



House of Commons  
Defence Committee

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**Defence Procurement:  
Government's  
Response to the  
Committee's Eighth  
Report of Session  
2002–03**

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**Fourth Special Report of Session  
2002–03**

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## The Defence Committee

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### Committee staff

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# Fourth Special Report

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## DEFENCE PROCUREMENT

The Defence Committee published its Eighth Report of Session 2002–03 on Defence Procurement as HC 694 on 23 July 2003. The Government’s response to this report was received on 14 October 2003 and is published as an Appendix to this Special Report.

## Appendix

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1. This memorandum constitutes the Government’s response to the House of Commons Defence Select Committee’s Eighth Report of Session 2002–03, on Defence Procurement. The Government welcomes the Committee’s report, which is generally positive in tone and includes a number of constructive observations and recommendations.

### Defence Industrial Policy

**We very much welcome the publication of the Defence Industrial Policy, bringing as it does a useful, though long overdue, increase in transparency to this important area. The way its provisions and statements should be interpreted will inevitably have to be developed; by further debate and through “case law”. Indeed, in some areas, including the use of competition and open markets and in risk management, the Policy’s utility will be evident only with the passage of time. (Paragraph 23)**

2. The Government welcomes the Committee’s support for the publication of the defence industrial policy. This provides the basis for the MOD’s long-term engagement with industry. The MOD holds regular meetings of the National Defence Industries Council to review progress. We are working hard, both internally and externally, to maximise the benefits of the policy. As more acquisition decisions are made on the basis of this new policy, the Department will be able to draw upon more evidence as to how successfully it is operating and how it needs to be developed.

3. The MOD expects to publish shortly a review of the operation of the policy following its first complete year of operation.

**From whatever direction one views the defence research environment, in terms of the adequacy of the MOD’s long-declining research budget or the aims to which it is applied, it is clear that great care will be needed to protect those parts of the UK’s scientific base upon which the fighting effectiveness of the Armed Forces depend. (Paragraph 14)**

4. The Government acknowledges the contribution of investment in research and technology to the future prosperity of the defence industrial base and the capability of the Armed Forces. The MOD will always retain a requirement for niche capabilities. Protection and stimulation of research in these areas is important. However, it is equally important that the research undertaken is focused on specific capability needs. In order to focus research effort more effectively, the management of research and technology within

the MOD has recently been restructured to become output-driven. The aim of this is to introduce a new way of doing business that results in better outcomes for defence, increased efficiency and value for money.

5. The Department will also seek to avoid duplication of effort with our allies, improve access by industry to foreign technology, and increase the proportion of research collaboration. The UK is in an excellent position to capitalise on this, having co-operative links already in place with more than 20 nations, covering over 1000 activities across a wide range of technologies.

6. The Department is working with industry and academia to co-ordinate our joint resources, to maximise exploitation of civil technology, and to target investment into areas of military importance in which UK industry can be global leaders. In many fields of research, the commercial market invests more heavily than Government is able to, particularly in the biotechnology, communications and IT sectors. Effort is becoming more directed into 'pulling through' these civilian technologies into the acquisition stream. The Department is able to stimulate research in the industrial sectors through two key collaborative schemes: Defence Technology Centres and Towers of Excellence. These are focused on areas of key importance to military capability and help prevent duplication of research effort, thus maximising the effects of available funds.

## Opening Up Markets

**We welcome the sensible and balanced approach to the use of competition under the Defence Industrial Policy, recognising as it does that its benefits in the short-term may bring disadvantages later on. Though curtailing competition in order to secure such a more favourable scenario in a sometimes distant and uncertain future has risks of its own, it is right that the MOD should be alive to the issue and give it early consideration in each project. (Paragraph 28)**

7. The Government welcomes the Committee's reaction to the approach to competition set out in the defence industrial policy. Open and fair competition remains the bedrock of the Government's defence procurement policy, but we will not use the competitive process beyond the point where it can offer long-term advantage. The Department will use other approaches where these offer better long-term value for money. Our approach to competition will continue to evolve with the developing defence market. A key element of the Department's approach to implementation of the defence industrial policy is to set out clearly at an early stage in a project's life the wider factors that need to be addressed in deciding how best to proceed. As part of that approach, we will continue to engage in dialogue with industry on how well we run our competitions and on the balance between the costs and benefits of competition.

**Whichever way the MOD goes on the Advanced Jet Trainer programme, we expect in its reply to this report to make clear how its decision fits with the value for money, competition and risk management provisions of the Defence Industrial Policy. (Paragraph 27)**

8. The Defence Industrial Policy makes clear the importance the Government attaches to maximising the economic benefit to the UK from our defence expenditure and of having a

healthy, innovative and globally competitive UK defence industry. In the case of the Advanced Jet Trainer, a range of military, industrial and economic factors were considered. These included: the way in which fast jet training would develop in the future; the relative merits for this project of pursuing a PFI/PPP solution or a conventional procurement route; the likely overall effectiveness of running a competitive procurement exercise to select the aircraft; and the industrial/economic consequences of the proposed approach. As the Committee suggests, there are also advantages in settling the AJT element of the overall UK Military Flying Training System early to remove uncertainty in the project as a whole.

9. After much deliberation, an order for a new advanced variant of the successful Hawk aircraft was considered to meet defence requirements, support the UK's high technology aeronautical capability, including skilled jobs, and assist in future exports of Hawk variants. The Government welcomes the subsequent announcement by the Indian Government that it has selected a Hawk variant to meet its fast jet flying training needs.

**We are happy to lend our weight to a campaign to address the lack of open markets in other countries. Ministers and their officials must maintain pressure for reciprocal treatment from other defence manufacturing countries. An open market approach might help the MOD secure good value for money in its procurements, and as such might earn our commendation, but not if other countries fail to adopt a reciprocal approach which allows UK industry to compete overseas on merit, and if as a result the scope for home-grown competition dies. (Paragraph 33)**

10. Reducing the barriers to co-operation with our allies is a priority and the Government therefore welcomes the Committee's continuing interest in and active support for this issue. This effort is being pursued at the highest levels within the Government. On his recent visit to Washington, the Prime Minister secured an agreement with President Bush radically to improve the sharing of defence information and technology between our two countries. The Government is also working with the US Administration to secure a waiver for the UK from the US' International Traffic in Arms Regulations. We have made good progress with our European allies under the umbrella of the Letter of Intent and we are taking a pivotal role in shaping the discussions on the formation of a new European body to oversee capability development. The UK defence industry has shown itself to be very capable of exploiting opportunities in overseas markets; we are sure that our industry will take full advantage of the progress we are making.

## **Framework Agreement & Declaration of Principles**

**The UK defence industry would suffer more than most from a retreat into protectionism. It is precisely because of the success abroad of UK firms that pressure must be maintained on the US and European countries to level the playing field. (Paragraph 37)**

11. The Government's objective is to open up defence markets. UK defence industry performs well in competition with overseas companies and is well placed to capitalise upon the level of government to government equipment co-operation. In the absence of more open defence markets, we use Industrial Participation as a lever to secure greater opportunities for UK companies.

12. The Government is pursuing its goal of more open defence markets overseas through the US/UK Declaration of Principles (DoP) and the 6-nation European Letter of Intent (LoI) Framework Agreement. Work continues under the DoP to improve defence industrial and equipment co-operation between the UK and US. Achievements to date include the agreement of an unclassified International Traffic in Arms Regulations (ITAR) waiver (but which can only come into effect once various legislative hurdles have been cleared), increased assurance on security of supply, streamlined visit procedures and the setting up of a group to improve the flow of technical information. We are also working on a strategy to increase UK exports to the US and to improve the flow of defence information between our two countries.

13. On the LoI, all six nations have now ratified the framework agreement and are in the process of signing a number of Implementing Arrangements. In addition to removing barriers to industrial co-operation, many of the measures are designed to help in more efficient equipment and industrial co-operation with our European partners. One Implementing Arrangement (Security of Supply) commits the six nations to provide information about forthcoming bid opportunities and proposed contracts in a time-scale that will enable companies to make the necessary preparations in advance of tendering. The arrangement further commits the LoI nations to treat all such bidders equitably regardless of the country of origin. On the basis of evidence of market access we have signified a willingness to consider the waiver of offset (Industrial Participation) on a reciprocal basis.

**We welcome any initiative that encourages movement towards a rationalised and efficiently managed defence market in Europe. It is important, however, that any developments on that front do not create agencies and programmes which foster European preference at the expense of the UK's two-way transatlantic trade. In that regard, we join the House of Lords European Union Committee in its warning about the need to guard against a European Commission report on a "Defence Equipment Policy" becoming "a tool for protectionism or constraining the ability of Member States to order armaments independently". (Paragraph 41)**

14. While the Government supports the Commission's aim of a genuine European defence equipment market and the removal of internal barriers, we are opposed to the creation of a closed European market. We remain committed to equipment co-operation, including the sustainment of strong trade links, with our European allies and with the United States.

15. We envisage, as a priority, the enhancement of European military capability being supported by an agency to be established under the European Council. We are working under the Italian EU Presidency with our European partners on the detail of an Agency to enhance European defence capabilities. This we believe, must remain the main thrust of our approach.

**Another concern about a formalised vehicle to take the European Commission's agenda forward is that it might risk undermining the prospects for further progress by the six nations of the "Framework Agreement" and the four of the OCCAR organisation. Trying to do what the Framework Agreement and OCCAR are intended to do, but with three or four times the number of countries risks being a backward step. (Paragraph 42)**

16. The Government acknowledges the Committee's concerns over the potential risks inherent in expanding the membership of OCCAR and the Letter of Intent (LoI) Framework Agreement too quickly. We are acting to minimise these risks. In conjunction with our partners in these institutions, the UK is pressing for the creation of a European defence capabilities agency. This agency would accommodate the needs of European nations as a whole but also preserve what has already been achieved with these established ventures.

17. With this aim, we envisage that OCCAR and the Framework Agreement would become self-contained, but fully co-ordinated elements of the wider agency. This would allow both of these ventures to develop, while permitting governments to enjoy the benefits of a coherent capability development and armaments acquisition process. Under this model, the agency as a whole would be open to all European countries while OCCAR and the Framework Agreement would continue to operate in accordance with their founding principles. With existing membership entry criteria remaining in place, we expect that OCCAR and the Framework Agreement would be able to expand naturally, as now, to accommodate additional membership. This would allow both initiatives to develop gradually, thereby enhancing the benefits they offer and helping to ensure that they do not become unworkable.

18. European countries will continue to have the opportunity to become members of the Framework Agreement and OCCAR after meeting the entry criteria and, in the case of OCCAR, non-members will continue to be able to participate in OCCAR managed programmes. In this regard, the Committee may recall that Belgium joined OCCAR as the fifth member in May 2003, and that Spain, The Netherlands and Turkey currently participate as non-members in programmes managed by OCCAR.

## ITAR Waiver

**We are disappointed about the suspicion with which some in Congress have viewed the draft agreement on a UK waiver for the US International Traffic in Arms Regulations, not only because with the delay in implementing it, the benefits for both US and UK remain unfulfilled, but more importantly because of the message that the delay conveys about the nature of the UK-US relationship. (Paragraph 52)**

**The importance of the waiver extends beyond its immediate procedural and legal scope, because it is a touchstone for our relations with our closest ally. A failure to implement this first step in bringing closer together the industrial side of that alliance has the potential to become the thin end of a damaging and undesirable wedge in the political side. (Paragraph 54)**

19. The Government notes the Committee's observations on the ITAR waiver, and is grateful for the Committee's support for its efforts to secure it.

## Nimrod MRA4 and Astute

**The way production of the Nimrod MRA4 aircraft is brought to a stop will have to be very carefully managed. Although the MoD and BAE Systems are considering**

**continuing some low-risk production work to maintain skills, there remains a real risk that vital skills will be lost and will be very difficult to replace. (Paragraph 65)**

20. Both the Government and BAE SYSTEMS recognise the risks associated with the controlled stop to the production element of the Nimrod MRA4 programme. However, this break in activity is necessary to ensure design maturity is established before further production of aircraft 4 onwards. This will avoid the time and cost penalties associated with concurrent design and production. The controlled stop to production is essential to the long-term health of the programme. The Company has assured us that it is working to retain the key skills required to meet its obligations under the Agreement announced on 19 February. We shall consider with the Company any low risk production activities that can be undertaken. But we must balance the benefits of this against the risks and impacts of any design change that could arise from the remaining development programme and associated flight test programme.

**In many ways, the root causes of the Astute submarine programme's problems had some similarities with Nimrod's. There was, in particular, a degree of over-ambition in terms of sizing up the technical risks. (Paragraph 68)**

21. The Government accepts this observation. The contract was predicated on certain assumptions made at the time of contract let (March 1997) which included the expected benefits to be derived from the first comprehensive application of computer aided design (CAD) techniques to UK submarines. It is now clear that the effort required to introduce CAD was underestimated: experience from surface-ship design was of less benefit than expected because of the much more demanding component density and placement accuracy required for a submarine. We now know that the US Navy was having similar experience with the design of their Sea Wolf class submarines in the early 1990s. This has led to MOD's facilitation of the assistance of General Dynamics/Electric Boat (EB) company to provide key design management expertise and drawing office support.

22. Astute represented the first break in an almost continuous production of nuclear submarines at Barrow in Furness. The last submarine to be completed was HMS VENGEANCE, the last of the four Trident submarines. Key skills were lost in the gap before ASTUTE commenced production (VENGEANCE was laid down in 1993 and ASTUTE in 2001 – the first time since the laying down of HMS SOVEREIGN in the early 70s that there had been no concurrent production of nuclear-powered submarines). Continuity in the industrial base is therefore an important factor to consider in our future plans for submarine production.

23. Under the Astute prime contract, industry was to take full design authority responsibility and most of the risk, supported by strict application of “eyes on/hands off” management. The lesson being taken forward for Astute is to promote open, co-operative working, to share all information and to take a pragmatic view on risk and its management. In this respect we need to retain specialist skills within the MOD to enable closer involvement in the management of risk at the prime contract level and down the supply chain.

**On one level the MOD could stand by its Nimrod and Astute contracts and insist on delivery by BAE Systems against the terms of those contracts. But the MOD needs those**

programmes to be delivered, and would have only a hollow victory if its insistence left the programmes stalled. In hindsight, it is clear that the firm discounted its bids by under-pricing its risks—either in error or by being blinded by a must-win determination. If the MOD now has had to renegotiate the contracts in a way which more reliably reflects those risks, then digging into its pockets to rescue these programmes might indeed be, as the Minister put it, a “sensible use of taxpayers’ money”. It is important, however, that in bailing out the contractor the MOD does not pay more than that earlier unwarranted discount – to do so would send a message that commitments made in firm-priced contracts are in reality little more than a basis for further negotiation at the first sign of trouble. (Paragraph 77)

24. In both these cases, risk emerging since contract placement has meant that the overall cost of delivering the programmes is significantly higher than that envisaged at contract placement. Particularly for Astute, the Department shares some of the responsibility for these additional costs, and for Nimrod, we have agreed to contribute towards the restructured programme. The re-negotiation of both contracts has been a long and complex process, requiring judgements to be made on both sides. But the significant losses made by the company and subsequent provisions in their accounts support our belief that the MOD is not paying for more than any earlier ‘unwarranted discount’, and send a clear message that we do not bail out programmes at the first sign of trouble.

### **Future Aircraft Carrier**

**There is significant merit in the novel ‘Alliance’ arrangement for the Future Carrier programme. There may be some very difficult issues to iron-out, which may yet defeat the MOD. But we welcome the way the Alliance model is trying to avoid some of the pitfalls of the Nimrod and Astute programmes. We welcomed Lord Bach’s assurance that the discussions with France on a possible co-operation with its carrier programme would not be allowed to jeopardise the UK Carriers’ in-service dates. (Paragraphs 81–82)**

25. The Government considers that the Alliance approach being applied on the future aircraft carrier project is the most effective procurement strategy for such a complex programme. Our detailed analysis of the performance of BAE SYSTEMS and Thales UK during the Assessment phase concluded that each company had significant, and largely complementary, strengths. To deliver value for money and provide the best capability, it was therefore important to exploit all the strengths of the two companies; and it was concluded that an Alliance offered the best means of drawing in the necessary resources and expertise to deliver the carriers to time and cost.

26. This innovative approach builds on the principles of smart acquisition and the defence industrial policy that was published in October 2002. It enables us to make the most of the resources and strengths of both companies and the skills and expertise of the MOD project team. The Alliance will also enhance the project and performance management arrangements and will ensure that risk is allocated to the party best suited to manage and mitigate that risk.

27. Since the Secretary of State's announcement on 30 January 2003 that the Alliance approach represented the best way forward for the programme - and whilst maintaining

progress with the carrier design - discussions have been conducted with BAE SYSTEMS and Thales UK on how to take forward the Alliance. Specifically, the companies and the MOD have now agreed contracts for Stage 3 of Assessment which will be managed by a single, integrated team staffed from both BAE SYSTEMS and Thales UK. Stage 3 of the CVF Assessment phase commenced formally on 5 September. The current intention remains to place a Demonstration and Manufacture contract in Spring 2004, with target ISDs for the two vessels of 2012 and 2015.

## Management of Small and Medium Enterprises

**We welcome the Ministers' robust approach to safeguarding the position of smaller firms. Smaller firms provide the essential foundation for the UK defence industry, and the MOD must ensure it considers the implications for such businesses as it develops its procurement processes and policies. (Paragraph 85)**

28. The Government welcomes the Committee's positive comments.

## Procurement Agility

**Slippage continues to be a problem, particularly on older "legacy" projects. But even in regard to newer projects which should be able to be fully moulded according to Smart Acquisition principles, there remains a question about the agility of the Department's acquisition systems. (Paragraph 93)**

29. The Government welcomes the Committee's acknowledgement that slippage is a problem predominantly on older projects, but shares their concern about the delay reported by some Smart projects. A number of steps have been taken as part of Smart Acquisition to address slippage including the better estimating and management of risk, the introduction of technology readiness levels and the wider adoption of incremental acquisition techniques. However, the Department recognises that more needs to be done, and CDP's review (covered below) is in part designed to identify other areas where improvements can be made to our acquisition processes.

**We are disappointed that the MOD has so far been unwilling to share its thinking with us on where the capabilities added by some programmes may be subject to a "hard look". (Paragraph 96)**

30. The Government acknowledges that the New Chapter White Paper published in summer 2002 contained relatively few specific equipment capability announcements. Equally, whilst the Spending Review 02 settlement included some £1½ billion across the three-year period earmarked for the New Chapter, this was not allocated to specific projects.

31. That allocation of funds to individual programmes is a function of the MOD's normal internal financial planning processes. Our priority has been to focus on new technologies that can be harnessed to deliver flexible Armed Forces and controlled, precise military effect, in particular to link sensors and weapon systems, to command control and information systems and decision makers. The Department has, for example, been able to: press ahead with improvements to UAV capability through the WATCHKEEPER

programme and by establishing a programme for Joint Service UAV experimentation; incorporate plans for improvements to communications and datalinks; and increase experimentation in support of NEC through the establishment of a Network Integration Trials and Experimentation (NITE) works programme. The Department is also considering a number of measures to improve force protection and to improve the flexibility, deployment, mobility and firepower of forces.

32. As the Secretary of State for Defence has indicated since publication of this Committee Report, it is not sensible to invest money in new systems without looking at the existing programme. That work is in progress. It involves looking at how best the size and shape of the Royal Navy should evolve as we introduce the new aircraft carriers, amphibious shipping, Type 45 destroyers and Astute class submarines; at shifting within the Army to a more graduated and balanced structure of light, medium and heavy forces with the right emphasis on enabling capabilities; at shifting the emphasis within the Royal Air Force from dedicated air defence aircraft to capable multi-role platforms equipped with precision munitions and enhanced sensors.

33. Consistent with long-standing practice, it is not, however, the Government's intention to identify detailed measures under consideration as part of the planning process until they have been formally endorsed by Ministers and approved in the normal way.

**We are impressed with Sir Peter Spencer's determination, as the new Chief of Defence Procurement, to make Smart Acquisition truly agile and responsive to equipment customer's needs. He appears to share the view of the Chairman of the Defence Industries Council, and our own, that "we need to be prepared periodically to refresh Smart Procurement". (Paragraph 103)**

34. The Government welcomes the Committee's recognition of the need for periodic reviews of Smart Acquisition. As he briefed the Committee during his first evidence session, the Chief of Defence Procurement has initiated a 'stocktake' of the implementation of Smart Acquisition. This work has been supported by McKinsey, in order to provide a link to the original thinking behind the Smart Acquisition initiative. McKinsey's work concluded that the underlying principles of Smart Acquisition remain as relevant today as they did at the outset. They noted that the initiative had seen a number of successes, including the creation of a strong Central Customer and the establishment of IPTs, but they also confirmed CDP's view that some elements of the initiative would benefit from being reinvigorated. The work on the stocktake is continuing in order to identify the appropriate way forward, and the Department expects to be reaching conclusions over the coming few months.

### **Watchkeeper/Future Rapid Effects System**

**The Watchkeeper UAV and Future Rapid Effect System programmes are instructive. They are interesting case studies, beyond their increased relevance following the Strategic Defence Review New Chapter, on two counts. First, they both exemplify the MOD's efforts to explore opportunities to bring important new capabilities into service more quickly. Second, and to some extent in conflict with that desire to speed up their progress, the MOD has maintained a cautious approach in both with a view to reducing project risks. In the case of Watchkeeper, the caution has been directed at reducing the**

**likelihood of fielding a UAV platform unable to contribute fully to ‘networked’ capabilities; and in the case of FRES, to deal with “cutting edge” technologies involved and to explore opportunities to take advantage of US experience in developing very similar capabilities in a similar timeframe. As such, these programmes demonstrate that the MOD is still finding some difficulty in balancing increased agility against decreased risk, and it may continue to do so unless, to pave the way, it facilitates greater investment in technology demonstration research. (Paragraph 103)**

35. The Government recognises the difficulty of balancing increased acquisition agility with project risk. The MOD believes it has struck a reasonable balance in the case of both WATCHKEEPER and FRES.

36. On WATCHKEEPER, developmental activities are focused on integrating the air vehicles, sensors and the ground segment into a UAV system and that system into existing and emerging information and communications architectures. Every effort is being made in the assessment phase to identify trade-offs that will deliver a capability as early as possible. This is being done without unduly raising the levels of risk acceptable at the Main Gate investment decision point due in 2004.

37. In parallel with the WATCHKEEPER project (which is focused on the information requirements of land commanders), we are investing in the Joint UAV Experimentation Programme (JUEP) to determine the wider potential operational utility of UAVs. Early JUEP activities have focused on participation in experimentation programmes, including co-operative exercise activities with our allies and at BATUS using a medium altitude, long endurance UAV system, and the provision of specialist UAVs, such as mini-UAVs. JUEP will increase our understanding of the issues raised by UAVs in all the elements of military capability, including concepts and doctrines, infrastructure, manpower, training and sustainability as well as equipment technology. It will help us define our future requirements, reduce risk in the delivery of military capability and help us acquire technology we can use successfully.

38. On FRES, there are a number of factors which need to be managed in taking this project forward. These include the increasingly urgent need to replace a range of aged in-service armoured vehicle types; support to the development of medium weight forces in the Army; the potential to exploit a number of innovative technologies; the desire to deliver a solution that exploits network-enabled capability and offers growth potential for the future. There is also a range of wider factors, consistent with our defence industrial policy, that need to be considered. Work is in hand already on new technologies, including the development of electric drive. Although it has taken longer than anticipated to launch this project on its Assessment Phase, the Department believes that additional time invested now is essential to ensure the project has a good prospect of delivering against requirements. It is expected that a decision on the way ahead on FRES will be announced later this year.

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