



House of Commons
Committee of Public Accounts

Ministry of Defence: Major Projects Report 2005

**Fiftieth Report of
Session 2005–06**

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

*Ordered by The House of Commons
to be printed 12 June 2006*

HC 889
Published on 27 June 2006
by authority of the House of Commons
London: The Stationery Office Limited
£8.50

The Committee of Public Accounts

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Mr Alistair Carmichael MP (*Liberal Democrat, Orkney and Shetland*)
Jon Trickett MP (*Labour, Hemsworth*)
Stephen Williams MP (*Liberal Democrat, Bristol West*)

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Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at <http://www.parliament.uk/pac>. A list of Reports of the Committee in the present Session is at the back of this volume.

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Summary

The Major Projects Report 2005¹ provides information on the time, cost and performance of the Ministry of Defence's (the Department's) 20 largest projects where the main investment decision has been taken; and the 10 largest projects in the Assessment Phase. For the approved projects,² forecast costs were some £700 million lower compared to the previous year. This change was primarily due to reductions in either capability or platform numbers to balance the overall programme. Total forecast costs for these projects now amount to £29 billion, some 10% over budget. In-year timescale slippage increased by 45 months, giving a total delay of 375 months, or an average of some 20 months per project. The Department does, however, expect to meet the majority of its Key User Requirements.

The Government launched its Defence Industrial Strategy³ in December 2005. The Strategy flows from the wider Defence Industrial Policy (2002)⁴ and was developed directly in response to the changing threat facing the United Kingdom and consequently the manner in which equipment will be procured and used in the future. The Strategy aims to promote a sustainable and globally competitive defence manufacturing sector. If the Department and its industry partners can implement the Strategy successfully it could mean a significant improvement in the delivery of operational capability to the frontline but there are risks to be managed not least in sustaining competitive pressures. Projects could be delivered on time and at the right cost with this improved performance reflected in future Major Projects Reports.

On the basis of a Report from the Comptroller and Auditor General, the Committee took evidence from the Department on three main issues: enhancing programme and project management of defence acquisition; the impact of older projects on overall acquisition performance; and value for money from the Defence Industrial Strategy. As an annual report, our conclusions and recommendations should be read in conjunction with the findings of earlier Major Projects Reports as part of a sequence of recommended improvements.

1 C&AG's Report, *Ministry of Defence: Major Projects Report 2005* (HC 595, Session 2005–06)

2 Excludes the cost of the Typhoon combat aircraft, which is commercially sensitive

3 *Ministry of Defence: Defence Industrial Strategy: Defence White Paper Cm 6697*, December 2005

4 Ministry of Defence Policy Paper No. 5, *Defence Industrial Policy*, 2002

Conclusions and recommendations

- 1. The Department has reduced the forecast costs of its top 19 projects by some £700 million. These reductions in forecast costs were not the result of better project management but were cuts needed to bring the Defence Equipment Plan under control.** The Department achieved these reductions by cutting the numbers or capability of equipment, and has yet to demonstrate that it can consistently manage individual projects to deliver the planned operational benefits to the Armed Forces to cost and time.
- 2. Some of the latest capability cuts are short-term expediencies which may result in an erosion of core defence capability or in higher costs throughout the life of individual projects.** When deciding how to live within its overstretched budget, the Department should not make short-term cuts without first spelling out the longer-term negative impacts in terms of core capability or poor value for money.
- 3. The Department's defined levels of capability do not include the quantity of equipment bought. So they can allow quantities to be cut to offset cost overruns, without affecting measured capacity.** In defining threshold levels (minimum acceptable capability) and objective levels (full capability desired) for equipment capability on projects coming forward for approval, the Department should reflect quantities as well as performance characteristics.
- 4. Despite previous assurances that it had restructured many of its older projects, at considerable cost, to address past failures, the Department still attributes much of its historic poor performance to so called "toxic legacy" projects which continue to accumulate considerable time and cost overruns.** The Department cannot indefinitely hide behind past deficiencies, while claiming to be taking a proactive approach to addressing the problems. It is time that these projects were put on a firm footing with realistic performance, time and cost estimates against which the Department and industry can be judged.
- 5. The Department has improved its practice in setting meaningful in-service dates, but still not all future in-service dates represent the delivery of useable capability to the frontline.** In defining these dates it needs to incorporate areas such as logistic support and training to enable the Armed Forces to use the equipment effectively.
- 6. In co-operating with the United States on defence projects, the United Kingdom is the junior partner, which reduces our influence over the project's direction.** Conversely, a lack of focused leadership has stymied progress on many European collaborative projects. The Department should routinely analyse co-operative projects to see how far the expected benefits are delivered, so that it can make better informed decisions before committing to future co-operative acquisitions.
- 7. The Department has introduced key supplier management to assess the performance of its 18 largest suppliers, but much of the innovation which will drive better acquisition performance comes from the second and third tiers of the supply chain.** The Department considers that these arrangements have already had a beneficial impact by focusing suppliers on areas for improvement, but to maximise

the benefits the Department should progressively extend the principles of key supplier management through its supply chain.

8. **The Defence Industrial Strategy aims to promote a sustainable and globally competitive defence manufacturing sector but the Department has not traditionally quantified or measured these wider benefits.** The Department should more accurately quantify what these wider beneficial outcomes might be at the time defence acquisition decisions are made, and should monitor their achievement throughout the life of the project.

1 Enhancing programme and project management of defence acquisition

1. In 2004–05 following two years of large forecast cost increases, the Department took steps to bring its Equipment Plan under control and to deal with continuing cost increases on some individual projects. For the projects in the Major Projects Report, forecast costs were reduced by some £700 million mainly by cutting equipment capability or numbers.⁵ Given previous poor performance in controlling the costs of the projects in the Major Projects Report, reductions were inevitable. The Department said that it had only undertaken these cuts after taking a serious look at what capability it needed in the light of the current threat and had identified the least damaging solutions.⁶ In some cases, the threat in certain areas had declined, for example, the submarine threat, and in others fewer weapons were needed as the Department was purchasing fewer planes, ships and helicopters.⁷

2. We have previously recommended that the Department be willing to trade off capability to manage cost increases and to ensure more timely delivery of individual projects.⁸ This trade-off should not result in the delivery of a level of capability insufficient to meet the needs of the Armed Forces, but should mean that project teams do not continue to pursue incremental refinements at unplanned expense in cost and time. The best time to make major trade-offs is in the assessment phase when decisions have yet to be reached as to how best to deliver the required capability and substantial funding has not yet been committed.⁹ But it is important to retain some scope to trade capability later to bring projects back on track when things go wrong.

3. As projects come forward for approval at the end of the assessment phase, the Department is now defining a threshold level of capability representing the minimum acceptable level below which the equipment would not be worth buying. It also agrees an objective level of capability, representing the full capability it would wish to have. These measures, together with the cost and time ranges approved by the Department, define the envelope within which trade-offs may be made between cost, time and performance. This information is shared with the contractor.¹⁰

4. Meeting either the threshold or objective levels will not necessarily deliver the required capability to the front-line. As currently defined, these levels only cover technical aspects of performance and not the quantity of weapons or platforms required. For example, although the Meteor missile is currently forecast to achieve 100% of its Key User Requirements, a recent £55 million cut in the numbers of missiles procured is not taken

5 C&AG's Report, para 1.3

6 Q 5

7 Q 32

8 3rd Report from the Committee of Public Accounts, *Ministry of Defence: Major Projects Report 2004* (HC 410, Session 2005–06) Recommendation 5, p4

9 Q 29

10 Q 30

into consideration when measuring overall capability.¹¹ Consequently, a project could meet all requirements, but not meet the operational needs of the frontline because the available numbers of weapons are too low.

5. The Department has decided to collaborate with France on the Demonstration Phase of the Future Carrier project, and under the terms of the agreement, France will meet a third of the Carrier's demonstration costs already borne by the Department.¹² This contribution will include payments of £55 million, with approximately an additional £45 million at the end of the Demonstration Phase if France decides to remain with the project into the Manufacturing Phase. This collaboration should generate economies of scale benefits for the United Kingdom but consequential risks to the in-service date for the Future Carrier will need to be managed.¹³ France has no joint control over the Demonstration Phase of the Future Carrier,¹⁴ and the intended economies arising from collaborating with France are to be driven by industry, not Governments. Industry demonstrated its ability to produce such economies of scale on the shared technology used to meet the Storm Shadow/Scalp cruise missile requirement for the United Kingdom and France, respectively.¹⁵

6. Previous European collaborative projects, such as the Typhoon aircraft, have been beset by a lack of management direction and problems created by the agreement that the share of work given to the industry in each partner country be in proportion to the intended equipment buy, rather than being allocated to those contractors providing the best value for money. Conversely, projects involving the United States of America have a dominant partner, but British control over these projects is more limited.¹⁶ For example, the Department would prefer that the United States of America commissioned a second engine for the Joint Strike Fighter which would involve British industry in its development and is making its views known.¹⁷

11 C&AG's Report, p25

12 Q 18

13 Q 21

14 Q 14

15 Q 20

16 Q 43

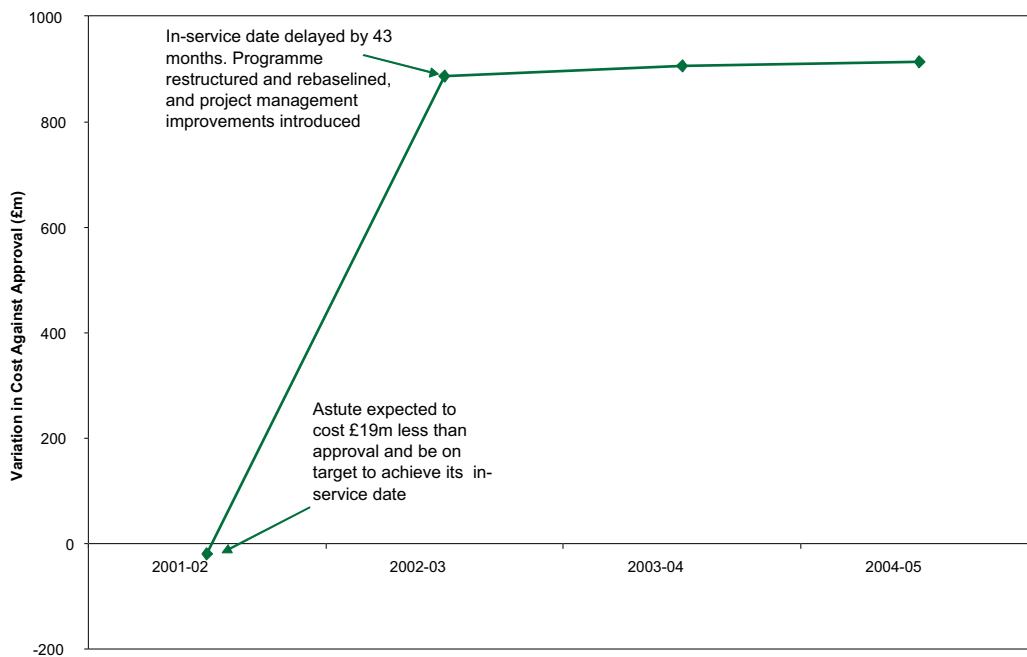
17 Qq 26-28

2 The impact of older projects on overall acquisition performance

7. The Department blames its overall poor performance on the older projects which remain in the Equipment Plan and Major Projects Reports for many years, the so called toxic legacy.¹⁸ Previous cost and time overruns on these older projects do continue to impact on the overall forecast time and cost budgets. But only current performance on these projects features in the in-year cost and time variations reported on in the Major Projects Report. The Department argued that the challenge with the older projects is to deal retrospectively with poor contracts and inappropriate levels of financial exposure.¹⁹ It regarded the Astute submarine; Nimrod MRA4 aircraft; Type 45 Destroyer and Typhoon as particularly difficult projects.²⁰ **Figure 1** illustrates the problems on Astute, Nimrod MRA4 and Type 45 projects and what the Department has done to rectify them:

Figure 1: Cost and time histories of the Astute submarine, Nimrod MRA4 aircraft and Type 45 destroyers.²¹

Astute submarine



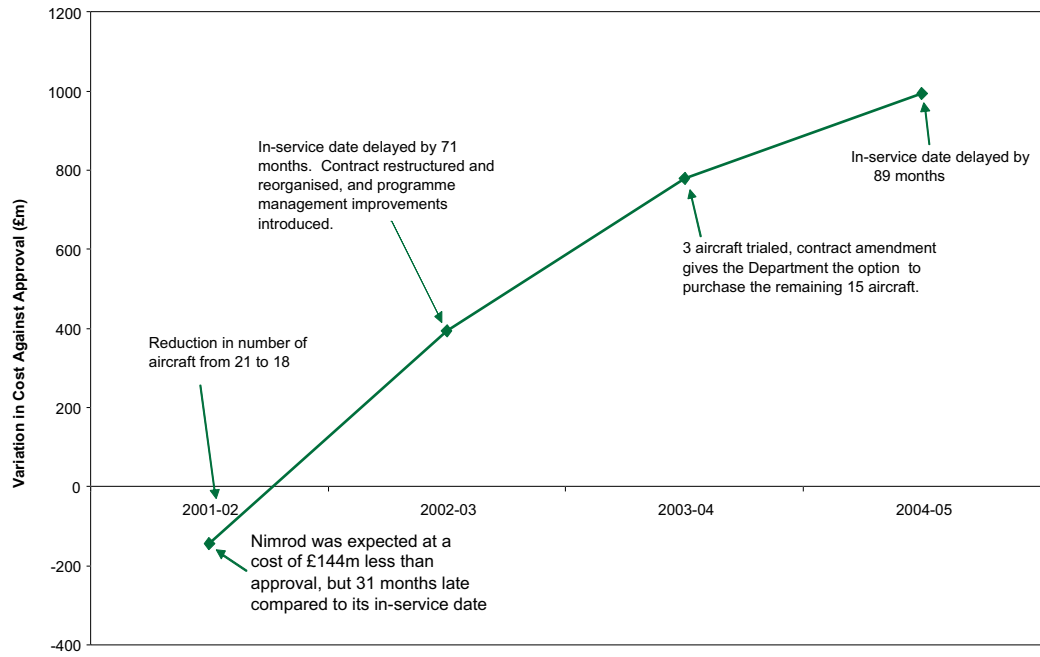
18 Q 39

19 Qq 39, 42

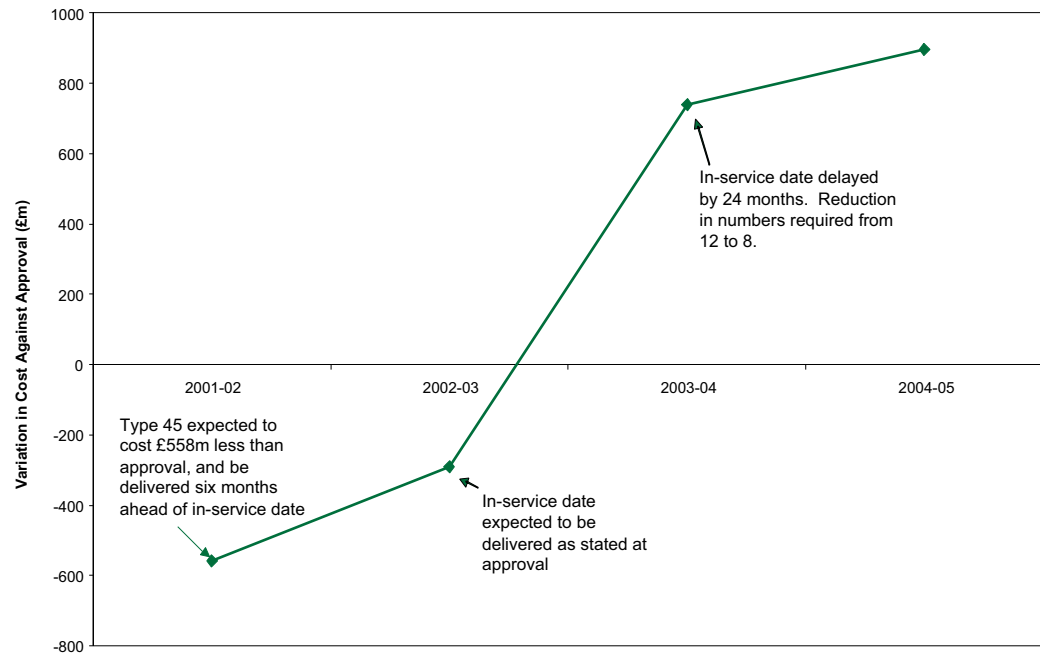
20 Qq 37, 39

21 Q 42; C&AG's Report, *Project Summary Sheets*, pp 67, 107

Nimrod MRA4 Aircraft



Type 45 destroyers



Source: National Audit Office

8. As Figure 1 illustrates, the Department has experienced great difficulties on the Nimrod MRA4 aircraft project. As reported in the Major Projects Report 2003,²² the Nimrod was forecast to be delayed a further 3½ years and cost a further £540 million in-year. The Department recognised the problems and restructured its contract with BAE Systems and introduced improved project management. But still Nimrod continues to slip and to cost more money.

9. Eight of the more recent projects are forecast to be delivered on or less than their budgeted costs. Time overruns forecast in-year are concentrated on four more recent projects and Nimrod, leaving other projects in the Major Projects Report forecasting no additional in-year delays.²³ The Department has now had many years to sort out the problems on older projects and in some cases has put them on new contractual footings.

10. Historically, the in-service date of a project was set as the delivery to the front-line of a particular piece of defence equipment. For example, the in-service date for Typhoon was measured by the delivery of the first aircraft to the Royal Air Force, which was achieved in June 2003. This date did not represent delivery the start of operational capability, however, since supporting elements such as training and logistics had still to be delivered. The aircraft is not yet available operationally to the Royal Air Force. The elements needed to provide operational capability are called ‘Lines of Development’, and include infrastructure, logistics, organisation, personnel and training as well as the equipment itself.

11. Although the Department has made considerable progress in addressing inconsistencies in setting credible In-Service Dates for projects, the term is not always applied consistently, nor does it always represent real delivery of defence capability. More recent projects in the Major Projects Report have in-service dates that do relate to the delivery of defence capability to the front line. For example, the in-service date for Precision Guided Bomb provides for a stated number of weapons and suitably modified aircraft; trained personnel and support equipment; as well as the necessary flight test programme clearances to permit the capability to be used on operations.²⁴

12. More consistency is required, however, across the individual capabilities listed in the Major Projects Report. Some projects, such as Nimrod MRA4, still focus on the delivery of pieces of equipment, even though there was the opportunity to change this when the in-service date was modified in February 2003. In some cases, the Department has modified in-service dates to better reflect the delivery of operationally-available capability. For example, the Airborne Stand-Off Radar system had its in-service date amended to include the operational availability of the system. But not all project in-service dates are expressed in terms of all the Lines of Development necessary to ensure the capability is operationally usable and supportable.²⁵

22 43rd Report from the Committee of Public Accounts, *Ministry of Defence: Major Projects Report 2003* (HC 383 Session 2003–04); Qq 3, 42; C&AG’s Report, *Ministry of Defence: Major Projects Report 2003* (HC 195, Session 2003–04) paras 3.2–3.23

23 C&AG’s Report, *Ministry of Defence: Major Projects Reports 2003* (HC 195, Session 2003–04) Figures 4, 6 and Appendix 3

24 C&AG’s Report, *Project Summary Sheets*, p75

25 C&AG’s Report, *Project Summary Sheets*, p93; C&AG’s Report, *Ministry of Defence: Major Projects Report 2004* (HC 1159, Session 2003–04) Box 1, p12

3 Value for money from the Defence Industrial Strategy

13. The Government's Defence Industrial Strategy takes forward the 2002 Defence Industrial Policy by providing greater transparency of future defence requirements and by setting out the industrial capabilities needed in the United Kingdom to meet those requirements and protect our national security. The Strategy was in part developed in response to the changing threat facing the United Kingdom and consequently the manner in which defence capability will be procured and used in the future.

14. The Strategy aims to promote a sustainable and globally competitive defence manufacturing sector. The aspirations of the Defence Industrial Strategy face a tension between economical and effective procurement and the need to retain a significant level of defence industrial capacity for security reasons, with the consequent need to support the British defence industry. The Department reported that though this tension was unlikely ever to disappear, there was now more scope for multinational competition for contracts.²⁶ Competition is still the preferred route for procurement when the civilian market is strong and the Department is a small customer.²⁷ For example, in Command, Control, Communication, Computers, Intelligence, Surveillance, Target Acquisition and Reconnaissance there is a highly competitive market and the Department is a relatively minor customer.

15. The Defence Industrial Strategy is explicit sector by sector as to which areas of capability need to be maintained in Britain and those areas which should be subject to greater competition. This greater visibility is designed to allow industry to make clearer assumptions about future work so they can plan and manage their business better, in particular when investing in new facilities²⁸

16. A lack of competition, and a limited number of suppliers, might well erode value for money.²⁹ Competition at arms' length has meant that decisions on contractors have often been made on the basis of information which turned out to be faulty when negotiating the detailed contract.³⁰ Where it is not possible to have a full-blooded competition, the Department believes that other means must be found to make its suppliers provide value for money. The Department is doing further work including pilot projects where the contractor is given incentives to provide savings which are shared with the Department.³¹

17. The Department had introduced comprehensive arrangements to assess and get feedback on the performance of its 18 largest suppliers. These arrangements will be used in the assessment of future procurement bids by the suppliers. Innovation often comes, however, from the second and third tier suppliers that feed into the larger prime

26 Q 17

27 Defence White Paper, *Defence Industrial Strategy*, Cm 6697 December 2005, Section B8, pp 106–113

28 Q 53

29 Q 39

30 Q 36

31 Q 40

contractors.³² The Department has also improved its engagement of industry in work in the assessment phase on achieving greater cost efficiencies, for example, in the provision of munitions. Recognition of the benefits resulting from such early engagement has been fed into the development of the Defence Industrial Strategy.³³

32 Q 40

33 Q 35

Formal minutes

Monday 12 June 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Annette Brooke
Greg Clark
Helen Goodman

Mr Sadiq Khan
Mr Austin Mitchell
Kitty Ussher
Mr Alan Williams

A draft Report (Ministry of Defence: Major Projects Report 2005), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 17 read and agreed to.

Summary read and agreed to.

Conclusions and recommendations read and agreed to.

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

Ordered, That the Chairman 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.

[Adjourned until Wednesday 14 June at 3.30 pm.]

Witnesses

Wednesday 1 February 2006

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**Mr Bill Jeffrey CB, Sir Peter Spencer KCB, and Lt General Sir Robert Fulton
KBE, Ministry of Defence**

Ev 1

List of written evidence

Letter from the Chief Executive of the Defence Procurement Agency to
Sarah McCarthy-Fry MP

Ev 11

List of Reports from the Committee of Public Accounts Session 2005–06

| | | |
|-----------------------|--|---------------------------|
| First Report | Managing National Lottery Distribution Fund balances | HC 408 (<i>Cm 6712</i>) |
| Second Report | The regeneration of the Millennium Dome and associated land | HC 409 (<i>Cm 6689</i>) |
| Third Report | Ministry of Defence: Major Projects Report 2004 | HC 410 (<i>Cm 6712</i>) |
| Fourth Report | Fraud and error in benefit expenditure | HC 411 (<i>Cm 6728</i>) |
| Fifth Report | Inland Revenue: Tax Credits and deleted tax cases | HC 412 (<i>Cm 6689</i>) |
| Sixth Report | Department of Trade and Industry: Renewable energy | HC 413 (<i>Cm 6689</i>) |
| Seventh Report | The use of operating theatres in the Northern Ireland Health and Personal Social Services | HC 414 (<i>Cm 6699</i>) |
| Eighth Report | Navan Centre | HC 415 (<i>Cm 6699</i>) |
| Ninth Report | Foot and Mouth Disease: applying the lessons | HC 563 (<i>Cm 6728</i>) |
| Tenth Report | Jobskills | HC 564 (<i>Cm 6724</i>) |
| Eleventh Report | Local Management of Schools | HC 565 (<i>Cm 6724</i>) |
| Twelfth Report | Helping those in financial hardship: the running of the Social Fund | HC 601 (<i>Cm 6728</i>) |
| Thirteenth Report | The Office of the Deputy Prime Minister: Tackling homelessness | HC 653 (<i>Cm 6743</i>) |
| Fourteenth Report | Energywatch and Postwatch | HC 654 (<i>Cm 6743</i>) |
| Fifteenth Report | HM Customs and Excise Standard Report 2003–04 | HC 695 (<i>Cm 6743</i>) |
| Sixteenth Report | Home Office: Reducing vehicle crime | HC 696 (<i>Cm 6743</i>) |
| Seventeenth Report | Achieving value for money in the delivery of public services | HC 742 (<i>Cm 6743</i>) |
| First Special Report | The BBC's investment in Freeview: The response of the BBC Governors to the Committee's Third Report of Session 2004–05 | HC 750 (<i>N/A</i>) |
| Eighteenth Report | Department for Education and Skills: Improving school attendance in England | HC 789 (<i>Cm 6766</i>) |
| Nineteenth Report | Department of Health: Tackling cancer: improving the patient journey | HC 790 (<i>Cm 6766</i>) |
| Twentieth Report | The NHS Cancer Plan: a progress report | HC 791 (<i>Cm 6766</i>) |
| Twenty-first Report | Skills for Life: Improving adult literacy and numeracy | HC 792 (<i>Cm 6766</i>) |
| Twenty-second Report | Maintaining and improving Britain's railway stations | HC 535 (<i>Cm 6775</i>) |
| Twenty-third Report | Filing of income tax self assessment returns | HC 681 (<i>Cm 6775</i>) |
| Twenty-fourth Report | The BBC's White City 2 development | HC 652 |
| Twenty-fifth Report | Securing strategic leadership in the learning and skills sector | HC 602 (<i>Cm 6775</i>) |
| Twenty-sixth Report | Assessing and reporting military readiness | HC 667 (<i>Cm 6775</i>) |
| Twenty-seventh Report | Lost in translation? Responding to the challenges of European law | HC 590 (<i>Cm 6775</i>) |
| Twenty-eighth Report | Extending access to learning through technology: Ufi and the learndirect service | HC 706 (<i>Cm 6775</i>) |
| Twenty-ninth Report | Excess Votes 2004–05 | HC 916 (<i>N/A</i>) |

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|-----------------------|--|---------------------------|
| Thirtieth Report | Excess Votes (Northern Ireland) 2004–05 | HC 917 (<i>N/A</i>) |
| Thirty-first Report | Northern Ireland's Waste Management Strategy | HC 741 |
| Thirty-second Report | Working with the voluntary sector | HC 717 (<i>Cm 6789</i>) |
| Thirty-third Report | The Royal Parks and the Diana, Princess of Wales Memorial Fountain | HC 644 (<i>Cm 6789</i>) |
| Thirty-fourth Report | Returning failed asylum applicants | HC 620 |
| Thirty-fifth Report | The refinancing of the Norfolk and Norwich PFI Hospital | HC 694 |
| Thirty-sixth Report | Tackling the complexity of the benefits system | HC 765 |
| Thirty-seventh Report | Inland Revenue Standard Report: New Tax Credits | HC 782 |
| Thirty-eighth Report | Channel Tunnel Rail Link | HC 727 |
| Thirty-ninth Report | Consular services to British nationals | HC 813 |
| Fortieth Report | Environment Agency: Efficiency in water resource management | HC 749 |
| Forty-first Report | The South Eastern Passenger Rail Franchise | HC 770 |
| Forty-second Report | Enforcing competition in markets | HC 841 |
| Forty-third Report | Delivery chain analysis for bus services in England | HC 851 |
| Forty-fourth Report | National Offender Management Service: dealing with increased numbers in custody | HC 788 |
| Forty-fifth Report | Employers' perspectives on improving skills for employment | HC 862 |
| Forty-sixth Report | Governance issues in the Department of Enterprise, Trade and Investment's former Local Enterprise Development Unit | HC 918 |
| Second Special Report | The BBC's White City 2 development: The response of the BBC Governors to the Committee's Twenty-fourth Report of Session 2005–06 | HC 1139 (<i>N/A</i>) |
| Forty-seventh Report | NHS Local Improvement Finance Trusts | HC 562 |
| Forty-eighth Report | HM Customs and Excise: Standard Report 2004–05 | HC 874 |
| Forty-ninth Report | Corporation Tax: companies managed by HM Revenue and Customs' Area Offices | HC 967 |
| Fiftieth Report | Ministry of Defence: Major Projects Report 2005 | HC 889 |

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 1 February 2006

Members present:

Mr Edward Leigh, in the Chair

Angela Browning
Mr David Curry
Helen Goodman
Sarah McCarthy-Fry

Mr Austin Mitchell
Jon Trickett
Kitty Ussher

Mr Tim Burr, Deputy Comptroller and Auditor General, National Audit Office, was in attendance.

Mr Marius Gallaher, Second Treasury Officer of Accounts, HM Treasury, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

MINISTRY OF DEFENCE: MAJOR PROJECTS REPORT 2005 (HC 595-I)

Witnesses: **Mr Bill Jeffrey CB**, Permanent Secretary, **Sir Peter Spencer KCB**, Chief of Defence Procurement & Chief Executive of the Defence Procurement Agency, and **Lt General Sir Robert Fulton KBE**, Deputy Chief of Defence Staff (Equipment Capability), Ministry of Defence, gave evidence.

Q1 Chairman: Good afternoon and welcome to the Committee of Public Accounts where today we are looking at the *Major Projects Report 2005* from the Ministry of Defence. We are joined for the first time by Permanent Secretary Mr Bill Jeffrey, you are very welcome, and Sir Peter Spencer, who returns to us again, who is the Chief of Defence Procurement and Chief Executive of the Defence Procurement Agency, and once again by Lt General Sir Robert Fulton, who is the Deputy Chief of Defence Staff (Equipment Capability). Sir, Mr Jeffrey, it is your first time here. What are your ambitions for the equipment programme?

Mr Jeffrey: One of my ambitions, Chairman, is to build on the progress that I think the Report before this Committee does show but we need to achieve a further significant improvement in the way we do this. I think it is clear to everybody in the Department and everybody I have spoken to in the first couple of months, including the two gentlemen on either side of me, that we do not think we are getting this right yet. We think there has been some progress but there is still a good deal to do. One of my highest priorities as I take over is to really drive through the changes that are necessary and are being made and deliver them through the performance in this field.

Q2 Chairman: Could you speak up a bit. What will success look like to you?

Mr Jeffrey: I think success, among other things, will include better figures and reports like the one that the Committee has now. There is an extent to which these annual reports are much dominated by projects that went wrong many years ago and that still shows in the figures and the analysis. I feel that the real test will be whether in a year's time or two years' time, particularly in relation to the newer

projects that have got going since Smart Acquisition was introduced, or more recently, we are delivering high quality military capability on time to cost. As the NAO have said in their Report, that depends greatly on the quality of the Assessment Phase, on taking the risk out of these projects as much as we can, on us providing our staff with the skills they need and possibly on some further changes in the way we do this business.

Q3 Chairman: Thank you. By the way, please let Sir Peter or the General answer questions if you wish them to, I am very relaxed. I will direct my questions to you and if you want to pass questions to your colleagues, please do.

Mr Jeffrey: That is very kind, Chairman. If you will forgive me, I have been in post for just under two months so there are some questions that I will need to pass over.

Q4 Chairman: This is not a fierce inquisition, it is very friendly.

Mr Jeffrey: I know from previous experience of this Committee just how friendly it can get!

Q5 Chairman: Can you start by looking at page nine of the Comptroller and Auditor General's Report, paragraph 1.5, where it tells us that: "The decreases in forecast costs this year were primarily due to reductions in the numbers or capability of the equipment driven by changed budgetary priorities". How much capability are you going to have to trade or delay to keep your programme within budget?

Mr Jeffrey: As expressed, that is a very difficult question to answer. I certainly think it is the case that the Department and, indeed, this Committee and its predecessors have always correctly analysed one of the problems as being that we tend to regard

 Ministry of Defence

capability as inviolate, we tend to regard key requirements as inviolate, and whenever there is a problem we tend to allow things to slip and costs to increase. To the extent that we are succeeding in looking hard at the capability outcomes dimension of this and asking ourselves seriously do we need all of this, can we scope it down, I think that is a good development. Clearly we must not do that in ways that could damage the intended outcome. I think one of the tests of success is where we do trade off capability, are we doing sensible things on the basis of a very careful analysis of what would be the least damaging option.

Q6 Chairman: Of course, in your two months I am sure you have had time to read our Report of last year and the Treasury Minute in reply. There is a PAC conclusion which states that we recommend you develop measures of maturity for commercial issues, such as procurement strategy, supplier relationships and financial risk. There was a Treasury Minute in which the Department acknowledged the point we were making and seemed to accept it. Can you tell us how much progress has been made on this recommendation accepted by the Treasury?

Mr Jeffrey: One significant piece of progress is that my predecessor last February, almost a year ago, issued some guidance to the Department on the whole question of project maturity which laid down what comprises project maturity, technical maturity, financial maturity and procurement strategy. I think that helped to meet the sense of the Committee's recommendation anyway. Reading the reports and trying to understand some of these huge projects that the Department is engaged on, I think there is a greater readiness to appreciate at the point when the Main Gate decision is taken that the project really does have to be mature and these considerations already need to have been addressed. I think that may be something that the Chief of Defence Procurement might want to say something on himself.

Sir Peter Spencer: We followed up the minute to which the PUS has just referred with more detailed guidance for the project leaders and the directors of equipment capability who are the sponsors of the business cases. We have identified under each of those headings in some detail the sorts of tests that will be applied. Most importantly, as was indicated earlier, we have moved on from simply applying tests of technological maturity, which we have been using for some time, and recognised there are wider issues as well, in particular a proper assessment of the supplier and whether or not we are confident in their track record of success and in the maturity of the commercial arrangements that have been achieved at the Main Gate. If you would wish to see more detail of that we could provide you with a short note.

Q7 Chairman: So, Sir Peter, we now have a quantified measure for commercial maturity, do we?

Sir Peter Spencer: We have a number of quantified measures which provide guidance and, as is indicated in the NAO's Report, the challenge here is there is such a wide range of different types of project that the challenge is to identify a set of metrics and a set of numbers which you could apply to every single project. I am saying what we are doing is to recognise this progress that has been made and to give more explicit guidance to projects concerning the amount of money we would expect to be spent and time in the Assessment Phase for a particular level of risk, the technology readiness level number, which we would expect to be achieved at the Main Gate, the system integration readiness level, the risk maturity levels and a whole range of things like that. That sort of cookery book set of instructions will never replace judgment. On top of that there will need to be a proper understanding of how the total package fits together. The evidence that we are spending longer and taking more care over Main Gate business decisions is drawn out by the NAO report, particularly in the context of those 10 pre-Main Gate projects which have been reported on.

Q8 Chairman: While you have got the floor, Sir Peter, could I ask about in-service dates. This is referred to in paragraph 1.15, but you do not need to refer to it because you know it all by heart anyway. Can we talk about Typhoon, for instance, Sir Peter, which has been apparently in-service since 2003 but will not have operational capability for a number of years. For us laymen, can we not have in-service dates that actually mean in-service?

Sir Peter Spencer: Yes, you can. The reason why Typhoon looks rather eccentric is because that was the definition which was used a long time ago when setting the project parameters for time and cost. If you look at virtually every other in-service date in this Report you can see it is written in capability terms. In other words, it represents something which the lay person could recognise as the degree to which the Armed Forces are going to be able to use equipment in an operation. It is not just the delivery of the equipment, it is the fact that the operators have been trained, the logistic support is in place and a level of use is defined.

Q9 Chairman: So in future when you tell us something is going to be in-service, it is going to be in-service?

Sir Peter Spencer: That is already happening.

Q10 Chairman: Right. Shall we talk about carriers for a moment while we are talking about in-service dates, Sir Peter. Is it still realistic to talk about an in-service date of 2012 and 2015?

Sir Peter Spencer: I think the Ministry of Defence's public position on this is well-known and well-rehearsed. That in-service date will be announced when we complete the Main Gate decision by announcing the decision to go forward into manufacturing.

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Q11 Chairman: It is already two years late, is it not? With the benefit of hindsight was it unwise, perhaps, for Lord Bach to make the announcement when he did, to set these in-service dates?

Sir Peter Spencer: I do not think it is a reasonable question to ask me to comment on one of the Defence Minister's public statements.

Q12 Chairman: It is not something that you would recommend in the future, is it?

Sir Peter Spencer: I think what we are doing at the moment is more indicative—

Q13 Chairman: I will not use the word “unwise”, perhaps it was too early for Lord Bach to have made the announcement when he did.

Sir Peter Spencer: I think it is a question of how you interpret the announcement. In the past it was customary when announcements were made to give an indication of what our planning assumptions were and that was all it was at that stage, a planning assumption. The point at which we are audited by the National Audit Office coincides with the figures we set out when the formal approval is made and those planning assumptions which were previously indicated by the previous ministerial team were not based on any formal approval basis. This is a fairly spurious point in terms of procurement. I can see that it is quite an interesting point in terms of politics but I deal with procurement, not politics.

Q14 Chairman: Will the agreement with the French which was announced recently delay the project any further, do you think?

Sir Peter Spencer: No. We have put those arrangements in place very carefully to ensure that there is a minimum possibility. There are no absolutes in this world. We have minimised the possibility. For example, as I was publicly reported as saying, there is no joint control here, the Demonstration Phase of the common baseline design is a UK controlled project. The French will contribute towards it, they will have visibility, but they will not control it.

Mr Jeffrey: Just to supplement that, part of the understanding is that the involvement of the French value have value from all sorts of points of view, including cost reduction, but it should not delay the project overall.

Q15 Chairman: Mr Jeffrey, have you learned the lessons from the Brimstone project, or perhaps Sir Peter may want to deal with this. I am particularly looking in terms of the Beyond Visual Range Air-to-Air Missile. Can you tell us what is going to happen with that project, please?

Sir Peter Spencer: The Beyond Visual Range Air-to-Air Missile project, as you know, is an extremely ambitious European collaboration and as audited in this Report you can see that part of the difficulty was that the point at which the Main Gate decision was taken preceded confirmation that all the European partners were signed up and preceded the contractual arrangements. Since that time the development of the Meteor missile has gone

reasonably well. The first of the key technical milestones, which is the firing, is due to take place in April, slightly delayed by the Swedish winter. That is slightly later than the contractors planned but well inside the risk adjusted plan against which we signed up to. The comparison between Brimstone and BVRAAM is quite stark. Brimstone was a much less ambitious project technically and was a single national project, so we have much greater areas of risk involved with BVRAAM and Meteor. In particular, we have the challenge of integrating the missile into Eurofighter, which is another multinational programme. The risk inherent in BVRAAM is orders of magnitude greater than in Brimstone.

Q16 Chairman: Lastly, particularly for the benefit of the new Members, there is talk in this Report of the Defence Industrial Strategy. Do you want to tell us a bit about that, Sir Peter, and the tension there is between cheap and effective procurement and the understandable desire to support British industry?

Mr Jeffrey: If I can say a word about it. I arrived on the scene just as the Defence Industrial Strategy was being finalised. My own view of it is that it is an extremely important development because first of all it gives much greater visibility to industry to Parliament and, indeed, the public of our forward plans. It is clearer about our working assumptions based on our budget. It indicates more clearly than we have ever done before what we think needs to be done onshore and what does not. It feels to me, having observed the final stage of the process, that the very act of putting this Strategy together has helped us to build a closer relationship with the industry. However, what it does do is to place significant responsibilities both on the defence industry and on the Department because it describes a picture in which the balance of our investment will change significantly over time from the acquisition of new equipment to through life support of that equipment. Those who I have been speaking to in the industry in my early days, senior figures, understand that there are going to need to be significant changes on their part. We certainly understand that there will need to be a good deal of adjustment within the Department and I am very keen to use the publication of the Strategy as a platform for looking hard again, and it says this in part C of the published Strategy, at the way we organise procurement within the MoD and the processes we use, our structures, *et cetera*.

Q17 Chairman: It does help when we ask a question if you would try and answer the question. I did ask you how the Defence Industrial Strategy was going to resolve the inherent tensions between cost-effective procurement, particularly from America, and the need to support United Kingdom industry.

Mr Jeffrey: I do not think it can resolve them completely because these tensions are inherent in the business. What it does do is to provide a clearer set of working assumptions about what we want to do onshore, whether by British industry, or British based industry from elsewhere, and what we are

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happy to obtain from elsewhere. That at least achieves a greater degree of clarity for resolving the tension that you have described and that we have had before.

Q18 Mr Curry: I have learned some wonderful vocabulary while I have been reading this. I just came across this phrase, “improving situational awareness”, I must try and remember that, but quite what it means is absolutely mind-bogglingly mysterious to me, no doubt I will get there. I would like to ask you about two developments which are not covered in this. I would like to go back to the deal with the French on aircraft carriers. In the past, we tended to have faced the dilemma that if we wanted to develop something ourselves, it cost an arm and a leg and we could not afford it so we have got to share them, but when it is a joint project it becomes complicated, difficult and, in many ways, inefficient because of the division of labour. We have abandoned destroyer projects and quite recently joint projects with the French and other nations. This is different in that it appears to be a French buy-in who bought a ticket into this project, there was a cost attached. How do you arrive at the price of a buy-in on that sort of thing?

Mr Jeffrey: I think the point you make, Mr Curry, about the risks inherent to this is a very important one. My observation in the last few weeks is as we got closer to reaching this understanding with the French, there was a very strong awareness that international projects of that kind come with risks by virtue of their very international nature. We were satisfied on the basis that was agreed with the French that this could be managed, namely that they would be buying into the work that we have already done and the negotiations around the entity, as you put it, which led to the understanding between our secretary of state and his French opposite number a week or so ago, were intended to ensure that the French did make a contribution which reflected the investment that we had already made. The plan, as I think you will know, is that they will meet a third of the demonstration costs and they will make staged payments of £30 million now, a further £25 million in July, and £45 million at the end of the Demonstration Phase, if they decide to go ahead, as a contribution to the sunk costs that we have already incurred.

Q19 Mr Curry: There was an actuarial process which arrived at this sort of level of cost, the value of the ticket.

Mr Jeffrey: I think the intention is that at the end of all of this we should have two carriers and they should have one.

Q20 Mr Curry: I understand the logic. That was because the French decided to replace a carrier, not to go nuclear but to go with a conventional carrier. So far as I am aware one of their old carriers is currently stuck in the Suez Canal or trying to make its mind up about which way to go out of it. My interest is how you fix the entry cost, as it were, to this. It is innovative, I think it is very sensible. I am

then going to ask you, does this arise from very specific one-off circumstances or are there projects in which you think this might be a way forward to getting round the dilemma of a normal multinational arrangement?

Sir Peter Spencer: Certainly it is not the first time it has happened because it happened in the reverse way when the UK bought into the missile project for the major weapons system fitted into the Type 45 Destroyer and we judged with France and Italy, who had funded the early stages of development of their version of the system, what they had spent on the bit which would be common to the UK and we agreed to pay a percentage of that and agreed the way in which those payments would be made. We have adopted the same logic on this occasion and we have indicated to the French the amount of money which we have spent which would be relevant to what is called the common baseline design because the ships will not be exactly the same for obvious reasons, they are flying different aircraft. We had an interesting and amicable, but fairly tough commercial negotiation on the value which we put on what we had produced and what we thought was an appropriate contribution from France. They had to look at their own business case to make sure it satisfied the test in France that this did represent a value for money proposition for them compared with a national programme. Fortunately for both sides we have converged. What was very important was that we had in place arrangements which then did not inadvertently cause us to make slower progress through the next phase and we have put in place arrangements which the French are content with. At the end of the demonstration phase we will take a look and see to what extent there are further economies. The fundamental principle here is that those economies need to be jointly proposed by industry because the lessons we have learned from a lot of the earlier collaborative programmes is that if governments get together, fudge issues and then try and force industry to sort it out, the project often ends in tears. We do have examples, such as the Storm Shadow in UK industry and SCALP missile in the French industry where UK and French industry got together and said we can meet your separate proposals with some technology which is common and we will then make it bespoke for your separate purposes and then gainshare the benefits of that. If we incentivise industry, as we shall, to gainshare the benefits then we will get sensible proposals because they will put forward something that they know is going to work and they will share the benefit of it.

Q21 Mr Curry: What we have had up to now is an arrangement which covers a project up to a certain point but perhaps some more genuinely joint development work might then take place later under the sort of scenario you just outlined.

Sir Peter Spencer: Absolutely. If, for example, we decided to buy the same main engines then although it might not look as if buying three sets as opposed to two sets represents huge economies of scale, there

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will be some economies of scale, but there are always quite a lot of non-recurring costs in setting up production lines which will then be shared.

Q22 Mr Curry: On the agreement as it is at the moment, what will the total saving be, as it were, to British expenditure because of French participation? How much will we not have to spend, as it were, because the French are spending?

Sir Peter Spencer: At the moment the net cost to the UK Exchequer will be at least the £55 million which France are going to pay regardless of whether or not we go into manufacture, together with one-third of the demonstration costs for the common baseline design, which will probably be in the order of another £40 million. Should the French go ahead they will then pay a further amount. The intention, recognising industry's contribution to this, is to make some of that available to recycle through the project to incentivise greater levels of joint procurement so we get even higher net savings.

Q23 Mr Curry: That brings me to my next question. I understand that the Chancellor's *billets-doux* about the Spending Review which is now being embarked upon have been popping through letterboxes quite recently. How much of this is the Chancellor going to take, as it were, and how much does he think you might get rewarded for good thinking on this? How is this reflected in your baselines?

Mr Jeffrey: This is catered for in the existing baselines but clearly the next Spending Review will cover a period towards the end of the decade. The position we have reached in Government generally, as you will know, is that it was decided not to have a Spending Review this year but instead to spend this year looking across Government at a set of wider issues, looking at areas that could be examined to see if there is any serious scope for savings and then moving on to a conventional Spending Review covering everything next year. It would be unwise of me to speculate on the outcome of that, but clearly some of the issues that we are discussing here—

Q24 Mr Curry: The French cheque arrives this year, does it? The French cheque goes in the Barclays account this year, does it?

Sir Peter Spencer: We will get one payment this financial year and one payment the next financial year.

Q25 Mr Curry: So it falls within the scope of the existing financial framework?

Sir Peter Spencer: It does, yes.

Q26 Mr Curry: Talking of engines, on the joint strike fighter there is quite a lot in the papers about the alleged debate with the United States as to whether or not they should commission two engines or a single engine. How important is it to the UK that Rolls-Royce should have part of this action?

Mr Jeffrey: We certainly think it is important and we have been saying so to the United States' Government, largely on the basis that clearly UK

industry is involved in the second engine but also that to have an alternative is always a more comfortable position than to only have one. This is an issue that the US Government still has very much in its sights and we will be keeping closely in touch with them.

Q27 Mr Curry: What would be the consequences if they took a decision which was an adverse decision as far as we were concerned?

Mr Jeffrey: The immediate consequence would be that it would be necessary to pursue the programme on the basis of the other engine that is currently being considered. I do not know whether you would like to add to that, Sir Peter.

Sir Peter Spencer: So far as the cost to the Ministry of Defence in initial acquisition, as we do not yet know what the cost of one engine versus the other might be. It would be too early to give you an exact figure. In a big market and with the sort of competition which could be mounted we would obviously hope to get some benefits. We would expect to get some benefits, from a competitive arrangement, but it would do nothing to stop us achieving the capability that we need. We would need to examine the impact on the prices which are charged in the light of better knowledge nearer the time when we make that production decision.

Q28 Mr Curry: The decision on the engines will not influence the number of aircraft we expect to take, will it?

Sir Peter Spencer: I have no reason to suppose that it would because I have no reason to suppose that the cost differentials would be so great in a non-competitive environment and a competitive environment, but I cannot give you an absolute assurance of that in the absence of any data.

Mr Jeffrey: Be in no doubt that we would prefer to see a second engine and the US Government is aware of that.

Q29 Sarah McCarthy-Fry: I would like to go back to the point that the Chairman made right at the start about decreasing costs being primarily due to reductions in numbers or capability of equipment. I would like to ask Lt General Fulton, do you think it is reasonable to bring projects back on track by reducing capability?

Lt General Sir Robert Fulton: I think it is entirely reasonable. That is what we ought to be doing and, indeed, it is what we have been recommended to do by this Committee in the past. There is a process of working out in the first instance what it is that we think we would like to have and then the Assessment Phase is responsible for working out what the cost and time implications of that are. What we are seeing here is that process working out in practice. Clearly we cannot have everything in terms of numbers and in terms of quality of equipment that we would like in an ideal world, everything is a balance. I think this reflects exactly the process we ought to be going through.

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Q30 Sarah McCarthy-Fry: Looking at the Defence Industrial Strategy with our new mature, grown-up partnership with industry, do you think it would be fairer to more adequately define our requirements rather than saying “This is the Rolls-Royce” and bidding for it to actually say, “This is what we think we need and can do within cost”?

Lt General Sir Robert Fulton: The question was asked earlier about metrics of performance. One of the ways in which we have taken that forward in the capability area is to define for each project as it comes forward to Main Gate a threshold level of capability and an objective level of capability, the threshold being, as the name implies, below which it would not be worth buying the equipment if it could not do a certain number of things, but clearly some areas into which we would like it to go. That is how we now define the trade space so that as the project goes forward the directors of equipment capability and the project team leaders understand where the envelope sits for their cost, time and performance trades. That is what we share with industry. As the requirements are exposed to industry, very often that fruitful relationship with industry that you have described leads to a process whereby industry can identify things that they could put into the programme, and the precision-guided bomb is a very good example of that where we had a requirement for it to be targeted by a laser designator and industry came back and said, “Actually, the one that we have already has a laser seeker head in it. It would cost us more to take it out so, therefore, why don’t you have the laser literally free of charge”. The engagement of industry allows us to understand not only where we need to make greater provision either in cost or time but also where we can get more for our money. This is all part of the process.

Q31 Sarah McCarthy-Fry: It sounds as if what you are saying is that you do not say, “This is the outcome I want to achieve, what can you make me that will do it”, but you go to them with a specific requirement.

Lt General Sir Robert Fulton: The point of the concept phase of the so-called CADMID cycle is to identify what the end user, the front line command, would like it to do and how it would fit into the plans. That then sets an agenda for the Assessment Phase and the industrial companies that are conducting the Assessment Phase understand the envelope within which they are working. That then goes forward in most cases, but not all, to a competition for the Demonstration and Manufacture Phase which has by then refined some fairly broad statements, some fairly high level statements, some fairly aspirational statements, into some hard criteria against which, firstly, they are going to compete and then against which they are going to manufacture.

Mr Jeffrey: I think the crucial thing is in the Assessment Phase there should be intelligent discussion involving the procurement people, the military customer and the supplier in the spirit of openness that you mentioned earlier so that sensible judgments are made about where there should be

any give in capability. It should not just be a question of lopping off bits of capability. The NAO Report in the case studies gives some good examples of where that has been done quite well.

Q32 Sarah McCarthy-Fry: I will come back to that. We have been talking so far about projects that have yet to get through Main Gate. Can we talk about projects that are actually here. We have got 19 out of the 20 top projects that are still £2.7 billion or 10% over budget. Do you anticipate that you are going to have to make further significant cuts in capability to get back on budget?

Lt General Sir Robert Fulton: The Report identifies those projects which are over the original budget and also identifies the measures that we have taken, in some cases in those projects themselves and in other cases in other projects, in order to live within it. That is not done arbitrarily but in all cases it has been done on the basis of an assessment of what capability we are going to need in the sort of timescale that we are talking about here. For example, in some cases there are reductions in torpedoes because not only do we have fewer ships, helicopters and planes in the timescale we are talking about but also we perceive that in comparison to other threats the submarine threat will have reduced and it is more important to use the money that we were going to allocate to the anti-submarine threat to another emerging threat. It is a case, not just within this population of projects but across the whole of the equipment plan, of understanding which aspects of our capabilities should be on the increase and which we can afford to take and which we can afford to do with less of.

Q33 Sarah McCarthy-Fry: I was not quite clear from reading the Report, on the plans you have put in place now you expect to bring all of your projects in on cost, do you?

Lt General Sir Robert Fulton: Both in terms of this project population and in terms of the equipment programme as a whole I would certainly hope to bring the programmes in on cost because any change in one area means that we have to take something out of the project somewhere else in order to live within our means. I would prefer to be able to do that change as a result of just a capability assessment but as we have discussed, and as the Report makes clear, all of these are a balance of cost and time. It might also be it is not just that a particular project is going over in cost but it might be going over in terms of time and then we would have to understand what that would mean in capability terms and also in payment profile terms because clearly we pay for these when we get them. This is a constant juggling act between these three components. I do not expect ever to get to complete stability, so I expect that this will be a continuous process. Anyway, the world around us is changing all the time and, therefore, we have to respond to that.

Q34 Sarah McCarthy-Fry: Can I ask Mr Jeffrey, we do seem to have made some progress this year on reducing costs, do you anticipate that graph will be going down in future years?

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Mr Jeffrey: I think there is still some time in this year to go so we cannot be absolutely certain of that. One thing I was going to say in response to an earlier question, if I understood it correctly, was we certainly do not expect to get to the point where the total estimated cost of the 20 top projects is what it was originally estimated to be. These 20 include some of the great disasters of the past where costs have escalated substantially. What we are very keen to do is to hold the position we have achieved and not see, unless it is absolutely inescapable, any further increase in the cost of these projects.

Q35 Sarah McCarthy-Fry: If we go to paragraph 2.19 on page 23, it talks about the early engagement of British industry within the Assessment Phase and some experimental approaches that were done in MARS and in Watchkeeper and IFPA. Were the early results that have come back from that fed into the DIS and informed you that might that be the way forward? Have you got quantifiable evidence on these programmes?

Mr Jeffrey: What did strike me reading this Report, and preparing myself for this hearing, was that one or two of these—Watchkeeper in particular—are very good examples of what I was saying earlier about the intelligent use of the Assessment Phase. It reflects the spirit of the Defence Industrial Strategy but whether it fed directly into it, Sir Peter may want to say something.

Sir Peter Spencer: It did feed straight into it. One of the Smart Acquisition principles was that should have a more intelligent engagement with industry and, as we recognised three years ago when we did a stock take of the implementation of those principles, there was a problem with compliance and take-up. This has been very much reinforced by these worked examples where we can see the benefit of a more sensible engagement with industry and that is very much one of the principles of the Defence Industrial Strategy and it does not make it an easy relationship. Tough love is probably the best way of describing it in terms of the fact that you have got that close engagement with industry, which does not necessarily mean in any way that it is going to be something easy for both sides to work at. The trust comes from openness and success builds upon success and we have certainly now got a core of people inside the military customer community and inside the team leader community who are the evangelists of this approach. We have “Learning From Experience” sessions at my headquarters so that people can come and hear how those successes were achieved and industry comes in as well.

Q36 Sarah McCarthy-Fry: Would you say that the ability of industry to work with your procurement process should in the future be part of the evaluation process as to whether that particular contract ever should—

Sir Peter Spencer: Yes, it will. If you look at the worked example of Watchkeeper, we started out competitively. When we had enough evidence to demonstrate that we knew who the winner was, we deselected the rest of the field in return for locking in

the supplier with the terms and conditions and basic price models and then worked together to understand the proposal much better. One of the problems we have had in the past with competitions was that it was all done a bit at arms’ length so you chose the result of the competition on the basis of the information that you had but then when you started to test it in greater detail which you needed to produce a detailed negotiated contract you tended to unearth problems and that did not help. Now, we delay the Main Gate capital investment decision until we have matured the commercial understandings as well and that means closer engagement with industry.

Q37 Mr Mitchell: I am a newcomer to this so I know what the average *Guardian* reader knows, which is nothing, about the whole subject but I think dealing with major projects there is a long history of overruns and ex-projects which turned out to be fantastically expensive which we never should have done. I wonder what the main problem is? Have you got a uniquely incompetent set of contractors who cannot supply to price and to contract or a uniquely inadequate supervisory process on the part of the Ministry of Defence who cannot see things coming in on time and their orders can be delivered.

Mr Jeffrey: I think the main problem in the past, if you look at the history of some of the big projects that are still in this list of projects, like Nimrod and Astute, was that bids were made to accomplish projects which turned out to be unrealistic and assumptions were made about how much risk could in practice be transferred from Government to supplier which did not turn out to be realistic either. My reading of it is that all the efforts over recent years, Smart Acquisition, the changes that have taken place under Peter Spencer’s leadership, are intended to build better processes so we do not pretend that we can transfer risk when we cannot, so that we do assess the viability of projects extremely carefully and not commit ourselves until we are pretty confident about cost and timescale. It is a gradual process. I am very keen, as I said at the beginning, in my time to advance that and to get to the point where we are producing results that this Committee will be satisfied with.

Q38 Mr Mitchell: That is a nice straightforward answer. Is there a problem in the sense that there are so few suppliers in this area you are pretty well at their mercy?

Mr Jeffrey: I do not think it is quite that. The only thing I should have mentioned in response to your first question was that a lot of this, in my view, is about the people we employ. I have visited the DPA once and I think we have well-motivated staff who are doing their best but we do need to look, and are looking, at how we train them and the skills they have and the way we apply them. I do not think it is shortcomings in the industry, although there may well have been in the past. Industry is changing rapidly.

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Q39 Mr Mitchell: There is only a limited number of suppliers, are there not? You are pretty well dependent on them?

Mr Jeffrey: Nonetheless there is a measure of competition and there is also a growing habit of constructive collaboration, if I can put it that way, through alliances with a number of partners in the industry. I do not know if Peter would like to add to that but clearly it is the core question.

Sir Peter Spencer: We publicly recognised that a whole list of issues had not been properly addressed both in industry and inside the Ministry of Defence. We have been working hard on making the improvements which are necessary in both places and it has been recognised in the NAO report that we are moving in the right direction. The frustrating thing is that five of the projects which are on the current list of 20 will still be on that list of 20 in five years' time because of the way they are selected. Unlike a company which with a really bad piece of business can do a write-off, get it off the books, take its medicine from the shareholders and then move on, we continue with this toxic legacy for some years and part of the challenge is how we try retrospectively to deal with the problems which needed to have been sorted out *ab initio*. When I make that statement it sounds like an excuse but it is not. It is a reality and some of the best people that we have got slug it out trying to retrospectively deal with these projects for which we just wish we had not signed the contracts on that basis. We are constrained by the art of the possible under contract law. Sometimes we look at cancellation options and we find that in return for the privilege of killing the project off we would pay exactly the same amount of money to have nothing. Then the General says, "Oi, where is my military capability?", so you then have to factor in the cost of doing something else. It is going to be a long haul. We are going to have to demonstrate to this Committee, to ourselves and to others that we are genuinely moving in the right direction. Part of the frustration is if you look at Javelin which comes up as a really good little project—and by the way achieved its in-service date in July, four months earlier than predicted last year—it makes one glorious appearance in this Report and then disappears. Meanwhile, Astute, Nimrod, Typhoon, Type 45 and some of the other old lags go stumbling on. I am not here to tell you my hard luck story but I am here to try and put this into a context to establish realistic expectations of when the bottom line is actually going to change which is why we are interested in measuring year-on-year changes.¹

Q40 Mr Mitchell: Whose fault is it? Here is a problem which is something like the IT problems in Government departments where the department's reach, or the public sector's reach, exceeds its grasp. You said that some of the projects are over-ambitious and therefore have to cut back. Whose fault is it that they are over-ambitious? Do you have—because staff must change in procurement,

people move in and move out and move onto greater things or whatever the continuity of experience in procurement to know what suppliers are going to cause what kind of problems, who is going to be able to deliver, who is not going to be able to deliver, what is likely to work? How is the voice of experience held together in the procurement department?

Sir Peter Spencer: We have put in place a comprehensive system for key supply management and we collect data on the top 18 key suppliers on their performance on each one of their projects and we assess them on a regular basis. They have a senior member of the Ministry of Defence as the point of contact for these regular meetings and we tell them if they are in the top quartile, the middle two quartiles or the bottom quartile. It is no surprise they are now taking these reports very seriously because we have made it clear that we will risk adjust their bids on the basis of their track record. There is at least one company where for the senior directors their own remuneration arrangements are directly related to the score they are going to get from that independent assessment. It is about time too that we started to leverage our position as the customer. A lot of this is fed into the Defence Industrial Strategy and we are now beginning to move on to look at the next stage of this which is to get into the detail of the supply chain because the key suppliers, in the main, tend to be the prime contractors. A great deal of the innovation and imagination comes from the second and third tier, small and medium sized enterprises, we want to get into a position with our prime contractors where they should be doing the same sort of supply chain management that would characterise the behaviour of an automobile manufacturer where they are having to do that because of the competitive pressures in the marketplace. We need to find some way where there is not the opportunity to have the sort of full-blooded competition that we might have had in the past to simulate the same sort of stimuli to make our suppliers lean, mean and value for money. There are ways in which we have proved already in the pilot projects where if we recycle some of the savings back in a gain sharing arrangement we do get a very positive response and that is beginning to work quite well.

Mr Jeffrey: If I could just add to that, Mr Mitchell. Also, and I am sure Sir Peter would agree with this, we need to look to ourselves. I do not think any of us would argue, and certainly it is not my initial estimation, that we are in the position we ought to be in. I want to create more of a culture within the Department that values high performance by our own staff when they perform well on project teams or otherwise and make sure people do not flourish if they perform less well. This is not just about industry, it is something we have got to look to internally as well.

Q41 Mr Mitchell: Let me just give you a concrete example. The Type 45 Destroyer—I have to say I am very fond of destroyers having spent a considerable amount of time on one in the Navy scheme for MPs, experienced sailor me—is basically a simple project,

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it is not a big, enormously complicated thing and yet I see the project has now had £145 million of costs taken out of it. Why is that? Is it because you wanted something too elaborate in the first place or have you just discovered that the equipment would not fit or would not work? It sounds as though you are starting to complicate a basically simple project too much.

Sir Peter Spencer: This is a very, very complex project. *HMS Daring* was launched today, the first of class. There has been a certain amount of press coverage on the capabilities which are necessary to protect ships at sea from low-level supersonic sea skimming missiles. The technology which has gone into this ship is very advanced.

Q42 Mr Mitchell: Now you have taken it out can it still do the job you want it to do?

Sir Peter Spencer: We are not taking it out. What we are doing is we are trading some elements of performance to live within our means. This is one of the projects where the way in which the contracts were placed simply would not happen today. I would characterise it by saying that we had entered into financial exposure levels which went far beyond our understanding of the problems at the time. It is a fact that we still have not yet put on contract all of the money for the final three ships that have been approved, and that has been a major source of concern to me as we seek to ensure that we can tie down the completion of these ships. What you are seeing there in terms of some of the measures which have been taken is to delay some of the software upgrades in the combat management system and in the electronic warfare system to some later stage, so they will come in later on but they will not form part of the initial procurement because one of the fundamental principles that we are all signed up to is to do whatever we can to live within our means.

Q43 Mr Mitchell: Just one final question which the Chairman might allow because it comes from a Euro-sceptic point of view. I see from Richard North's writings that we are now ordering more and more stuff from the Europeans instead of buying it from America where it is cheaper to do so where there are marginal costs because they have got a huge market for their own armaments. It makes us dependent on the kind of combined projects which have produced such glories as the Eurofighter. Are we going to be much more subject to cost overruns if we are going to order more from Europe?

Mr Jeffrey: As I look across the range of projects that I have inherited they are a good mix. We are still doing a lot of business with American companies. I do not detect a significant trend towards continental European countries other than the British based ones that we know about or, indeed, the Americans that we are already doing much business with.

Sir Peter Spencer: I think there is an important point here in terms of judging what the costs are going to be in whole life terms and supporting American sourced equipment occasionally can be rather more expensive than we had understood *ab initio*. Other countries have found this out too. On the other

hand, it is true to say that where we can do something like purchase Tomahawk missiles at effectively marginal cost it does represent very good value for the money which we spend. The challenge with European projects tends to be the management arrangements. If you are buying from America or you are in an American co-operative arrangement, America is the dominant partner so you have actually got somebody who is in charge. If you look at Eurofighter, we have got four nations and the amount which I bring to bear in decision making is 25%, so inevitably it is more complex and we have to work quite hard at those. In the European context in the past with Eurofighter the contractual arrangements were set up under the so-called *juste retour* where an enormous amount of effort went into sorting out work share for the participating nations almost regardless of the efficiency of what resulted. Under the new arrangements with the European procurement organisation called OCCAR those sorts of *juste retour* arrangements are no longer in place. Although clearly participating nations expect to have some involvement for their industries the arrangements are sorted out over a much broader portfolio of projects which are calculated over time. The track record of those projects is much better than Eurofighter, as you would expect.

Q44 Chairman: I have a figure of costs for Type 45 of £153 million, is that right?

Sir Peter Spencer: Per copy?

Q45 Chairman: Per copy, yes.

Sir Peter Spencer: I do not think so.

Q46 Chairman: I read it somewhere. I just wanted to get it right.

Sir Peter Spencer: The UPC listed here is £561.6 million.

Q47 Chairman: I am sorry, I under-estimated it. Will you forgive me asking, Sir Peter, because we are not defence specialists, with the possible exception of Ms McCarthy-Fry who represents a defence constituency, but you mentioned the threat to the Type 45 of supersonic low-level skimming missiles.

Sir Peter Spencer: Amongst other things.

Q48 Chairman: How many low-level skimming missiles has al-Qaeda got? The serious part of this question is are we building another dinosaur that could be sunk by one terrorist approaching it in the harbour when it is refuelling or something?

Sir Peter Spencer: Clearly high value assets in harbour need to be protected and that is a matter of tactics and doctrine as much as anything else. In terms of the realism of the threat, and the expert is on my right, it does not take a lot of money to fit a missile into a small boat and to send that out against some high value merchant ship which is bringing much needed equipment into theatre to support a military operation in peacekeeping and peace support. Depending upon that threat we do still have to protect the sea lines of communication and it

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would be hugely unwise to imagine that the sea is by definition a safe place to move about simply because people do not live on it.

Chairman: Thank you, Sir Peter. I am sorry to ask you that question.

Q49 Mr Curry: Can I just pursue that with one question. When you talked about Type 45 you said it costs a great deal to defend it from attack and I am thinking if the bulk of the money goes to protect the ship it becomes a bit like—

Sir Peter Spencer: It was defending another ship, so it defends a large area of the ocean in which the assets you wish to protect would be based.

Q50 Mr Curry: There is no point in building a vessel if its main purpose is to defend itself. It is a bit like “Do not throw stones at this notice”.

Sir Peter Spencer: No, its main purpose is to defend other ships.

Mr Jeffrey: To get the division of labour right, I do not know whether General Fulton would like to answer that.

Lt General Sir Robert Fulton: It is designed either to protect a sea area which might contain our own carrier, which will certainly need protection, or it might be another nation’s ships or, indeed, it might be a civilian merchant ship.

Q51 Mr Mitchell: The Report observes the point that when a project is mature enough for the main investment decision to be taken will look very different from one project to another dependent upon the perceived benefits of progressing the project quickly, albeit with a greater level of recognised uncertainty and risk. I do not want you to define the process of maturity for different kinds of weaponry but in that kind of decision, once it is considered mature and the order goes ahead, are the politicians brought in then or is that entirely a Ministry decision?

Mr Jeffrey: Both the Initial and Main Gate decisions are put to the Minister for Defence Procurement for agreement, so in that sense politicians are very much involved, and the Chief Secretary of the Treasury as well.

Mr Curry: Mr Mitchell introduced a question from the Euro-sceptic point of view so perhaps I ought to declare that I am notoriously Europhile.

Mr Mitchell: Shame!

Q52 Mr Curry: Just as well since my French wife and I are coming up to our 35th wedding anniversary. The French Government has recently listed a series of industries it regards as strategic, which appears to include yoghurt and steel. Does the British Government have an idea of the capability which ought to be kept in national hands? Is it a concept which means anything internally for the UK Government? How would one characterise it?

Mr Jeffrey: My colleagues may want to comment but the Defence Industrial Strategy in part addressed that issue, not by saying that there are things that can only be undertaken by British owned companies in the United Kingdom but by saying

that there are certainly some capabilities which we would want to see onshore in whoever’s hands they may be. I do not know if that is the thrust of your question, Mr Curry, but there certainly is a working set of assumptions about what we need to keep on these islands.

Q53 Mr Curry: We would put location over ownership, as it were?

Sir Peter Spencer: We define as a UK company a company which creates intellectual capital in the UK itself. For example, BAES, where the shareholding ownership is 46.7% overseas, is a UK company, as is Thales UK and certain American companies who operate inside the UK and do the development design here. What the Defence Industrial Strategy has done is to be much more explicit about what the Government regards it needs to have immediate access to in the UK to support military operations and define so-called sovereign operational capability through life. Whereas the previous document on which the Defence Industrial Strategy was based, namely the Defence Industrial Policy, named a handful of capabilities such as nuclear weapons, nuclear steam raising plant, cryptography and certain other areas, this is much more explicit sector by sector as to what is going to be important enough to nurture and sustain in the UK and by the same token it has identified some areas which in the past we have not opened to competition as not enjoying that particular status. Industry feels that this enables them to take a longer term view which, together with better access to our forward planning, enables them to judge the sort of investments they might wish to make both in new facilities and in restructuring old facilities. We would expect to see the benefits of that over time rather than a series of apparently independent competitions running for different capabilities which to industry represent instability.

Q54 Chairman: To sum up: the figures on costs have improved, for which we congratulate you, but they have improved because you have made cuts and these are cuts which we, ourselves, recommended you make in the past to get a more realistic picture. Things are improving slowly but the overall cost of these projects, despite decreasing in one year, is still an enormous £2.7 billion more than the original budgeted cost of £26 billion. Lastly, can we assume, Mr Jeffrey, that we are now at the start of a new dawn in defence procurement?

Mr Jeffrey: I think it is always unwise to use that sort of phrase. I am certainly both encouraged and challenged by what I have inherited here. I think there are signs of improvement. The test now is how we manage the more recent stuff but, as the Chief of Defence Procurement has been saying, we live with the inheritance of the past. We really have got to work very hard, adjust our systems as necessary, push our people who are very willing, I sense, and make sure that we do make it a new dawn. I am reluctant to give any hostages to fortune, particularly with this Committee.

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Q55 Chairman: Sir Peter, this Committee has great respect for what you have achieved so far, do you want to have the last word?

Sir Peter Spencer: I would say it was good to table this result. I remain concerned about the risks with what I describe as the toxic legacy and we are going to have to work really hard to sit on top of that. I

think there will be some storms ahead and it is going to be a real test of character and the working relationship that we enjoy between myself and General Rob and his people to ensure that we do the right sort of things to sit on top of the budget but that is going to be tough.

Chairman: Thank you very much.

 Letter from Chief Executive, Defence Procurement Agency to Sarah McCarthy-Fry MP

I have seen the record in Hansard¹ of your remarks during last month's defence procurement debate in the House of Commons, where you quoted my evidence the previous day to the Committee of Public Accounts. The Hansard record reads as follows:

Sarah McCarthy-Fry MP (Portsmouth, North) (Lab):

"Does the hon Gentleman agree with yesterday's comments by Sir Peter Spencer to the Public Accounts Committee on the MOD Major Projects Report? He said that procurement difficulties are due in large part to the 'toxic legacy' of previous Governments and that he expects such difficulties to continue for some years to come."

In response, Mr Gerald Howarth MP is recorded as saying:

"I have not seen Sir Peter's remarks, and I shall read them with great care. Sir Peter is in charge now; the delays are occurring now; and the in-service dates are slipping now. It is no good blaming the Government of eight years ago for something for which this Government have taken responsibility for the past eight years. Sir Peter has been in office for the past two or three years, so he should be careful when it comes to casting beams out of other's eyes."

I am writing to put on record that your statement appears to be based on a misunderstanding of my evidence to the PAC hearing on the Major Projects Report 2005 on 1 February 2006. As the transcript of that hearing shows at question 39, in referring to continuing problems on older projects included in the current Major Projects Report population, what I actually said was that the Department would "continue with this toxic legacy for some years and part of the challenge is how we try retrospectively to deal with the problems which needed to have been sorted out *ab initio*."

These remarks were wholly without reference to which Government was in power at the time these older projects were initiated. Indeed the facts as demonstrated by the MPR itself show that the approval of the range of such projects straddles both the current and previous Administrations.

I trust that this clarification will set the record straight.

Sir Peter Spencer KCB
Chief of Defence Procurement & Chief Executive

14 March 2006

¹ Hansard, 2 February 2006, Col 508.