:** I am not sure it is up to me to personally resist them.

**Q92 Chairman:** Who is it then?

**General Sir Kevin O'Donoghue:** These are decisions by ministers, who chose to spend more money on other sorts of capability, particularly for current operations, than on the aircraft carriers. That is a political decision; that is a capability requirement.

**Q93 Nigel Griffiths:** There is a lot of emphasis on the role of helicopters in modern defence requirements and the likely future role of them. I am a little concerned that at paragraph 2.11 on page 26, “The Department did not undertake formal operational analysis on the impact of the reduction”—of the Lynx Wildcat flying hours. Why was that?

**General Sir Kevin O'Donoghue:** I am sorry, could you give me the reference?

**Q94 Nigel Griffiths:** Page 26, 2.11, the last three lines.

**Sir Bill Jeffrey:** I think all this sentence is saying is that when the Equipment Examination, which we have discussed earlier in a much higher profile context, namely the decision on the carrier, was being undertaken, the option of reducing the flying hours of the Lynx Wildcat was on the table and there was military advice available to the effect that it was a manageable reduction; but, as the NAO brings out, there was not a formal operational analysis as such.

<sup>2</sup> Note by witness: The correct figure is £374M

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 Ministry of Defence
 

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**Vice Admiral Lambert:** There are lots of ways of doing operational analysis. One way is to use a Military Judgement Panel; another way is to do it in a scientific way, of looking at a whole series of criteria.

**Q95 Nigel Griffiths:** What is a Military Judgement Panel?

**Vice Admiral Lambert:** It is, like this room, full of people who are experts, asking them their views, voting accordingly, and you get a series of subjective views which brings it up to a more objective way of looking at a problem.

**Q96 Nigel Griffiths:** Not that in particular but what the issue highlights, for instance of the Lynx and the Merlin and reflected in figure 10 on page 21, seems to be a sort of mix of available cuts or delays to meet the money. Was it considered that one big hit might be a better way of achieving this *i.e.* cancelling the QE Class aircraft carriers.

**Sir Bill Jeffrey:** I can hear Mr Davidson coughing! In a way, it brings us back to the point I was making earlier, which is that we have faced these cost pressures over a period when there has not been the kind of strategic review that you would expect to have before making major decisions that would reduce military capability substantially long-term. It is inevitably a consequence of that, I fear, that when we faced this issue a couple of years ago—and we have done almost annually in the last few years—we were looking at less dramatic but none the less cost-reducing measures such as the two you have just referred to. What we try to do is to manage that process in a manner that has the least adverse impact on military capability overall.

**Q97 Nigel Griffiths:** Yes, but it does seem plain on the Lynx that the reduced numbers are not sufficient to meet military tasks.

**Vice Admiral Lambert:** I would disagree with that. I think that, as we see in theatre, some of the military tasks, ie the intelligence collection-type tasks, the ISTAR-type tasks that Land uses helicopters for, will be delivered by other means. We have seen some of that task being done by unmanned air vehicles. The maritime task will be a combination of both Lynx and Merlin, and I think we will end off with the number of Lynx that we require.

**Sir Bill Jeffrey:** Perhaps I may add that I also understand it to be the case, and the Admiral will tell me if I am wrong, that to some extent the reduction in planned numbers was achieved through some rationalisation of the Army and the Royal Navy variants of the Lynx Wildcat; so that, between the two Services, it was possible to deliver similar outputs with fewer aircraft.

**Vice Admiral Lambert:** It is combining the training requirements and other lines that allow us to reduce the amount of equipments that we require.

**Q98 Nigel Griffiths:** You have raised unmanned vehicles and figure 15 gives a very good, simple chart for the layman on that. However, there is not good information on the overall costs of the programmes.

Is that defensible? If these are such, as I read, a great way forward and especially a way of protecting the lives of both pilots and others, why is there not good information on overall costs of the programmes?

**Vice Admiral Lambert:** We can provide the numbers for Watchkeeper.<sup>3</sup> That programme is delivering and will deliver to theatre at the latter part of this year. We have another programme which is called DABINETT, and we can let you know the amounts that we have allocated in the order of magnitudes towards DABINETT for the future.<sup>4</sup> We also have urgent operational requirement for delivering Reaper into theatre.

**Q99 Nigel Griffiths:** What has been the problem? Why did the Programme Boards not have good information, as the Report says?

**Vice Admiral Lambert:** I think they have good information on Watchkeeper. The issue is that the requirement for the more strategic unmanned air vehicles such as Reaper, and in the future DABINETT, has come in reasonably quickly during this particular campaign. Therefore, they would not have had the numbers for the in-year requirements and the requirements over the short term.

**Q100 Nigel Griffiths:** What about the Falcon communications system? Why has that been downgraded in importance?

**Vice Admiral Lambert:** I do not think it has been downgraded in importance. What has happened with Falcon is that, like many of the equipment programmes, we have to look at the priorities across the piece. Every year we do look at the priorities we give these equipments and, in a constrained budget, we have to look at where we invest our money and where we disinvest from. At the end of the day, however, we are trying to deliver the capabilities to meet defence policy as currently laid down.

**Q101 Mr Davidson:** Can I ask whether or not, if the aircraft carrier had gone originally to plan, the Joint Strike Fighter would have been ready to go on board it?

**Sir Bill Jeffrey:** It is quite a difficult question to answer, because we make estimates and sometimes, as this Committee knows well, they end up changing. Certainly part of the judgment at the point when the decision to delay the aircraft carriers was taken was that—and I put to one side the important arguments about value for money that we have heard this afternoon—in capability terms we were unlikely to lose much, if anything, because the aircraft carriers would still be delivered at around the time when we were expecting the first Jump Strike Fighters to be delivered.

**Q102 Mr Davidson:** Let me be clear. You now expect the aircraft carrier to be delivered around the time, I think you said, when the first Joint Strike Fighters are available—which effectively means that, had the

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<sup>3</sup> Ev 16

<sup>4</sup> Ev 16

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 Ministry of Defence
 

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Government not changed the schedule for the aircraft carriers, you would have built two aircraft carriers and not had any planes to put on them.

**Vice Admiral Lambert:** We have Harriers on our current aircraft carriers and the Harriers can go on the future aircraft carriers and, when Joint Strike Fighters come, Joint Strike Fighters will take over the Harriers' role.

**Q103 Mr Davidson:** But the plan is to have the new carriers and the new planes and, in fact, had you gone according to schedule you would have ended up with the new carriers and the old planes.

**Sir Bill Jeffrey:** That is true, although—

**Q104 Mr Davidson:** So in those circumstances it is not unreasonable to accept the delay in the new carriers?

**Sir Bill Jeffrey:** In capability terms that is why we considered that it was lower impact than other things that were being examined; because in capability terms we could continue in service, as the Report brings out, the existing class of carriers for a year or so longer.

**Q105 Mr Davidson:** Can I ask the National Audit Office whether or not that particular point was taken into account in establishing whether or not the delay was value for money?

**Mr Morse:** Yes, it was.

**Q106 Mr Davidson:** What conclusion did you draw?

**Mr Morse:** That the issue is that, seven months after deciding to deliver the carriers over the one period, to extend it by a year still drove very substantial cost growth. I do not think, Mr Davidson, that there was—unless the MoD wants to enlighten me—an enormous amount of new information about when the Joint Strike Fighter would be available during that time. General Sir Kevin O'Donoghue is nodding. That is my understanding, therefore.

**Sir Bill Jeffrey:** Perhaps I could clarify a little, subject to Sir Kevin's views on this. I do not think it was so much that the Joint Strike Fighter was slipping, so we might as well slip the carriers; it was more that, at the time when we had to address the option of delaying the carriers, we could be confident that even by delaying them we would still deliver them at around the same time as the Joint Strike Fighters were being delivered.

**Q107 Mr Davidson:** The new planes could not fit on the old carriers but the old planes can fit on the new carriers?

**Sir Bill Jeffrey:** Correct.

**Q108 Mr Davidson:** Can I clarify about the next set of orders for shipyards? My understanding was that, if you had not delayed the carriers, you would have basically run out of work for the shipyards; because the Future Surface Combatant was not coming along until a later period and that that effectively would have meant that the shipyards, which is an

integral part of the Defence Industrial Strategy, would have had no work for a period, unless work had been found.

**Sir Bill Jeffrey:** I do not think we are as yet clear enough about the timescales for the Future Surface Combatant to confirm that in terms. I certainly do not think that we could have justified the delaying of the aircraft carrier construction on grounds of industrial continuity, although undoubtedly by doing so we will keep the yards occupied over that period of time.

**Q109 Mr Davidson:** Given that it is part of the Defence Industrial Strategy to keep the shipyards open in order to retain that capacity, what else would you have put in had the second carrier been launched in 2016?

**General Sir Kevin O'Donoghue:** As I am sure you are aware, there are three classes of the Future Surface Combatant. The right way to go for capability reasons is the way we are going, which is the Class 1 and the anti-submarine warfare frigate as the first in line. We could have put the third-class or the second-class in first. Shorter design time would have kept the shipyards—

**Q110 Mr Davidson:** So it would have gone in in 2016?

**General Sir Kevin O'Donoghue:** There are a number of levers we could have pulled to keep the skill sets up in the dockyards for when we were ready to put the Future Surface Combatant in.

**Q111 Mr Davidson:** Would there have been cost implications if you had moved the Future Surface Combatant forward to 2016? Would it have been affordable?

**General Sir Kevin O'Donoghue:** I do not know but I do not think we would have wanted to do that, because there is a finite design time to design the ships before you—

**Q112 Mr Davidson:** If you did not do that, you would have a gap and the shipyards would have no work.

**General Sir Kevin O'Donoghue:** No, because we could have put a simpler ship in—a ship that is simpler to design—such as the Class 2 or the Class 3 ships. That is why I say there are a number of levers we could have pulled. In the event, we did not have to and we are doing the right thing.

**Sir Bill Jeffrey:** I am tempted by your line of question, Mr Davidson, because it would be nice to be able to say that this slippage made that kind of industrial sense, but I do not think that was the driving motive.

**Q113 Mr Davidson:** Could I ask about the Type 45? Am I right in thinking that during the most recent period the cost of the platforms has come down because of early delivery?

**Sir Bill Jeffrey:** I think this Report brings out—and Sir Kevin might want to say something about the more recent period than this Report covers—that, after all the vicissitudes of the past, which we have

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 Ministry of Defence
 

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been into with this Committee, in the year covered by this Report the estimated cost remained absolutely steady and in fact we will get delivery of the first in class some months earlier than we had previously been assuming.

**Q114 Mr Davidson:** Yes, but saying the costs are steady, it is a decrease in the platform cost and an increase in the systems cost, is it not? So the two balance themselves out effectively.

**General Sir Kevin O'Donoghue:** You are right, the cost is coming down now—not over the period of this Report—but that is a reduction in the cost of capital and a reduction in inflation because they have come in earlier than we thought.

**Q115 Mr Davidson:** Can I clarify and seek some help on this, because there has understandably been quite a lot of focus on the bow wave effect, so to speak. Perhaps we can strip out the bow wave effect; because it seems to me that questions of delay because of ministerial decisions are in a sense political and to some extent some of those are beyond the remit of this Committee. As to the underlying costs, as it were, I am not clear whether or not projects have been kept better under control than they have in the past—because we have had some of the legacy projects, which were horrendous, and we have discussed that over a period. I now find it very difficult to see whether or not, leaving aside the bow wave stuff, things are much better than they were.

**Sir Bill Jeffrey:** Two points on that. The first is that, to quote the Report at paragraph 10, “Taken together, these cost and timescale indicators suggest that project control has improved in 2009”. As I said at the very beginning of the session, we are not there yet by any means but I take some comfort from that. On the bow wave, I guess it is always the case that in the early years of a ten-year period there are more identifiable commitments than in the later years. The sort of picture one sees therefore has that hump in it. I think that, to attempt to answer more completely the question Mr Bacon put earlier, I certainly do not dispute that if you examine our essential estimate of the existing programme and set it against likely outcomes in terms of planned expenditure, the next Defence Review will have to address a very significant affordability issue.

**Q116 Mr Davidson:** Absolutely. It seems to me that the whole question of affordability is for another place. We ought to be discussing whether or not you are improving the cost management and time management of the existing projects. Apart from the bow wave effect, unless I am mistaken, you are doing much better than you have in the past.

**Sir Bill Jeffrey:** I believe so and I do not think that is something we are complacent about. I do not think the CDM is complacent about it for a moment; because, as Mr Gray's report brought out, there are still issues for us to address about cost estimation in particular. I think a lot of the effort in the Defence Equipment and Support organisation at the moment is around building authoritative cost estimation

centres that are not in the project teams themselves, building skills and estimating the costs, should-cost techniques and that kind of thing. I think that for all sorts of reasons, as Bernard Gray observed, there is a tendency in our organisation to be over-optimistic about cost, and that is the source of some of the problems that we have been discussing this afternoon. We have to get better at that. I think we are getting better at it and there is some evidence in this Report to support that.

**Q117 Mr Davidson:** Some of my colleagues have touched on this point already but this seemed to be very important. Once you start negotiating with suppliers with whom you have signed contracts, the real danger then is that they just take you for a ride, because they have got you over a barrel; you have signed the contracts and so on. To what extent are the contracts that you have now much more open-book and much more partnership than they were, so that you can avoid being exploited in a way that perhaps you have been in the past?

**Sir Bill Jeffrey:** I think—and there are one or two individual inquiries that this Committee has undertaken which have demonstrated this—that, where we have succeeded in turning projects with longstanding problems round, it has been because we have moved from imagining that with a contract of a particular kind we were transferring risk to the supplier when we were not actually, into something more like a partnership in which there is a greater transparency and there is a genuine sharing of risk, and the supplier is incentivised to reduce costs in our interests and his own.

**Q118 Mr Davidson:** Can you point to any example here where there is clear evidence that risks were transferred to the supplier and the supplier suffered?

**General Sir Kevin O'Donoghue:** I am not sure about the supplier “suffered”.

**Q119 Mr Davidson:** You see, unless you see blood on the floor or pain you have no evidence really that your risk has been transferred.

**General Sir Kevin O'Donoghue:** No, I think we do transfer costs and some of the in-service support cost contracts are very good examples. Rolls-Royce, we tend to buy power by the hour, for availability. We incentivise them to build in reliability in the engines. A very good example—there is a sign in the Rolls-Royce aero engine operation centre from Rolls-Royce management to their workforce, “Remember! Spares are now a cost, not a profit”. This is the behavioural change that we are trying to develop with this change in the way we do business. You are absolutely right. Open-book accounting: gain share; an agreement to look at the prices and the profit margins; contracting for availability; start small; contracting for availability of spares; go for platform availability and then go for mission availability. Completely open-book accounting. That is the direction we are going in.

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 Ministry of Defence
 

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**Sir Bill Jeffrey:** An area of the Report we have not touched on this afternoon but is one of the new elements of it is the examination of five significant in-service capabilities where, over the year, we saw an overall decrease in costs of £274 million.

**Q120 Chairman:** Admiral, you are head of capability. There is nothing new about this problem of affordability, is there? You were aware of it at the time that you committed to the carriers and the Joint Strike Fighter, were you not?

**Vice Admiral Lambert:** I think that the problem with affordability has increased year on year. We have always said that each planning round is worse than the last. I think that we are now at the point where there are some major issues and those issues can only be addressed through a defence type of review.

**Chairman:** There are a couple of supplementaries, first from Mr Bacon and then Mr Mitchell.

**Q121 Mr Bacon:** Sir Bill, I have one question about the comment you have just made. You said that we have had a tendency at the Ministry of Defence to be over-optimistic. Do you use the techniques of optimism bias in project appraisal? They are well established and have been for years. I see the Treasury Officer of Accounts laughing. I remember being in a seminar at the Treasury years ago where optimism bias was discussed. I do not know how widespread it now is in its use in project appraisal throughout Whitehall, but it has been around for quite a few years. Do you use it?

**Sir Bill Jeffrey:** We do. Whether we call it that or not, we certainly do it. As I said earlier, we are consciously building skills in cost estimation and creating within the Department an independent cost assessment function, whose assessments of cost will be authoritative and will be the only ones that we work to.

**Q122 Mr Bacon:** General, you looked like you were about to say something.

**General Sir Kevin O'Donoghue:** I think that is absolutely right. Where I think we got it wrong in the past is that there have been more than one set of costs and they are suppressed. The frontline wants the kit; industry wants to sell it to us; my teams in the past have perhaps been over-eager to get on to the point—

**Q123 Mr Bacon:** It is not unfamiliar. This is the world. If you are buying a car, there are different sets of costs. Actually, there are different sets of lawyers, depending upon what advice you want as well. It is a common theme.

**General Sir Kevin O'Donoghue:** What we have done now is set up a cost estimation organisation, which Lord Drayson has decreed will be the one and only true cost that we will all use. That will be an independent cost estimation.

**Q124 Mr Bacon:** You say that “will be”, when will it be set up?

**General Sir Kevin O'Donoghue:** It is set up already, but it is not big enough to look across more than the major Cat A projects. It needs to be able to look at the Cat A and Cat B projects; it needs to give the Admiral independent advice on cost.

**Q125 Mr Bacon:** Just for the clarification of the Committee, what is a Category A and a Category B project?

**General Sir Kevin O'Donoghue:** Cat A is over £400 million, Cat B is over £100 million.

**Mr Bacon:** So Mr Hutton was right, was he not? You need not answer that!

**Q126 Mr Mitchell:** Optimism bias is about all that has kept me going for 30 years as a Back Bencher! I want to ask about pessimism bias. We seem agreed that there is a kind of affordability gap, whether it is £36 billion or the IPPR £80 billion. The Report summary on page 4, paragraph 2, says that this will “need to be addressed . . . as part of the Strategic Defence Review which is expected after the General Election”. The general election is 6 May. The Secretary for Defence told us that. I announced it before, well before. However, a Defence Review takes several months, say the end of the year at the earliest. Now there is a year's saving that you could make—and these are quite substantial savings—by cancelling projects now. Is that not possible?

**Sir Bill Jeffrey:** First of all, I am in no position to confirm or deny the date of the general election! However, the shape and timing of a Defence Review will depend on the outcome of the general election. My assumption is that it will take most of the rest of the current year, but a great deal depends on what ministers of the day decide. It is always open to us—and this is the dilemma we faced in the period that we have been discussing—to decide to cancel things without the benefit that a Strategic Defence Review provides. As a matter of fact, observable fact in the last few years, we have not done much of that. I suspect, as close to an election as we are now, ministers, both before and after the election, will conclude that the right thing to do is to have the thoroughgoing examination that a review enables, but do so against the fiscal context that we have been discussing this afternoon.

**Q127 Mr Bacon:** If you are doing your job, Sir Bill, you and your staff will be writing various possible Defence Reviews so that, on day one, whoever takes over as Secretary of State for Defence will have handed to him his options, will you not? If you were doing your job, would you not be doing that now?

**Sir Bill Jeffrey:** I hope the Committee has some confidence that I will be doing my job, but we do. We will be trying to prepare ourselves so that we can hit the ground running in support of whichever ministers emerge from the election. Indeed, the approach that the present Defence Secretary has taken, which is to ask us to prepare the Green Paper which he plans to publish next week, and to prepare it with the assistance of an advisory forum that he has put together with representatives from the other two political parties, has been administratively very

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 Ministry of Defence
 

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helpful to me; because it means that in these last few months, in preparing the Green Paper, we have been able in a non-partisan way to do some of the essential preliminary work that will enable us to get stuck into a Defence Review very quickly after the election.

**Chairman:** Mr Carswell asked you a couple of questions that you said you would be happier to reply to in private. Mr Carswell has told me that he does not want to move into a private session. He does not approve of them and he might blab afterwards.

**Mr Carswell:** I will blog rather than blab!

**Chairman:** That has killed off his chance of ever being given a job by any part of the establishment!

**Mr Carswell:** Good!

**Chairman:** And he says “good” to that! But before we finish I have one final question to put to you, which I suppose sums up. Frankly, the budgetary and governance arrangements of your Department, Sir Bill, are unacceptable to this Committee. Will you commit yourself to gearing up your entire

Department to redressing this budget deficit and achieving a balanced budget in your Department, whatever financial settlement you receive over the forthcoming years?

**Q128 Nigel Griffiths:** A planned budget in our time.  
**Sir Bill Jeffrey:** I do, Chairman, and I would say two things. The first is that I hope it has been clear from this session that the management of the defence budget over the last few years, for all the reasons I started with, has been extraordinarily difficult. I think some of the changes we are now making institutionally—and I do point to the ten-year programme as being a means of planning more effectively than it is possible to do with only, at best, a three-year horizon—these are changes that should enable us to improve the position significantly. The only proviso I would add is that, in the end, having a defence programme that is manageable within the resources provided depends on ministerial decisions about the content of that programme.

**Chairman:** Thank you, Sir Bill, Sir Kevin, Admiral.

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 Supplementary memorandum from Ministry of Defence
 

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Question 39 (Mr Mitchell): *List of the estimated costs of cancellation of individual projects*

On reflection, we do not think it would be right to offer the Committee estimates of the cost of cancelling individual projects. To do so would inevitably be speculative, and would undermine our commercial position in the event of such negotiations with industry.

Question 98 (Nigel Griffiths): *Overall Cost of Programmes*

#### WATCHKEEPER

The total procurement cost for WATCHKEEPER is £895 million. The Whole Life Cost over 30 years is predicted to be £4.65 billion.

A total of 54 air vehicles will be procured, up to 30 of which would be deployed on Operations at any one time, with 24 to be held as a sustainment fleet.

#### DABINETT

The DABINETT programme will deliver the software for managing the collection, analysis and sharing of UK intelligence. One element of that programme was a collect function described as the “Deep and Persistent” capability. The Deep and Persistent (UAS) element from DABINETT will be taken forward as the Operational Unmanned Aerial System (OUAS) programme. The OUAS Programme is currently in the Concept Phase, with the aim to achieve Initial Gate approval in July 2010. The In Service Date is planned for December 2015 and Full Operating Capability to be achieved by December 2021. OUAS estimated procurement costs are £640 million near cash; this does not include Whole Life Costs. Initial pre-assessment phase assumptions suggest we need to procure 18 platforms to provide the required capability.