

PERMANENT SECRETARY

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12 January 2021

Meg Hillier MP
Chair of the Public Accounts Committee
Sent electronically

Dear Chair,

EQUIPMENT PLAN 2020-2030: UPDATE ON AFFORDABILITY

I wrote to you last year to explain that in place of a full Equipment Plan financial summary report for 2020, we would provide the Committee with a concise summary of the Equipment Plan funding position for 2020-2030 with supporting data.

This letter and the enclosed tables provide the department's update and will be made available to the public on the gov.uk site alongside previous Equipment Plan reports. The enclosure provides continuity of financial reporting from previous years, including an update to the Project Performance Summary Table of major projects.

This assessment presents the affordability of our plans in April 2020, before the announcement of additional funding in the Spending Review and decisions being considered through the Integrated Review to match our ambition to our resources. The NAO have again worked alongside us to review our plans and published their report today. I want to thank them for their continued support on this work, which continues to help us improve our management of the Equipment Plan.

Fiscal and economic context

This note presents the affordability of our spending plans for equipment procurement and support at 1 April 2020, which were developed through our annual financial planning exercise following the outcome of Spending Round 2019 (SR19) last autumn. It does not therefore recognise the implications of the Covid-19 pandemic, which is having a very significant effect on the economy including the defence sector. We are monitoring the situation and its effect on the department and industry partners closely, and will review our plans in this context over the coming months.

This assessment also does not reflect the outcome of the Spending Review last month, in which the government announced an increase in defence spending of over £24 billion in cash terms over the next four years against the 2020-21 budget. This settlement provides

us with the certainty we need to proceed with a once in a generation modernisation of the Armed Forces and to move Defence onto a sustainable footing. This investment was the first outcome of the Integrated Review of the UK's foreign, defence, development and security policy. The full conclusions of the Integrated Review will be announced later this year.

Our approach to assessing affordability

We assessed the cost of our plans for equipment spending on a directly comparable basis to last year, using forecast costs provided by budget holders responsible for delivering these plans and using estimates of potential variations in these costs. These forecasts included reductions for plans to reduce costs through savings and for estimates of delivery realism.

The basis on which we have estimated the budget available for equipment spending has changed from last year due to differences in our approach to setting budgets in 2019-20. Expecting a multi-year Spending Review later in the year, our priority was to set balanced budgets for 2020-21 and retain choice for longer term spending decisions to be made as part of a future Defence and Security Review and Spending Review. We therefore set all parts of the Department a budget planning assumption of 0.5% real growth from 2020-21, consistent with the government's commitments on Defence spending. We used the portion of this planning assumption allocated to equipment spending as the basis for this assessment of affordability, on the principle that this was a faithful articulation of the Government's stated policy in relation to the MoD's Budget and so a realistic potential outcome from a Spending Review.

To make sure we did not commit to spend more money that we might secure in a Spending Review, we restricted the amount that the department could commit to spend from within allocated budgets as a temporary measure ahead of the Spending Review. Had we adjusted our equipment plan budget estimate for these restrictions, the available spending would have been £2 billion less over ten years. But given the Government's manifesto commitment to grow the defence budget by 0.5% in real terms we judged that it would not be appropriate to do so.

Affordability of the Equipment Plan

In 2019 we reported a central estimate for the shortfall between available spending and expected costs of £2.9 billion over ten years. The Department subsequently secured a revised budget settlement for 2020-21 that would enable £2.2 billion of additional spending. This included £1.2 billion to ensure the UK's world-class Armed Forces can continue to modernise, meet ever-changing threats and continue to protect the country's security. It allowed us to prioritise key capabilities such as cyber, shipbuilding and the nuclear deterrent, invest £700 million to address the additional cost of employer pension contributions, and up to £7 million to finalise construction of the British Normandy Memorial. A further £300 million was brought forward from 2020-21 to 2019-20 to press on with funding priority capability programmes.

However, because SR19 did not agree a longer term funding settlement for Defence, in April 2020 the years from 2021-22 remained challenging for the Department to maintain affordability while delivering policy ambition. The SR19 settlement broadly met the cost of new investments. However, the shortfall to budget increased as a result of cost increases in our plans that we could not fully meet without considering the full range of Defence priorities in the Integrated Review and Spending Review.

Over ten years, the shortfall between forecast costs and available funding increased from £3 billion to £7 billion, as forecast costs increased to £197 billion against available funding of £190 billion. This returns the expected shortfall to the same value as our first published assessment in the 2018 Equipment Plan, and is within the plausible range of the shortfall that we presented in our 2019 report.

There were three main reasons for the cost of our plans increasing by more than the available funding:

1. Decisions to save money in the early years by deferring spending into later years, rather than removing programmes entirely, to allow decisions about their future to be taken in the context of the Integrated Review and Spending Review.
2. There were more limited opportunities to reduce the cost of established projects than in previous years, as readily available savings had already been taken, and projects were more confident in delivering milestones and achieving their spending forecasts.
3. Risks materialising, including less favourable foreign exchange rate forecasts and additional non-discretionary spending in high-priority areas including the nuclear enterprise.

While our forecast costs went up, we made significant progress developing our plans for efficiency opportunities in the Equipment Plan. Over the year to April 2020, project cost forecasts reduced by a further £1 billion over the nine years from 2020-21 as efficiency initiatives reached sufficient maturity to have high confidence in their delivery. The overall forecast of efficiency benefits in the Equipment Plan remained stable at £11.0 billion over the same period.

There is significant uncertainty in estimates of future costs given the complexity of the programme and external risks we are exposed to. The Department's Cost Assurance and Analysis Service carries out an independent assessment of the cost of the Plan each year. Its estimate of expected outturn for the ten years from 2020-21 was £3.9 billion above project team cost forecasts. Further risks of cost increases include the effect of foreign exchange rate changes on overseas procurement. We estimate that these would add costs of around £3 billion over ten years if a sustained 10% decline in exchange rates were to materialise.

Making plausible assumptions on the potential range of costs and the budget available in April 2020, we estimated the shortfall to be between £1.8 billion and £17.4 billion over ten years and between £5.4 billion and £13.2 billion over the first five years of the programme. These estimates are set out in further detail in the enclosed supplementary tables.

Overall, this challenging outlook for the affordability of the Equipment Plan was consistent with the continued uncertainty over long term funding at April 2020 and the resulting emphasis on balancing spending against budget over the short term.

Managing affordability

Delivering our plans within budget in 2020-21 is proving challenging and is demanding difficult decisions on spending priorities, but we are working closely with HM Treasury to ensure we deliver our plans within budget.

Following the announcement of a four-year settlement at the Spending Review, we are now working on our plans for implementing the changes needed to modernise the Armed Forces and pursue our radical transformation programme. The settlement gives us confidence in our future funding and a clear basis on which we can now plan and make decisions. By the end of the financial year, we expect to have developed a new and affordable set of spending plans enabled by the Spending Review settlement. While the full details of these plans might take longer to establish, we expect to be able to set out the main implications for equipment spending in our Equipment Plan financial summary for 2021.

In the meantime, we continue to drive our ambitious transformation plans, which will help us deliver the Equipment Plan more efficiently in the coming years. These include continuing to improve the capability of our finance function and acquisition system. We presented a detailed update on our progress in the MOD annual report and accounts in October¹.

This letter and its enclosures will be published on the government's website (www.gov.uk). Copies will be placed in the library of the House of Commons and sent to the Comptroller and Auditor General.

Yours sincerely,



STEPHEN LOVEGROVE

Appendix A: commentary on the Project Performance Summary Table.
Enclosure 1: Equipment Plan 2020 financial reporting.

¹ [Ministry of Defence annual report and accounts 2019 to 2020](#)

Appendix A

PROJECT PERFORMANCE SUMMARY TABLE 2020

The Project Performance Summary Table (PPST) provides an overview of the delivery performance of the Department's largest Equipment Procurement projects. Each project has passed the Full Business Case (or previously the Main Gate) investment decision point to proceed to the Demonstration and/or Manufacture phases. For each project we report on the forecast cost, forecast timescales for achieving In-Service Date (ISD) and the forecast achievement of meeting Key User Requirements (KURs).

Independent validation of the data continues to be conducted by the Department's Cost Assurance & Analysis Service (CAAS), who review evidence provided by projects to support in-year cost and time variations. The overall PPST findings are summarised in the supplementary workbook.

Changes to the PPST Population

In total there are 21 projects within the PPST population for 2020, an overall reduction of six projects since 2019. The population has been rationalised to focus on Category A procurement projects (total value over £400 million) and as a consequence BVRAAM on Lightning, Future Anti-Surface Guided Weapon (Heavy), Future Anti-Surface Guided Weapon (Light), Sea Ceptor FLAADS T26 and ASRAAM (MG2) have left the population. In addition, Sea Ceptor FLAADS T23 and all three Typhoon Integration (Centurion) portfolio projects have been removed after having reached their ISDs during FY 2018/19. Brimstone 3B, Mechanised Infantry Vehicle (MIV) and Type 31e Frigate have entered the population following approval to enter the Demonstration and Manufacture phase during financial year 2019/20. While projects are typically removed from PPST population once they achieve ISD, we have retained Lightning II and Queen Elizabeth Class Carriers given their importance in the Equipment Plan.

Forecast Cost

During the 2019/20 financial year, the aggregate forecast costs of the 21 projects decreased by -£1,135 million. The most significant decreases were in Lightning II (-£724 million, primarily due to maturing the forecast estimates from the US programme office and risk review) and MIV (-£576 million due in the main to the removal of a VAT charge from HMRC under International Collaborative Defence Arrangements (ICDA)). The most significant increases were in P-8A Poseidon (+£110 million) and Apache CSP (+£42 million), both of which were primarily driven by fluctuations in the exchange rate. The key contributing factors for in-year cost variation by category were Procurement Processes (-£1,011m), International Collaboration (-£521m) and Exchange rate (£335m).

Forecast Time

18 of the 21 projects with an approved In-Service Date (ISD)² reported no in-year change to their forecast ISD. The other three projects reported a combined project increase of 12 months. Time increases were experienced by AJAX (+6 months) following a reset of the contractual baseline to resolve areas of technical and schedule issues. This was complicated by delays to the resolution of known design issues including the Fire Control Panel (FCP), and by an underestimation of the volume of work required from both DE&S and the contractor to produce appropriate safety documentation. New Style of IT (deployed) experienced a delay of +4 months due to technical integration and installation issues. Warrior CSP experienced a delay of +2 Months, as contract amendments were necessary to revise the detail of the delivery plan and schedule.

² In-Service Date (ISD) is defined by each project within its business case and can be Initial Operating Capability (IOC) or Equipment Delivery Date (EDD).