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Defence Committee

Ministry of Defence Annual Report and Accounts 2004–05

Sixth Report of Session 2005–06

Report, together with formal minutes, oral and written evidence

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Summary

This report analyses MoD's Annual Report and Accounts 2004–05 which combines MoD's Annual Performance Report and the Consolidated Departmental Resource Accounts.

Overall MoD's performance against its seven Public Service Agreement (PSA) targets has been mixed: three were "met", two were "partly met", one was "on course" to be met, and one was "not yet assessed".

The PSA target for recruitment and retention was partly met because manning levels in the Royal Navy and Royal Marines were some five per cent short of the overall requirement. There were also breaches of guidelines for deployed separated service for all three Services. The Army, in particular, had suffered because of the high operational tempo. Critical shortages exist in various specialist trades in all three Services. However, MoD considers that the impact of overstretch on operations such as the deployment to Afghanistan is manageable. We intend to monitor this closely.

The PSA target for defence equipment procurement was also assessed as partly met. MoD did not meet the targets relating to project time slippage. Cost decreases of £699 million were reported on the top 20 major defence equipment projects, but much of this was a result of cuts in the numbers of equipment ordered or in the capability of equipment.

Performance against the PSA target relating to value for money was assessed as on course. MoD reported savings of £400 million relating to the operating costs of the Defence Logistics Organisation, but it was unable to validate all of this. This suggests a need for an independent verification of such reported savings in the future.

Losses reported in MoD's Financial Accounts totalled some £400 million, a lower figure than the previous year but still a substantial sum. Reported losses on the Landing Ship Dock (Auxiliary) programme, which involves the procurement of four transport ships, were some £100 million and further losses might arise. Lessons need to be learned for future equipment acquisition.

Another loss totalling £147 million related to a building project at the Atomic Weapons Establishment at Aldermaston. The building was unable to meet the requirement and no other use could be found for it. MoD acknowledge that the project was "handled badly". It is another example of substantial waste which has to avoided in the future.

The Annual Report and Accounts was published at the end of October 2005, some seven months after the year end. It is important that MoD keeps to its plan to publish the Annual Report for 2005–06 before the Parliamentary Summer recess.

1 Introduction

1. The Ministry of Defence's Annual Report and Accounts 2004–05, published on 28 October 2005, combines the Annual Performance Report and Consolidated Departmental Resource Accounts for the year ended 31 March 2005.[1] This is the third year that the Ministry of Defence (MoD) has combined its Annual Performance Report and Consolidated Departmental Resource Accounts into one document.

2. Our inquiry examined issues relating to both the Annual Performance Report and the Consolidated Departmental Resource Accounts. We also examined the gifting of Operational Ration Packs to the United States of America which took place in the 2005–06 financial year.

3. Mr Bill Jeffrey was appointed MoD's Permanent Under Secretary of State (PUS) on 21 November 2005, replacing Sir Kevin Tebbit. We took evidence from Mr Jeffrey and Mr Trevor Woolley, MoD's Finance Director, on 24 January 2006. We received written evidence from MoD both before and after the oral evidence session. Both oral and written evidence are printed with this report.[2]

1 Ministry of Defence, *Annual Report and Accounts 2004–2005*, HC 464

2 Ev 1–32

2 Annual Performance Report

PSA Objectives and Targets

4. Table 1 in the Annual Performance Report provides a summary of performance against the 2002 Spending Review Public Service Agreement (PSA) Objectives and Targets.[3] MoD has six targets under three key objectives, and a seventh value for money target. Some of the targets have supporting performance indicators. A summary of MoD's performance is provided at Table 1 below.

Table 1: Summary of MoD performance against PSA Targets

PSA Target	Achievement
Objective I: Achieve success in the military tasks that we undertake at home and abroad	
1. Achieve the objectives established by Ministers for Operations and Military Tasks in which the UK's Armed Forces are involved, including those providing support to our civil communities.	**Met**
2. Improve effectiveness of the UK contribution to conflict prevention and management as demonstrated by a reduction in the number of people whose lives are affected by violent conflict and a reduction in potential sources of future conflict, where the UK can make a significant contribution. Joint target with DfID and FCO.	**Not yet assessed**
Objective II: Be ready to respond to the tasks that might arise	
3. By 2006 ensure that a minimum of 90% of high-readiness forces are at their required states of readiness with no critical weakness.	**Met**
4. Recruit, retain and motivate the personnel needed to meet the manning requirement of the Armed Forces, so that by the end of 2004, the Royal Navy and RAF achieve, and thereafter maintains, manning balance, and that by the end of 2005, the Army achieves, and thereafter maintains, manning balance	**Partly Met**
5. Strengthen European security through an enlarged and modernised NATO, an effective EU military crisis management capacity and enhanced European defence capabilities. Joint target with FCO.	**Met**
Objective III: Build for the future	
6. Develop and deliver to time and cost targets military capability for the future, including battle-winning technology, equipment and systems, matched to the changing strategic environment.	**Partly met**
Value for Money	
7. Increase value for money by making improvements in the efficiency and effectiveness of the key processes for delivering military capability. Year-on-year output efficiency gains of 2.5% will be made each year from 2002-03 to 2005–06, including through a 20% output efficiency gain in the DLO.	**On course**

Source: Ministry of Defence

3 HC (2005–06) 464, pp 12–15

5. We focused on those PSA targets which had either been partly met or were on course.

Recruitment and retention

6. PSA Target 4 relates to MoD's performance in recruiting, retaining and motivating Service personnel and MoD's performance against this Target is assessed as "Partly Met".

Manning levels

7. The first supporting performance indicator is to "achieve manning balance", defined as between –2 per cent and +1 per cent of the total manning requirement. As at 1 April 2005:

- the Royal Navy / Royal Marines were at 95.1 per cent of overall requirement (compared to 96.8 per cent on 1 April 2004);
- the Army were at 98.3 per cent of overall requirement (compared to 97.0 per cent on 1 April 2004); and
- the RAF were at 101 per cent of overall requirement (compared to 98.5 per cent on 1 April 2004).[4]

There was, therefore, a 4.9 per cent shortfall in the Royal Navy / Royal Marines; a 1.7 per cent shortfall in the Army; and a 1 per cent surplus in the RAF. This supporting performance indicator was assessed as "partly met".[5]

8. Mr Jeffrey acknowledged that the Royal Navy was facing a significant challenge in manning, but he told us that the forecast deficit for April 2006 was 3.6 per cent which "suggests that it is now moving in the right direction".[6] We were briefed on manning levels when we visited Fleet Command Headquarters on 9 February 2006, and were told that the overall situation was improving but that there was a serious shortage at Petty Officer level because of a cut-back in recruitment in the early 1990s.

9. **We are concerned that as at 1 April 2005 there was a 4.9 per cent manning shortfall in the Royal Navy / Royal Marines against the overall requirement. We note that by April 2006 the shortfall is expected to reduce to 3.6 per cent and look to MoD to take action to ensure that the improvements continue and to address the serious shortages at Petty Officer level.**

Overstretch

10. The second supporting performance indicator is to "achieve single Service guidelines for deployed separated service". All three Services have agreed Harmony Guidelines to allow members of the Armed Forces to have sufficient time to recuperate from operations; for unit, formation and personal training and development; and to spend more time at home with their families. This was assessed as "partly met". Surprisingly, given its manning

4 HC (2005–06) 464, p 13

5 *Ibid*

6 Q 3

shortfall, breaches of Harmony Guidelines in the Royal Navy are judged to be isolated.[7] Mr Jeffrey told us that "that may reflect the fact that the Navy, although it is much involved in current operations, is rather less involved than the other two Services".[8]

11. In respect of the other Services, the Annual Performance Report states that:

> **Army**: Some breaches of Harmony in the Army have been unavoidable owing to the level of operational tempo. Breaches of recommended tour intervals have been unavoidable for some Force Elements due to the current level of operational tempo, with Infantry averaging 21 months (18 months in 2003–04) and Royal Artillery 19 months (18 months in 2003–04).
>
> **RAF**: 3.9% of personnel more that 140 days detached duty over 12 months.[9]

A breakdown of the RAF personnel who exceeded the guideline for separated service is provided in MoD's second memorandum.[10]

12. We asked whether the three Services had management information systems which allowed them to work out the position of individual Service personnel relating to Harmony Guidelines.[11] MoD's second memorandum noted that individual separated breaches of service and breaches of harmony were currently managed under single Service arrangements using several information systems. However:

> the Joint Personnel Administration (JPA) change programme is introducing a harmonised personnel administration system for all military personnel that will make it possible to work out the separated service of every individual in the Armed Services using a single IT system.[12]

During our visit to Land Command Headquarters on 27 February 2006, we were told that it would be three years before information on individuals was readily accessible.

13. **We note that there have been some breaches of Harmony Guidelines in all three Services, but that the impact has been greater in the Army owing to the level of operational tempo. Members of the Armed Forces need time for training as well as for recuperation after operations, and they need time with their families, and we look to MoD to take action to ensure that breaches of Harmony Guidelines are minimised. Greater priority should be given to developing management systems which allow the pressure on individuals to be monitored.**

14. The Annual Performance Report states that "Areas of critical shortage remained in all three services".[13] It provides further details about the shortages:

7 HC (2005–06) 464, p 13

8 Q 3

9 HC (2005–06) 464, p 13

10 Ev 26

11 Q 8

12 Ev 24, para 3

13 HC (2005–06) 464, p 59

> there have been over twenty-five operational pinch point trades in 2004–05 including recovery mechanics, radiologists, ammunition technicians, information systems engineers, explosive & ordnance and military intelligence personnel.[14]

A list of the pinch point trades for all three Services as at February 2006 was provided in MoD's second memorandum.[15] This noted that the lists are "dynamic with trades moving on and off them according to the manning situation".[16]

15. In the Royal Navy there were shortages in several trades including fast jet and helicopter pilots.[17] During our visit to Fleet Command we were told that there was particular concern about the shortage of aircrew and Royal Marines junior ranks.

16. In the Army there were shortages in several trades including mechanics, bomb disposal and military intelligence. There were also shortages in medics, including Anaesthetists, Orthopaedic Surgeons, General Surgeons and Nurses. Shortages in the Defence Medical Services have been long-standing. The Annual Performance Report states that there had been a "further reduction in overall shortfall in medical personnel from 23 per cent to 20 per cent".[18] During our visit to Land Command, we were told that the Army had a management plan for each of the pinch point trades. There was little prospect of addressing the substantial shortfalls relating to Anaesthetists and General Surgeons, but it was considered that reservists could be used very effectively in these roles.

17. In the RAF the pinch point trades included engineers, weapons support and medical personnel. During a visit to Strike Command Headquarters on 9 March 2006, we were told there was particular concern about shortages of RAF Regiment gunners, firefighters and Motor Transport drivers and mechanics.

18. **We are concerned that there are critical shortages, in various specialist trades, in all three Services, including aircrew and medical personnel. We note that the overall shortfall in medical personnel has reduced from 23 per cent to 20 per cent, and look to MoD to take further action to address this substantial shortfall in such a vital area.**

19. We asked about the impact of overstretch on operations. MoD told us that it judged that the impact on the planned deployment to Afghanistan and on readiness for future operations was manageable. However, tour intervals for a number of pinch point trades were likely to breach Harmony Guidelines as the scale of effort in Afghanistan was increased. MoD was seeking to encourage "appropriate contributions from our NATO Allies in Afghanistan in order to take some of the pressure off these pinch points".[19] **We note that MoD considers that the impact of manning shortages on the deployment to Afghanistan is manageable, but we plan to monitor this closely in our inquiry on that deployment.**

14 HC (2005–06) 464, para 113

15 Ev 23

16 Ev 22, para 1

17 Ev 23

18 HC (2005–06) 464, p 59

19 Ev 24

Recruitment

20. The Annual Performance Report states that the Army is:

> having to work hard to maintain recruitment, particularly as market research has shown parental disapproval of the Army as a job has increased, reflecting perceptions of operations in Iraq and of Army training and care in the wake of Deepcut.[20]

21. We asked what was being done to make Army recruitment effective. Mr Jeffrey told us that:

> Apart from keeping up a very strong recruitment effort, the steps that are being taken are steps around improving recruitment, training, responding to the Deepcut events, looking at the way in which we support recruits under training through welfare and in other ways and, by these means, giving potential applicants the confidence that they need to put themselves forward, but it has to be recognised that we are operating in quite a difficult recruitment climate with still historically pretty high levels of employment, so the task of the Army recruiters is not straightforward.[21]

22. We asked about the damage that had been done by the Deepcut events and the related publicity. Mr Jeffrey considered this hard to assess but told us that everyone in the MoD from the Secretary of State down was utterly committed:

> to addressing this set of issues around the way in which we care for our military and civilian staff and the nature of the training experience and the culture of training establishments.[22]

Civilian staff

23. As at 1 April 2005, MoD employed some 108,470 Full Time Equivalent civilian staff.[23] Mr Jeffrey told us that the civilian element of MoD was important to almost everything that MoD and the Armed Forces did, but noted that "taken across the board, our efficiency savings involve quite significant reductions in the numbers of civilian staff".[24] Where there were civilian job losses, MoD would ensure that there was:

> consultation with the unions and with a full appreciation of the fact that the decisions we take…. are ones that also take account of the human dimension because it is very important.[25]

24. During our visit to Fleet Command Headquarters we were briefed on the merger of the Fleet Headquarters Top Level Budget (TLB), and the Second Sea Lord TLB. This was

20 HC (2005–06) 464, para 113

21 Q 7

22 Q 9

23 HC (2005–06) 464, p 59

24 Q 13

25 Q 14

expected to result in a variety of efficiency savings as well as enhanced operational effectiveness:

- 450 fewer people would be employed at the new Fleet HQ, representing a 25 per cent decrease in personnel from the old command structure;
- 300 fewer civilians would be employed at Fleet compared with the old command structure. This had been achieved without the need for compulsory redundancies;
- £16 million savings in operational costs per annum.

25. At Land Command, we were briefed on the merger of Land Command and the Adjutant General's Department (known as Project Hyperion). We were assured that the lessons from the Fleet merger were being learned. MoD told us that the reorganisation was "expected to generate savings of about 110 military and 240 civilian posts" and that a decision on the preferred location of the new headquarters should be taken in late Spring 2006.[26] At Strike Command we were briefed on the plans for closure of Personnel and Training Command at RAF Innsworth, and its effect on staff morale. **We support MoD's drive for greater efficiency but note that it is likely to result in substantial numbers of civilian job losses. We look to MoD to undertake the appropriate consultation with the organisations which represent its civilian staff and to provide as much support as possible to those who lose their jobs.**

Diversity

26. The Annual Performance Report provides details of MoD's achievements in relation to diversity, and states that:

> Overall Service ethnic minority strength (including Commonwealth recruits) increased to 5.2% at 1 April 2005 (4.9% at 1 April 2004) against target of 6% by 2006. UK ethnic minority intake: RN 2.3% (target 3%, 2004–04 intake 2.1%); Army 3.7% (target 3.4%, 2003–04 intake 2.8%); RAF 1.7% (target 3.1%, 2003–04 intake 1.8%).
>
> As at 1 April 2005, women comprised 9.0% of UK Regular Forces, and 10.5% of the total 2004–05 intake.
>
> Proportion of women and disabled personnel increased at all levels of MoD civil service. Proportion of ethnic minorities stable or slightly reduced. Civilian diversity targets exceeded for disabled personnel in MoD Senior Civil Service and women in Band B, and just missed for women in Band D. Significantly below target for women and ethnic minority personnel in Senior Civil Service, ethnic minority and disabled personnel in Band B and Band D.[27]

27. **MoD's performance against its diversity targets has been mixed in relation to both its Service and civilian personnel. It is disappointing that both the Royal Navy and the RAF failed to meet their target for recruiting from ethnic minorities. MoD was**

26 Ev 24, para 4

27 HC (2005–06) 464, p 59

significantly below some of its targets relating to women, ethnic minority and disabled personnel in the Civil Service. We look to MoD to identify ways to improve in those areas where it is falling significantly below its diversity targets.

Defence Procurement

28. PSA Target 6 relates to MoD's performance in developing and delivering military capability for the future to time and cost targets. MoD's performance against this target is assessed as "partly met". MoD did not meet the two Supporting Performance Indicators relating to time slippage; it met the Supporting Performance Indicator relating to meeting customers' requirements; and partly met the Supporting Performance Indicator relating to cost increases.[28] In contrast, Table 19 in the Annual Performance Report, which provides details of the Defence Procurement Agency's Key Targets and Achievements, reports that the DPA met five of its six Key Targets in 2004–05, including the Key Targets relating to time slippage and cost increases.[29]

29. We asked why the reported achievements against targets relating to procurement in Table 1 and Table 19 appeared to be different. Mr Jeffrey told us that:

> I think the reason for the disparity is that the main PSA targets are supplemented by a set of key targets which measure success in the procurement of equipment projects. If you look at the key targets, which are the ones on page 102 [Table 19], the DPA met five of six of these, which was an improvement on what they had done previously, but certainly, if you step back from that and look at the PSA target as a whole, the position is, I think, more accurately captured at the beginning of the document [Table 1]in the way that I have described.[30]

30. **MoD's Performance Report shows that MoD only 'partly met' its PSA Target relating to procurement, missing the targets relating to time slippage and cost increases. In contrast, the Report shows that the Defence Procurement Agency met five of its six Key Targets, only missing one target on customer satisfaction. We expect MoD to review the way that its performance in relation to defence equipment procurement is reported in order to provide a clearer picture on whether performance is improving or not.**

31. In its Major Projects Report 2003, the National Audit Office reported in-year cost increases of £3.1 billion on the top 20 defence equipment projects.[31] In its Major Projects Report 2004, it reported in-year cost increases of £1.7 billion.[32] We asked what had been the effect of these cost overruns, totalling almost £5 billion, on MoD's ability to manage its

28 *Ibid*, p 14

29 HC (2005–06) 464, p 102

30 Q 23

31 National Audit Office, *Major Projects Report 2003*, HC 195, Session 2003–04

32 National Audit Office, *Major Projects Report 2004*, HC 1159-I, Session 2003–04

future programme.[33] Mr Jeffrey told us that "it has a very significant effect; it is something that we clearly need to take into account".[34] In its second memorandum, MoD states that:

> Whilst it is inevitably the case that if we have to spend more of our resources on one project, less will be available for other purposes, there is not a simple relationship between historic cost-growth on one project and reduced spending elsewhere; the adjustments we make are the result of the interplay of a wide range of issues across the Defence Budget as a whole…. We continue to work to reduce cost-growth on equipment projects because widespread and unchallenged cost growth puts pressure on the total capability we can deliver…. Ministers and senior officials will continue to drive forward the necessary changes.[35]

32. The NAO's Major Projects Report 2005 reported in-year cost decreases of some £699 million on the top 20 defence equipment projects.[36] However, the NAO noted 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 and changed Customer requirements.[37]

We asked whether the reported decrease was due to a reduction in the amount of equipment being ordered. Mr Jeffrey told us that "there is a significant element of it which can be described in that way, though it is not by any means the whole story".[38]

33. **We note that in 2004–05, in-year cost decreases of some £699 million were reported on the top 20 major defence equipment projects. However, a 'significant element' of this decrease related to a reduction in the numbers of equipments being ordered. In our view, it is not a great achievement to report an in-year cost decrease, if this is only because less equipment, or less capable equipment, has been acquired.**

34. Mr Jeffrey told us that there was a readiness to acknowledge that the acquisition of large defence equipment projects had not been handled well in the past. His general sense was that there had been some improvements in the way in which acquisition was undertaken. He told us that he would be paying a lot of attention to whether the DPA had the staff, the training and the skills it needed to implement the Smart Acquisition principles.[39]

35. Mr Jeffrey did not think there was any sense in which MoD was "asserting that in the procurement area we are meeting all of our targets".[40] He thought he needed to apply a lot of attention to the "whole question of how we procure and acquire equipment for defence…. although improvements have been made, there is still a great deal to do".[41]

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33 Q 25 and Q 78

34 Q 78

35 Ev 27, para 9

36 National Audit Office, *Major Projects Report 2005*, HC 595-I, Session 2005–06

37 *Ibid*, para 1.5

38 Q 27

39 Q 29

40 Q 22

41 Q 1

36. On our visit to the Defence Procurement Agency on 26 January 2006, we were impressed by the candour and realism of the Chief of Defence Procurement and his team and the action in hand to improve acquisition performance. We have also been impressed by the vigour and commitment to change which the new Minister for Defence Procurement is bringing to the procurement process. The Defence Industrial Strategy, published in December 2005, requires improvements from both industry and MoD. Mr Jeffrey told us that:

> We are also up for serious and significant improvement in the way in which procurement is managed by the Department, but, as part of the follow-through to the Defence Industrial Strategy, there is a project which I instituted myself shortly after I arrived in which we will be looking hard at the way in which the procurement function operates, how it is structured, how the processes work, and looking at ways in which we can generally make it work better, and I am utterly committed to that.[42]

As part of our inquiry into the Defence Industrial Strategy, we are examining the changes needed to MoD's current approach to equipment procurement.

37. **We fully support MoD's efforts to improve procurement performance. We note that a review of defence procurement has been instituted and expect the recommendations of the review to be implemented both quickly and fully. Improvements in the way MoD procure equipment are vital to the success of the Defence Industrial Strategy and we plan to monitor this closely.**

Value for Money

38. PSA Target 7 relates to MoD's performance in achieving value for money, and MoD's performance is assessed overall as "on course".

Cost of training

39. One of the supporting performance indicators is to reduce the cost of training a military recruit by an average of six per cent by April 2006. It is reported that this was not met and that:

> owing to organisational changes it is no longer possible to measure per capita cost of successfully training a military recruit on the basis used in the PSA target. It is unlikely that this target would have been achieved.[43]

40. When asked why this target had been scrapped, Mr Woolley said that it was:

> because the target was very much related to measuring training on a single service basis and because of the creation of more joint service establishments it is not really possible to make the measure on a single service basis any more.[44]

42 Q 31

43 HC (2005–06) 464, p 14

44 Q 81

We find MoD's explanation as to why they had scrapped a target for reducing the cost of training a military recruit to be unconvincing. As part of its consideration of the outcome of the Defence Training Review, we recommend that MoD reconsider whether they should have a value for money target in such a key area as training.

Savings in logistics

41. Another supporting performance indicator is to:

> reduce by 14% (relative to planned expenditure in 2002–03) the output costs of the Defence Logistics Organisation (DLO) by April 2006, while maintaining support to the Front Line.[45]

It is reported that this was "ahead" as the DLO costs reduced by 4.2 per cent in 2004–05. This is a major element of MoD's efficiency programme. The overall Efficiency Programme has a goal of achieving savings of £2.8 billion.[46]

42. The Annual Performance Report states that over £400 million of savings in DLO operating costs have been delivered in 2004–05, although these reported savings were said to be "subject to validation".[47] It appeared surprising to us that £400 million from one MoD organisation was achieved in 2004–05, and we asked why these savings had not been identified and achieved in previous years. Mr Woolley considered that "the PSA Target system and indeed following on from the spending review 2002 PSA Target, the Gershon Efficiency Target has perhaps acted as something of a catalyst".[48]

43. Given that it was over nine months since the end of the 2004–05 financial year, we asked whether the £400 million had now been validated. MoD's second memorandum states that:

> The DLO efficiency achievement in 2004–05 is still being assessed in an internal audit to review the evidence supporting judgement of the level of benefits realised in the year. It is likely that this will indicate that some of the operating cost savings included in the total of over £400 million reported in paragraph 209 of the Annual Report and Accounts 2004–05 cannot be validated.[49]

The memorandum does not indicate how much of the £400 million is unlikely to be able to be validated.

44. **MoD reports substantial savings in its Annual Report and Accounts yet, when pressed by us, informs us that some of the reported savings "cannot be validated". This is worrying. We expect figures in MoD's Annual Report and Accounts to be based on robust evidence and look to MoD to introduce systems which can generate accurate**

45 HC (2005–06) 464, p 15

46 Q 17

47 HC (2005–06) 464, p 95

48 Q 46

49 Ev 24, para 5

figures relating to savings, rather than figures which cannot be substantiated fully. Overstating savings undermines confidence in the accuracy of the Performance Report.

45. **We consider that there is a strong case in the future for the National Audit Office to provide an opinion on the savings figures claimed by the MoD in its Performance Report, as we have little confidence in the accuracy of such figures.**

46. We were concerned that there was a real danger in the future of MoD not being able to support the front line in an efficient, sustainable and reliable way. Mr Jeffrey told us that:

> there are no indications that the pursuit of efficiency has in itself prejudiced the Defence Logistics Organisation's ability to meet the requirements placed on it to support its customers in the frontline.[50]

Tornado support savings

47. MoD's Performance Report provides examples of improved logistics delivery in 2004–05. One of these relates to the Tornado support facilities at RAF Marham, which we visited as part of our inquiry into *Delivering Front Line Capability to the RAF.*[51] It states that:

> At RAF Marham the introduction of 'Lean' engineering and support principles in the Tornado Propulsion Facility in partnership with Rolls Royce produced cost savings of £88M over 4 years, with the Pilot contract saving £9M in the first year.[52]

48. We asked MoD to check whether all the £88 million reported savings had been achieved or whether they were a mixture of achieved and projected savings.[53] MoD subsequently provided details of the reported cost savings of £88 million and the years in which they were achieved.

Table 2: Reported savings of £88 million relating to Tornado support arrangements

	2003–04 £ million	2004–05 £ million	Total £ million
Reductions in Tornado Propulsion Flight Local Unit Establishment		4	4
Reduced engine rejections	21 (part year)	50	71
Introduction of pilot contract with Rolls-Royce Defence Aerospace in October 2003	4 (part year)	9	13
Total	25	63	88

Source: Ministry of Defence[54]

49. This shows that the savings of £88 million were achieved in two years, rather than the four years stated in the Annual Report and Accounts. The Annual Report and Accounts

50 Q 20

51 Defence Committee, *Delivering Front Line Capability to the RAF*, Third Report of Session 2005–06, HC 557

52 HC (2005–06) 464, para 210

53 Q 98

54 Ev 27, para 11

states that the pilot contract with Rolls Royce saved £9 million in the first year, but the subsequent information from MoD shows that a £9 million saving from the pilot contract was achieved in 2004–05 but a further £4 million saving from the pilot contract had been achieved in the previous year. **Follow-up information provided by MoD showed that the savings of £88 million on Tornado aircraft support were achieved in two years, not four years as stated in MoD's Performance Report. This is a notable achievement. Nevertheless, once again, it raises questions about the accuracy of information provided in the Performance Report and we look to MoD to ensure that more accurate information is provided in the future.**

Equipment disposals

50. The Disposal Services Agency is responsible for selling surplus equipment. The Performance Report states that the Agency "had a successful year in which it achieved £21.6 million in gross cash receipts against a target of £20 million".[55] Major disposals included the sale of: T56-15 Engines; Off Shore Patrol Vessels; Stingray; MkII Depth Charge; and Tank Transporters and Vehicles.[56]

51. We asked whether MoD had bought back any surplus equipment in the year.[57] Mr Woolley told us that he was not aware of any cases.[58] MoD subsequently told us that they had identified two cases of buy back of surplus equipment in 2004–05:

> The Sea King Integrated Project Team purchased minor parts costing £500;
>
> The Maritime Logistics Support Integrated Project Team purchased minor spares for workshop based repairs costing £72,836. These replaced items that had previously been sold under a stock rationalisation programme on the basis of low usage but were then subsequently required.[59]

52. **We are surprised to learn that stock sold under a rationalisation programme had to be bought back for some £73,000 as it was subsequently found to be needed. We expect MoD to learn lessons from this case and, in future, to assess properly the future need for items before they are disposed of.**

Defence Agencies

53. Much of MoD's work is undertaken by Executive Agencies. The Annual Report and Accounts provides details of the Defence Agencies and their performance against their key targets.[60] A list of these Defence Agencies is reproduced at Table 3. As at 1 April 2005 there were 31 Agencies, five of which were Trading Funds and the other 26 'on-vote' agencies.

55 HC (2005–06) 464, para 219

56 *Ibid*

57 Q 93

58 Q 94

59 Ev 27, para 10

60 HC (2005–06) 464, pp 210–211

Table 3: Defence Agencies which reported performance in the Annual Report and Accounts 2004-05

Defence Agencies	
Armed Forces Personnel Administration Agency	Defence Vetting Agency
ABRO (Trading Fund)	Disposal Services Agency
Army Training and Recruiting Agency	Duke of York's Royal Military School
British Forces Post Office	Medical Supplies Agency
Defence Analytical Services Agency	Met Office (Trading Fund)
Defence Aviation Repair Agency (Trading Fund)	MoD Police and Guarding Agency
Defence Bills Agency	Naval Recruiting and Training Agency
Defence Communication Services Agency	Pay and Personnel Agency
Defence Dental Agency	Queen Victoria School
Defence Estates	RAF Training Group Defence Agency
Defence Geographic and Imagery Intelligence Agency	Service Children's Education
Defence Intelligence and Security Centre	UK Hydrographic Office (Trading Fund)
Defence Medical Education and Training Agency	Veterans Agency
Defence Procurement Agency	Warship Support Agency
Defence Science and Technology Laboratory (Trading Fund)	
Defence Storage and Distribution Agency	
Defence Transport and Movements Agency	

Source: Ministry of Defence[61]

Organisation

54. There have been a number of organisational changes relating to Defence Agencies, as set out in the Annual Report and Accounts:

> On 1 April 2004, the number of on-vote Defence Agencies reduced from 30 to 26 as a result of the merger of the Defence Housing Executive Agency with Defence Estates and the removal of agency status from the three single service manning agencies (the Naval Manning Agency, the Army Personnel Centre and the RAF Personnel Management Agency). From 1 April 05 agency status was removed from a further six on-vote agencies. These were the Warship Support Agency, the Medical Supplies Agency, the Defence Dental Agency, the Queen Victoria School, the

61 HC (2005–06) 464, pp 210–211

> Defence Geographic and Imagery Intelligence Agency and the Defence Intelligence and Security Centre.[62]

55. We questioned the witnesses about these changes. Mr Jeffrey told us that there had been a measure of rationalisation in relation to Defence Agencies and the kind of tasks they undertook.[63] Mr Woolley explained:

> In recent years we have begun to look at whether the overheads that go with a very decentralised structure of having lots of budgetary layers, for example—which although it has management benefits it also creates a certain amount of overhead…. Some of the very small agencies just no longer seem to be of sufficient size to justify agency status with some of the requirements that go with agency status…. So there has been some rationalisation of agencies in recent years reflecting that more general reassessment of whether the decentralising tendency in the Department went perhaps a little too far in the 1990s.[64]

56. Mr Woolley expected that the number of agencies would continue to fall.[65] **In principle, we support MoD's policy of rationalising the number of Defence Agencies, particularly those very small agencies where the costs of retaining agency status can be high. However, for some agencies there may be a strong case for retaining agency status and we expect MoD to review each agency on a case by case basis.**

57. It is the intention to collocate the Defence Logistics Organisation's Board with the Defence Procurement Agency's Executive Board at the earliest opportunity.[66] We asked whether there were any plans to merge the Defence Procurement Agency (DPA) with the Defence Logistics Organisation (DLO). Mr Jeffrey told us that:

> That is one of the issues, as I mentioned earlier, we need to address. I am struck, again as an early impression, by the fact that the two organisations do work closely together; the Chief of Defence Procurement and the Chief of Defence Logistics are in constant very close contact, as are their senior teams. There are a number of major projects, where we increasingly think in through-life terms, where the project team in effects accounts to both organisations. So there is a question about how far along the path towards integration one goes, if not actual merger.[67]

58. On our visit to the Defence Procurement Agency on 26 January 2006, we were told that there would be advantages and disadvantages in a DPA / DLO merger. Many of the Integrated Project Teams worked for both the Chief of Defence Procurement and the Chief of Defence Logistics, which reflected the through-life approach to project management. However, there were differences between the organisations: the DPA was responsible for high risk projects, whereas the DLO's focus was on the front line.

62 HC (2005–06) 464, p 211

63 Q 50

64 Q 52

65 Q 53

66 HC (2005–06) 464, para 217

67 Q 48

59. **We note that there are plans to collocate the Defence Procurement Agency's Executive Board and the Defence Logistics Organisation's Board. We support the move to bring both organisations close together, particularly given that projects are now managed on a through-life basis.**

Performance Targets

60. Defence Agencies are set targets each year and the performance of the Defence Agencies against their targets, for 2003–04 and 2004–05, are set out in a table in the Annual Report and Accounts.[68] Overall, the performance has been very mixed and inconsistent over time. For example, the Defence Storage and Distribution Agency met 100 per cent of its targets in 2004–05, but only 33 per cent of its targets in 2003–04. The RAF Training Group Defence Agency met only 33 per cent of its targets in 2004–05, but 71 per cent of its targets in 2003–04.[69]

61. The number of targets each Defence Agency is set varies greatly. For example, in 2004–05, the Defence Vetting Agency had 12 targets and the Medical Supplies Agency had four targets. For some agencies the number of targets had reduced since 2003–04. For example, the British Forces Post Office were set 11 targets in 2003-04 and only six targets in 2004–05. But for others the number of targets had increased. For example, Service Children's Education were set 16 targets in 2003–04 and 29 in 2004–05.[70]

62. We asked MoD about the variation in performance and the number of targets set. Mr Jeffrey admitted that it was quite hard to assess whether the performance of Defence Agencies overall was improving and he was struck "by the sheer variety of purposes and the extent to which there is a variety in performance".[71] The overall percentage of key targets met had increased from 72 per cent in 2003–04 to 78 per cent in 2004–05.[72] However, he accepted that there was a wide variety among the agencies.[73]

63. MoD's second memorandum notes that all those involved in the process of drawing up key targets for Defence Agencies are expected to draw on identified best practice. In terms of the number of targets, Defence Agencies typically have between five and ten key targets, but the precise number varies depending upon the size and complexity of the agency and the challenges it faces in a particular year. MoD:

> recognise that in judging performance it is preferable to have a run of comparable data over a number of years. However, a balance needs to be struck between continuity and the need to improve and amend targets to reflect new or evolving priorities.[74]

68 HC (2005–06) 464, pp 210–211

69 *Ibid*

70 *Ibid*

71 Q 54

72 *Ibid*

73 *Ibid*

74 Ev 25, para 6

Mr Jeffrey told us he was prepared to look at the way in which key targets for Defence Agencies were set and at whether there was a better way of measuring their performance.[75]

64. **We found it difficult to judge the performance of the Defence Agencies, as set out in the Annual Report and Accounts, as both their achievements against the targets set, and the number of targets set, vary considerably from year to year. We look to MoD to ensure that in the future, changes are made to the reporting of the performance of Defence Agencies, so that it is easier to assess whether their performance is improving.**

65. We have taken a close interest in the work of Defence Agencies. In our *Future Carrier and Joint Combat Aircraft Programmes* report we examined the Defence Procurement Agency's role in acquiring these two equipment programmes.[76] In our *Delivering Front Line Capability to the RAF* report we examined the impact on the Defence Aviation and Repair Agency (DARA) of the decision to concentrate on-aircraft support of the Tornado GR4 'forward' at RAF Marham.[77] We are also currently undertaking an inquiry into the Met Office and, as part of our Educating Service Children inquiry, we will examine the Service Children's Education agency.

75 Q 55

76 Defence Committee, *Future Carrier and Joint Combat Aircraft Programmes*, Second Report of Session 2005–06, HC 554

77 Defence Committee, *Delivering Front Line Capability to the RAF*, Third Report of Session 2005–06, HC 557

3 Consolidated Departmental Resource Accounts

Unqualified audit opinion

66. The Departmental Resource Accounts for 2002–03, which were examined by our predecessors[78], were qualified by the Comptroller and Auditor General because of concerns about the accuracy and reliability of MoD's stock management information. The move to Resource Accounting and Budgeting (RAB) from cash based accounting had created problems for MoD. On 7 January 2004, MoD's Finance Director, had told our predecessors that:

> Resource accounting and budgeting is a very much more complex way of managing finance than the old cash system that we used to use…. I think that the unique nature of the Ministry of Defence and defence business makes the application of resource accounting to it, in some cases, slightly strange. We have to have certain work-arounds to make sure that resource accounting and budgeting works in relation to the Ministry of Defence.[79]

67. The Departmental Resource Accounts for 2003–04 and 2004–05 were given an unqualified opinion by the Comptroller and Auditor General. **The fact that MoD's resource accounts for 2004–05 received an unqualified audit opinion for the second year running suggests that MoD's initial problems with Resource Accounting and Budgeting are being overcome**.

Contingent liabilities

68. MoD's Financial Accounts show that quantifiable contingent liabilities have increased by £400 million from 2003–04 and that this increase was due to a new liability for site restoration and clean up of British Army Training Units in Canada.[80] This liability represents a substantial amount and we sought further information from MoD.

69. MoD told us that a Memorandum of Understanding for its use of training facilities in Canada was being re-negotiated and it expected that a revised agreement would be signed in July 2006. MoD expected this revised agreement to be "open ended, but subject to termination by either party".[81] MoD has no plans to stop training in Canada, but in the event that UK training in Canada were to stop, MoD would be liable to clean any sites up to the standards required by Canadian law. MoD also told us that "the estimated liability of £400 million is an approximate assessment of the likely costs of such environmental measures, including the removal of unexploded ordnance".[82]

78 Evidence Session with MoD Permanent Under Secretary and Finance Director, 12 May 2004, HC 589-i

79 Defence Committee, Third Report of Session 2003–04, *Lessons of Iraq*, HC 57-III, Ev 305

80 HC (2005–06) 464, p 180

81 Ev 21, para xxii

82 *Ibid*

70. **A new contingent liability of some £400 million, relating to a liability to clean up training sites in Canada should the UK cease training there, has been included in the 2004–05 financial accounts. We consider this to be a substantial liability and expect MoD to re-assess, on a regular basis, the size of this liability and consider how such a liability of this scale would be funded if it fell due.**

Losses

71. MoD identified £402 million of losses in 2004–05, of which £322 million had been reported as Advance Notifications in previous years' accounts.[83] Compared to 2003–04, when losses stood at £461 million,[84] there has been a decrease of £59 million or 13 per cent.[85] Losses identified in 2004–05 were £80 million.[86]

72. We asked MoD about the level of losses set out in its financial accounts and how MoD was seeking to minimise such losses. MoD told us that:

> The losses statement provides a level of visibility and transparency not matched by commercial accounts as private sector organisations are not required to disclose similar information. The size of the MoD and its capital assets under active management, together with the range and complexity of defence business, means that the MoD also faces a scale of challenge unique in the public sector.[87]

73. MoD also told us that reported losses were not necessarily indicative of a failure of control, although it sought to identify those that were and the lessons to be learned. MoD considers that, with a large capital investment programme there:

> will inevitably be cases where we decide not to proceed with programmes because of changed priorities or requirements reflecting the defence need, or judgements that the technical challenge is too demanding.[88]

In respect of equipment acquisition, as part of the Smart Acquisition initiative, MoD told us that it has sought to increase the level of investment in the concept and assessment phases which should limit losses arising from a subsequent project failure.[89]

74. **We note that losses reported in MoD's 2004–05 Financial Accounts had reduced compared with the previous year, but consider that the sums are still substantial. We expect MoD to take appropriate action to minimise losses in the future.**

75. We examined two specific projects where losses were reported in the 2004–05 Financial Accounts—the Landing Ship Dock (Auxiliary) programme and a building project at the Atomic Weapons Establishment Aldermaston.

83 HC (2005–06) 464, p 190

84 Ministry of Defence, *Annual Report and Accounts 2003–04*, HC 1080, p 161

85 HC (2005–06) 464, para 107

86 *Ibid*, p 190

87 Ev 21, paras xiii and xiv

88 Ev 22

89 *Ibid*

Landing Ship Dock (Auxiliary)

76. We paid particular attention to two losses in the Annual Report and Accounts relating to the Landing Ship Dock (Auxiliary) programme, totalling £101.8 million. The programme is for four ships which are designed to provide tactical sealift as part of an amphibious group. A summary of the two losses is provided at Table 4.

Table 4: Losses reported on the Landing Ship Dock (Auxiliary) programme

Losses	£ million
Advance notifications – notified in prior years Slippage in the construction programme for two Landing Ship Dock (Auxiliary) caused delay in supplying design information and equipment to a contractor. This resulted in a claim on the MoD relating to the associated delay and dislocation costs. In 2003-04, an amount of £40,000,000 was included in Advance Notification as an estimate of the likely amount of the claim.	63.8
Advance notifications – notified during the year HM Treasury has agreed an ex-gratia payment of up to £84,500,000 to Swan Hunter subject to completion of certain contractual conditions relating to the construction of two Landing Ship Dock (Auxiliary) LSD(A). Total paid to date is £38,000,000.	38
Total	**101.8**

Source: Ministry of Defence[90]

77. We asked why MoD was picking up the bill for these substantial losses on the Landing Ship Dock Auxiliary programme. Mr Jeffrey explained:

> It is a programme where the contract was originally awarded in 2000 to Swan Hunter who were building two of these ships and BAE Systems were then brought in to build the other two. It is undoubtedly a project which has had problems arising from the fact, which I think Swan Hunter themselves would acknowledge, that the design that they intended to apply for these ships was less mature than had been assumed. The increases in cost are partly of course reflected in this Report, but there are broadly three elements. In December 2004 there was a renegotiation of the contract which allowed for up to £84.5 million more for Swan Hunter…. There was also, and this features also in the Report as something notified in a previous year, £63.8 million to BAE Systems arising from the fact that there was slippage in the Swan Hunter part of the operation. To these two elements there should be added to £62 million in addition to enable Swan Hunter to pass design information to BAE Systems, so it is classically one of these projects where the costs have escalated.[91]

78. We pressed MoD further on the total cost of the programme and we were told that the "total value of the contract now for Swan Hunter is £309 million and for BAE Systems £176 million".[92] The total value is, therefore, some £485 million. We were told that discussions

90 HC (2005–06) 464, pp 194–195

91 Qq 32–33

92 Q 34

were underway about "what would be required to completely deliver this project".[93] Mr Jeffrey did not want to discuss this in any detail during our public sessions owing to commercial sensitivity.

79. Mr Woolley told us that MoD had:

> reached a stage where we had to make a judgement between starting all over again and continuing and paying more and we had to judge what in those circumstances was likely to provide best value for money, and the judgement was to continue.[94]

80. MoD's second memorandum states that Swan Hunter confirmed in September 2003 that it was unable to meet the original programme requirements and accepted that its initial programme was "optimistic and underestimated the extent of the development issues inherent in the building of a new ship".[95] The memorandum makes reference to additional cost increases and states that MoD "is currently in commercial discussions with both companies as a result of these declared cost increases".[96]

81. **We find it hard to understand why the procurement of these four ships, which are not particularly sophisticated, is likely to cost in the region of half a billion pounds, substantially over the initial contract price. The Landing Ship Dock (Auxiliary) programme cannot be considered to have achieved value for money. MoD seems to have given the lead contractor on the programme an open-ended cheque book.**

82. **The first contract for two ships, on the Landing Ship Dock (Auxiliary) programme, was let in December 2000. While this was some time after the launch of the Smart Procurement initiative, this procurement cannot be considered 'smart'. It raises questions about how MoD assesses whether a contractor has the necessary skills to deliver a specific equipment programme. We expect the lessons from this sorry episode to be identified and implemented. We wish to be kept informed of the progress on this programme.**

Building project at the Atomic Weapons Establishment Aldermaston

83. Another matter of concern relates to a building project at Aldermaston. The Annual Report and Accounts states that "a loss of £65,000,000 has been incurred following the impairment of an Operational building". Mr Woolley told us that:

> this is a building at the Atomic Warfare Establishment that was unable to meet the requirement after it was built for which it was designed. No other use for the building could be identified and therefore it had to be written off.[97]

84. We asked for further details of this loss. MoD's second memorandum stated that the loss related to "work to build a substantial facility for the treatment of radioactive liquid

93 Q 34

94 Q 40

95 Ev 29

96 *Ibid*

97 Q 101

waste".[98] The memorandum also explained that a loss of £82 million in respect of plant and machinery, separately noted in the Annual Report and Account, was also related to the same building at Aldermaston.[99] A summary of these two losses is provided at Table 5.

Table 5: Losses reported on a building project at AWE Aldermaston

Losses	£ million
Advance notifications – notified in prior years A loss of £65,000,000 has been incurred following the impairment of an Operational building.	65
Advance notifications - notified during the year A loss of £82,000,000 has been incurred in respect of plant and equipment	82
Total	**147**

Source: Ministry of Defence[100]

85. MoD's memorandum notes that:

> the Department acknowledges that this project was handled badly in a number of significant respects. Lessons have been drawn from the experience, procedures have been changed, and the Department is determined to avoid any recurrence.[101]

86. **We are amazed at the scale of the losses relating to a building at AWE Aldermaston which could not be used. The total losses amount to some £147 million. MoD's acknowledgement that the project "was handled badly" is a considerable understatement. It is essential that the lessons are learned and we do not expect to see a repetition of such a debacle in the future.**

87. **We are concerned that the two losses relating to the building at AWE Aldermaston, one of £65 million and the other for £82 million, were listed separately in the losses statement in the Annual Report and Accounts, and that there was no way of linking the two losses from the information provided. In future, we expect MoD to provide sufficient information for related losses to be identified.**

Operational Ration Packs

88. One of the losses reported in MoD's Financial Accounts is for £1.4 million and relates to Operational Ration Packs:

> A food component was withdrawn from Operational Ration Packs (ORP) following discovery in tests that deterioration of the product's packaging could over time compromise the safety of the contents. The Contractor accepted liability in principle for this defect and agreed to supply a replacement product utilising an alternative packaging arrangement, at no cost to MoD, subject to being able to develop a

98 Ev 27

99 *Ibid*

100 HC (2005–06) 464, pp 194–195

101 Ev 28

> replacement product that could be warranted fully fit for purpose. This development work is continuing and if successful will substantially mitigate the overall loss to the Department brought about by a combination of loss of use of the original product and the cost of its removal / destruction.[102]

89. Shortly following the oral evidence session, a Departmental Minute from MoD "concerning the gifting of operational ration packs to the Government of the United States of America" was laid before the House of Commons on 6 February 2006.[103] It is normal practice when a government department proposes to make a gift of a value exceeding £250,000 to present to the House of Commons a Minute giving particulars of the gift and explaining the circumstances; and to refrain from making the gift until fourteen days (exclusive of Saturdays and Sundays) after the issue of the Minute, except in cases of special urgency.[104]

90. The Departmental Minute informed the House of a gift of 475,182 ORPs worth £3,114,845, delivered between 5–7 September 2005, at the request of the US Federal Emergency Management Agency, to assist the relief effort following Hurricane Katrina. The Minute stated that the gifting of humanitarian assistance, in the form of ORPs, was a case of special urgency.

91. We wrote to MoD to ask why it had taken MoD five months to inform Parliament of this gift; the total cost of the gift, including airlift costs; and whether reports in the media that the delivery of the packs had been delayed because of US Department of Agriculture objections to EU products were accurate.

92. MoD's response of 6 March 2006 states that the delay in informing Parliament was because there was:

> some debate within HM Treasury on how best to account for the ORPs that MoD provided to the US…. The conclusion reached was to gift the ORPs, hence the Departmental Minute on 6th February, and to write off the transport costs in the Department's 2005–06 accounts.[105]

We do not find MoD's explanation for the four month delay in informing Parliament of a gift of a value exceeding £250,000 sufficient and we call on MoD to report its gifts promptly in future.

93. MoD's response states that:

> the cost of providing the ORPs to the Government of the USA was £5,130,971, of which £3,114,845 represented the value of the ORPs gifted and £2,016,126 was the cost of airlift.[106]

102 HC (2005–06) 464, p 195

103 Ev 31

104 *Ibid*

105 Ev 32

106 *Ibid*

It states that MoD delivered some 475,000 ORPs between 5–7 September 2005 and the US Federal Emergency Management Agency then began to distribute the ration packs to the disaster area. However, this process was stopped on 8 September when the US Department of Agriculture realised that the ORPs did not comply with their regulations concerning the import of processed meat. MoD was not aware that there was a danger of the ORPs being impounded until after they had been delivered and, once informed of the problem, the UK stopped any further deliveries.[107]

94. MoD understands that some 330,000 ORPs were initially impounded in Arkansas, but that US Authorities have been in contact with various international and non-governmental organisations about how to make use of the ration packs outside the US. Some ORPs have already been given to non-governmental organisations for distribution "to populations in need and to the OSCE [Organisation for Security and Co-operation in Europe] for use in Georgia" (that is the country Georgia, not the US State).[108] MoD understands that "the US Authorities expect all the ORPs to be distributed this way".[109]

95. **The UK sought to assist the US following Hurricane Katrina by gifting Operational Ration Packs at a total cost of some £5.1 million. We have no objection to the gifting of the Operational Ration Packs and only regret that they were not used to help the victims of Hurricane Katrina as intended. We are satisfied that this was for reasons outside MoD's control and hope that it has learned lessons for the future.**

Flotation of QinetiQ

96. MoD's Financial Accounts provide details of MoD's shareholding in companies, including its shareholding in QinetiQ.[110] On 12 January 2006, the Secretary of State for Defence made a statement to the House announcing that the decision had been taken to float QinetiQ on the London Stock Exchange, some five years after it was first vested as a Government-owned company, and three years after The Carlyle Group became, through its minority stake, MoD's strategic partner.[111]

97. We asked when the flotation would take place and were told that it would be in February but that the size of MoD's stake to be sold could not be disclosed until the prospectus had been published.[112] We were also told that following the flotation, MoD would:

> have a single special share and that will be designed to protect our security by giving us the ability to prevent the purchase of a significant stake in the company by any foreign body that we regarded as incompatible with our security.[113]

107 Ev 32

108 *Ibid*

109 *Ibid*

110 HC (2005–06) 464, pp 167–169

111 HC Deb, 12 January 2006, cols 11–12

112 Qq 57–58

113 Q 59

98. We were concerned about the possibility of a conflict of interest arising, given QinetiQ's roles as an adviser to MoD on research issues and a potential supplier. Mr Woolley told us there was a "compliance regime" in place which was designed to ensure that QinetiQ did not get into a situation where there was a conflict of interest.[114] In terms of letting contracts, MoD explained that there was a clear understanding that, in relation to QinetiQ, there was a separate shareholder interest from a customer interest. Mr Woolley explained that he represented the shareholder interest, but he and his team, were "not involved in any way in discussions about the award of contracts to QinetiQ or not QinetiQ, so to the outcome of competitions in which QinetiQ might be involved".[115]

99. On the issue of how much MoD would be allocated following the flotation, we were told that MoD had been given an indication by the Treasury of the sort of figure it might be allowed to retain, but it had not been finalised.[116] MoD subsequently told us that it had been agreed with the Treasury that MoD "will retain £250 million of the receipts from the QinetiQ IPO for reinvestment in the defence programme. The remainder of the receipt from the IPO will go to the Exchequer".[117]

100. The National Audit Office (NAO) is undertaking an examination into the privatisation of QinetiQ to assess whether the privatisation was good value for money. Among the issues that the NAO are planning to examine are expected to include: the choice of privatisation strategy; the price achieved; and whether the deal is likely to meet its objectives. The NAO expects to publish its report by the end of 2006.

101. **We note that the flotation of QinetiQ has taken place and that £250 million from the sale will be retained by MoD to be invested in the defence programme. We look to MoD to inform us as to how its proceeds from the sale will be used. The NAO has announced that it is to examine the privatisation of QinetiQ to assess whether value for money was achieved: we await this report with interest.**

Costs of operations

102. The Annual Report and Accounts provides only limited information on the costs of military operations in the Balkans, Afghanistan and Iraq.[118] We examined the adequacy of this information in our report on *Costs of peace-keeping in Iraq and Afghanistan: Spring Supplementary Estimate 2005–06*.[119] We considered that the information provided in the Annual Report and Accounts was insufficient and recommended that in future MoD's Annual Report and Accounts contain significantly more detailed information on the cost of operations. We welcome the Minister for the Armed Forces' positive response to this recommendation during the debate on the Report in the House.[120]

114 Q 62

115 Q 64

116 Q 68

117 Ev 31

118 HC (2005–06) 464, p 188

119 Defence Committee, *Costs of peace-keeping in Iraq and Afghanistan: Spring Supplementary Estimate 2005–06*, Fourth Report of Session 2005–06, HC 980, para 10

120 HC Deb, 20 March 2006, col 70

Laying of Annual Report and Accounts

103. The Annual Report and Accounts 2004–05 were published on 28 October 2005, some seven months after the end of the financial year to which the reported performance and financial accounts relate. Most government departments and agencies are expected to have their financial accounts audited and laid before the parliamentary Summer recess. Sir Kevin Tebbit, the former Permanent Under Secretary of State, told our predecessors on 12 May 2004, that:

> We are progressively getting better at laying our accounts and reports earlier in the year. In 2000–01 we were back in December and we have come forward by a month each year. So by 2005–06 I hope I shall be in a position to lay our accounts with the report linked to them before the recess.[121]

104. We asked MoD about the likelihood of having its 2005-06 financial accounts audited and laid before the parliamentary Summer recess. We were told that MoD recognises that it will be a challenge to complete and lay the 2005–06 financial accounts prior to the Summer recess, but MoD is confident that this will be achieved. MoD is working with the National Audit Office and has set up an internal working group to identify and mitigate the known risks in order to ensure that the target is met.[122]

105. **We note that MoD has put in place arrangements to ensure that its 2005–06 Annual Report and Accounts are published before the parliamentary Summer recess. We look to MoD to push forward with these arrangements so that the publication target is achieved.**

121 HC (2003–04) 589-i, Q 1

122 Ev 20, para ix

Conclusions and recommendations

1. We are concerned that as at 1 April 2005 there was a 4.9 per cent manning shortfall in the Royal Navy / Royal Marines against the overall requirement. We note that by April 2006 the shortfall is expected to reduce to 3.6 per cent and look to MoD to take action to ensure that the improvements continue and to address the serious shortages at Petty Officer level. (Paragraph 9)

2. We note that there have been some breaches of Harmony Guidelines in all three Services, but that the impact has been greater in the Army owing to the level of operational tempo. Members of the Armed Forces need time for training as well as for recuperation after operations, and they need time with their families, and we look to MoD to take action to ensure that breaches of Harmony Guidelines are minimised. Greater priority should be given to developing management systems which allow the pressure on individuals to be monitored. (Paragraph 13)

3. We are concerned that there are critical shortages, in various specialist trades, in all three Services, including aircrew and medical personnel. We note that the overall shortfall in medical personnel has reduced from 23 per cent to 20 per cent, and look to MoD to take further action to address this substantial shortfall in such a vital area. (Paragraph 18)

4. We note that MoD considers that the impact of manning shortages on the deployment to Afghanistan is manageable, but we plan to monitor this closely in our inquiry on that deployment. (Paragraph 19)

5. We support MoD's drive for greater efficiency but note that it is likely to result in substantial numbers of civilian job losses. We look to MoD to undertake the appropriate consultation with the organisations which represent its civilian staff and to provide as much support as possible to those who lose their jobs. (Paragraph 25)

6. MoD's performance against its diversity targets has been mixed in relation to both its Service and civilian personnel. It is disappointing that both the Royal Navy and the RAF failed to meet their target for recruiting from ethnic minorities. MoD was significantly below some of its targets relating to women, ethnic minority and disabled personnel in the Civil Service. We look to MoD to identify ways to improve in those areas where it is falling significantly below its diversity targets. (Paragraph 27)

7. MoD's Performance Report shows that MoD only 'partly met' its PSA Target relating to procurement, missing the targets relating to time slippage and cost increases. In contrast, the Report shows that the Defence Procurement Agency met five of its six Key Targets, only missing one target on customer satisfaction. We expect MoD to review the way that its performance in relation to defence equipment procurement is reported in order to provide a clearer picture on whether performance is improving or not. (Paragraph 30)

8. We note that in 2004–05, in-year cost decreases of some £699 million were reported on the top 20 major defence equipment projects. However, a 'significant element' of this decrease related to a reduction in the numbers of equipments being ordered. In our view, it is not a great achievement to report an in-year cost decrease, if this is only because less equipment, or less capable equipment, has been acquired. (Paragraph 33)

9. We fully support MoD's efforts to improve procurement performance. We note that a review of defence procurement has been instituted and expect the recommendations of the review to be implemented both quickly and fully. Improvements in the way MoD procure equipment are vital to the success of the Defence Industrial Strategy and we plan to monitor this closely. (Paragraph 37)

10. We find MoD's explanation as to why they had scrapped a target for reducing the cost of training a military recruit to be unconvincing. As part of its consideration of the outcome of the Defence Training Review, we recommend that MoD reconsider whether they should have a value for money target in such a key area as training. (Paragraph 40)

11. MoD reports substantial savings in its Annual Report and Accounts yet, when pressed by us, informs us that some of the reported savings "cannot be validated". This is worrying. We expect figures in MoD's Annual Report and Accounts to be based on robust evidence and look to MoD to introduce systems which can generate accurate figures relating to savings, rather than figures which cannot be substantiated fully. Overstating savings undermines confidence in the accuracy of the Performance Report. (Paragraph 44)

12. We consider that there is a strong case in the future for the National Audit Office to provide an opinion on the savings figures claimed by the MoD in its Performance Report, as we have little confidence in the accuracy of such figures. (Paragraph 45)

13. Follow-up information provided by MoD showed that the savings of £88 million on Tornado aircraft support were achieved in two years, not four years as stated in MoD's Performance Report. This is a notable achievement. Nevertheless, once again, it raises questions about the accuracy of information provided in the Performance Report and we look to MoD to ensure that more accurate information is provided in the future. (Paragraph 49)

14. We are surprised to learn that stock sold under a rationalisation programme had to be bought back for some £73,000 as it was subsequently found to be needed. We expect MoD to learn lessons from this case and, in future, to assess properly the future need for items before they are disposed of. (Paragraph 52)

15. In principle, we support MoD's policy of rationalising the number of Defence Agencies, particularly those very small agencies where the costs of retaining agency status can be high. However, for some agencies there may be a strong case for retaining agency status and we expect MoD to review each agency on a case by case basis. (Paragraph 56)

16. We note that there are plans to collocate the Defence Procurement Agency's Executive Board and the Defence Logistics Organisation's Board. We support the move to bring both organisations close together, particularly given that projects are now managed on a through-life basis. (Paragraph 59)

17. We found it difficult to judge the performance of the Defence Agencies, as set out in the Annual Report and Accounts, as both their achievements against the targets set, and the number of targets set, vary considerably from year to year. We look to MoD to ensure that in the future, changes are made to the reporting of the performance of Defence Agencies, so that it is easier to assess whether their performance is improving. (Paragraph 64)

18. The fact that MoD's resource accounts for 2004–05 received an unqualified audit opinion for the second year running suggests that MoD's initial problems with Resource Accounting and Budgeting are being overcome. (Paragraph 67)

19. A new contingent liability of some £400 million, relating to a liability to clean up training sites in Canada should the UK cease training there, has been included in the 2004–05 financial accounts. We consider this to be a substantial liability and expect MoD to re-assess, on a regular basis, the size of this liability and consider how such a liability of this scale would be funded if it fell due. (Paragraph 70)

20. We note that losses reported in MoD's 2004–05 Financial Accounts had reduced compared with the previous year, but consider that the sums are still substantial. We expect MoD to take appropriate action to minimise losses in the future. (Paragraph 74)

21. We find it hard to understand why the procurement of these four ships, which are not particularly sophisticated, is likely to cost in the region of half a billion pounds, substantially over the initial contract price. The Landing Ship Dock (Auxiliary) programme cannot be considered to have achieved value for money. MoD seems to have given the lead contractor on the programme an open-ended cheque book. (Paragraph 81)

22. The first contract for two ships, on the Landing Ship Dock (Auxiliary) programme, was let in December 2000. While this was some time after the launch of the Smart Procurement initiative, this procurement cannot be considered 'smart'. It raises questions about how MoD assesses whether a contractor has the necessary skills to deliver a specific equipment programme. We expect the lessons from this sorry episode to be identified and implemented. We wish to be kept informed of the progress on this programme. (Paragraph 82)

23. We are amazed at the scale of the losses relating to a building at AWE Aldermaston which could not be used. The total losses amount to some £147 million. MoD's acknowledgement that the project "was handled badly" is a considerable understatement. It is essential that the lessons are learned and we do not expect to see a repetition of such a debacle in the future. (Paragraph 86)

24. We are concerned that the two losses relating to the building at AWE Aldermaston, one of £65 million and the other for £82 million, were listed separately in the losses statement in the Annual Report and Accounts, and that there was no way of linking the two losses from the information provided. In future, we expect MoD to provide sufficient information for related losses to be identified. (Paragraph 87)

25. We do not find MoD's explanation for the four month delay in informing Parliament of a gift of a value exceeding £250,000 sufficient and we call on MoD to report its gifts promptly in future. (Paragraph 92)

26. The UK sought to assist the US following Hurricane Katrina by gifting Operational Ration Packs at a total cost of some £5.1 million. We have no objection to the gifting of the Operational Ration Packs and only regret that they were not used to help the victims of Hurricane Katrina as intended. We are satisfied that this was for reasons outside MoD's control and hope that it has learned lessons for the future. (Paragraph 95)

27. We note that the flotation of QinetiQ has taken place and that £250 million from the sale will be retained by MoD to be invested in the defence programme. We look to MoD to inform us as to how its proceeds from the sale will be used. The NAO has announced that it is to examine the privatisation of QinetiQ to assess whether value for money was achieved: we await this report with interest. (Paragraph 101)

28. We note that MoD has put in place arrangements to ensure that its 2005–06 Annual Report and Accounts are published before the parliamentary Summer recess. We look to MoD to push forward with these arrangements so that the publication target is achieved. (Paragraph 105)

List of Abbreviations

AWE	Atomic Weapons Establishment
DARA	Defence Aviation and Repair Agency
DfID	Department for International Development
DLO	Defence Logistics Organisation
DPA	Defence Procurement Agency
EU	European Union
FCO	Foreign and Commonwealth Office
IPO	Initial Public Offering
IT	Information Technology
JPA	Joint Personnel Administration
LSD(A)	Landing Ship Dock (Auxiliary)
MoD	Ministry of Defence
NAO	National Audit Office
NATO	North Atlantic Treaty Organisation
ORP	Operational Ration Pack
OSCE	Organisation for Security and Co-operation in Europe
PSA	Public Service Agreement
PUS	Permanent Under Secretary of State
RAB	Resource Accounting and Budgeting
RAF	Royal Air Force
TLB	Top Level Budget

Formal minutes

Tuesday 28 March 2006

[Afternoon Sitting]

Members present:

Mr James Arbuthnot, in the Chair

Mr David Crausby
Linda Gilroy
Mr David Hamilton
Mr Mike Hancock
Mr Dai Havard
Mr Adam Holloway
Mr Brian Jenkins
Robert Key

Ministry of Defence Annual Report and Accounts 2004–05

The Committee considered this matter.

Draft Report (Ministry of Defence Annual Report and Accounts 2004-05), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 105 read and agreed to.

Annexes [Summary and List of Abbreviations] agreed to.

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

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

Ordered, That the provisions of Standing Order No. 134 (select committee (reports)) be applied to the Report.

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

[Adjourned till a date and time to be fixed by the Chairman.

List of witnesses

List of written evidence

Ministry of Defence:

Defence Committee Reports in this Parliament

Session 2005–06

First Report	Armed Forces Bill	HC 747 (*HC 1021*)
Second Report	Future Carrier and Joint Combat Aircraft Programmes	HC 554 (*HC 926*)
Third Report	Delivering Front Line Capability to the RAF	HC 557 (*HC 1000*)
Fourth Report	Costs of peace-keeping in Iraq and Afghanistan: Spring Supplementary Estimate 2005–06	HC 980
Fifth Report	The UK deployment to Afghanistan	HC 558

Government Responses to Defence Committee Reports are published as Special Reports from the Committee (or as Command Papers). They are listed above in brackets by the HC (or Cm) No. after the report they relate to.

Oral evidence

Taken before the Defence Committee

on Tuesday 24 January 2006

Members present:

Mr James Arbuthnot, in the Chair

Mr David S Borrow	Robert Key
Linda Gilroy	Mr Mark Lancaster
Mr Brian Jenkins	John Smith
Mr Kevan Jones	Mr Desmond Swayne

Witnesses: **Mr Bill Jeffrey CB,** Permanent Under Secretary of State, and **Mr Trevor Woolley,** Director of Finance, Ministry of Defence, gave evidence.

Q1 Chairman: Good morning, Mr Jeffrey, Mr Woolley and everybody else. Welcome to this evidence session on the Report and Accounts of the Ministry of Defence. Mr Jeffrey, can I begin by saying thank you very much for coming to your first evidence session with the Defence Select Committee. You have been in post fully for two months now and here you are, expected to come and answer questions about absolutely everything which I think is a bit tough frankly. I am being soft obviously! How are you getting to grips with the MoD and what do you think the comparison with other departments you have knowledge of shows you about how you ought to be getting to grips with it?

Mr Jeffrey: Thank you, Chairman, and I am rather conscious of the fact that I am facing this Committee early in my time in the MoD. I think, if you will forgive me, as we get into the detailed questioning, I may well rely on Mr Woolley more than I hope to be doing before very long. As to how I am tackling it, I am tackling it by getting around the place and I was thinking this morning before coming to this session that it is actually more like six weeks because it takes account of the Christmas period. I have already been to the Permanent Joint Command Headquarters at Northwood, the DPA, the DLO, the personnel area, the finance area, the policy area, communications, and to the Defence Export Services Organisation yesterday, so I think the answer to your question as to how I am tackling it is that I am getting in amongst it because I am conscious that I did not grow up in this Department and I have to understand its business if I am going to be effective as one of the leaders of the organisation. My first impressions are, I have to say, very positive. I find, as I hope the Committee has found as it has done its business, that it is a body of people who are very committed to what they are doing. As you may know, I was responsible for several years for the Immigration Department in the Home Office and I felt that was true there as well in sometimes quite difficult circumstances; but the thing that I am impressed by in the MoD is, first of all, the joint working between military and civilians does seem to be genuine and quite deep-rooted and, secondly, that people are genuinely focused on delivering military capability and, as I go around the place, that phrase is used remarkably often. I think the priorities I would see, and I was struck by how coincident they are with the things that the Committee is taking an interest in, are, first of all, business effectiveness, building on what we have done in the past and what my predecessor, Kevin Tebbit, did to create a department that has, and deserves, the confidence of ministers, the public and Parliament. I think a part of my function is to provide leadership for the approaching 100,000 or so civilians; my military colleagues do that effortlessly and I think that is something I definitely have to do as Permanent Secretary. I think I need to apply quite a bit of attention to a topic that I know your Committee is becoming interested in, and indeed you are going down to Abbey Wood later this week, which is the whole question of how we procure and acquire equipment for defence. The Defence Industrial Strategy is a very important development, but it is quite clear from my early conversations that everyone accepts that, if it is going to work, we, as a Department, have got to play a big part and, although improvements have been made, there is still a great deal to do. I think I need to attend to the Efficiency Programme which you will no doubt want to ask us about later this morning and that is on course, but it is something that I need to pay a very close personal interest in. There is also a set of issues which I know your predecessor Committee and you have taken a close interest in to do with our duty of care to all of our staff. That is a selection and I think there are other issues. Obviously the Armed Forces are very busy at the moment and there are major commitments in Iraq and Afghanistan and, if I am going to support my Secretary of State as well as I need to, I need to understand these as well and play my part in that.

Q2 Chairman: That is very helpful, but, if those are the priorities that you have set out for yourself, how will we be able to judge whether you have achieved what you have set out to achieve?

Mr Jeffrey: Well, nothing is "unimprovable", but in the papers you have before you is the Balanced Scorecard, the way in which we set out our targets and how we are progressing towards them, which is a reasonably user-friendly way of tackling the management of this enormous business. I certainly have now chaired one meeting of the Defence Management Board in which we used the Balanced Scorecard and I think it is well established now. As I say, nothing is beyond improvement, but it gives us a means by which we can track achievement against our main targets. I think in the end one must not have alternative systems in these sorts of things. If we succeed and if I succeed in what I have just described, then it ought to show in the main measures that are described in these papers and, if not, then they are not the right measures, so I would say look to the main systems, look to the running systems and we can assess as we go whether we are achieving the outcomes that we want.

Chairman: One of the key issues that we are going to have to take an interest in over the coming years is the issue of recruitment, of overstretch, about all the various harmony guidelines and stuff like that which relate to the personnel of our Armed Forces, and I will ask Desmond Swayne to ask about those.

Q3 Mr Swayne: PSA Target 4, if we look at the performance of the Royal Navy and the Royal Marines, has essentially gone in the wrong direction. It was 95.1% on 1 April 2005 as against 96.8% in 2004, so it is going in the wrong direction and it is nearly 5% below what is required. What difference does that actually make, given that we are told that there have been only very isolated breaches of harmony guidelines and, if that is the case, have you set the target too high in the first place?

Mr Jeffrey: I think that the Navy is certainly, of the three Services, the one which is still facing a significant challenge in getting up to the strength that it is intended to be at. It is not yet at what is described as 'manning balance' within the 98–101% of the preset figure. The latest figures I have are that the forecast deficit for April 2006, a few months hence, was 3.6% compared with 4.9% in April 2005, so that suggests that it is now moving in the right direction, but I should emphasise that what one is measuring it against is also a moving target because there are planned reductions in manpower over that period as well. That may be a partial answer to your second question. It is certainly the case that, although the harmony guidelines are not proving possible to meet for the Army and the Air Force, they are, broadly speaking, being met by the Navy and the Navy is managing within that. That may reflect the fact that the Navy, although it is much involved in current operations, is rather less involved than the other two Services.

Q4 Mr Swayne: If we take the Army then, the Army is now in balance, is it not, at 98.3% which, after all, sounds a very creditable figure? I suppose we are all conditioned by pure maths O Level where, if anyone got over 45%, they were a real boffin, so 98.3% sounds pretty good. What are these statistics actually hiding? What are they not telling us because the anecdotal evidence is actually that there are real problems with the Army? Only yesterday in the press we are being told about the Paras being under strength, to be augmented by Infantry units, of Paras having to go direct from Iraq to Afghanistan and of there being tour intervals of less than one year. Are these statistics actually robust? Are they really telling us things that we need to know or are they just simply covering them up?

Mr Jeffrey: I think there are several points in response to that. The first is that the figures are accurate in the sense that they tell us what the strength of the Army is at any one time and what that represents as a percentage of what it was planned to be. What they conceal, although it is not really concealed in the sense that it is in there in the rest of the Report, is that for some particular trades there are what are described in the papers as 'pinchpoints' where historically it has been hard to recruit people with specialisms, people like ammunitions technicians, explosives and ordnance disposal officers, signals information systems engineers, these sorts of categories where it is hard to recruit and the recruitment climate is not as benign as we would want it to be and there are some special efforts to tackle these so-called pinchpoints. Otherwise, I think the only other point I would make is that there is no doubt that, although the percentage of the total Army manpower that is currently deployed in operations has been falling and is a little less than it was even when these papers were published, this is a very busy time for the Army and the commitment in Iraq and Afghanistan in particular is such that on the ground there may well appear to be difficulties of the kind that you describe, but certainly the advice I am hearing from senior military colleagues is that, although this is a very busy time, it is manageable and will continue to be so.

Q5 Mr Swayne: The 25 pinchpoints in 2004–05, how are they actually defined, what impact do they have on operations and will the deployment to Afghanistan make them worse?

Mr Jeffrey: They are a collection—and I am not sure if they appear in the published Report or not, but we can certainly provide the Committee with a full list of what these categories are.

Q6 Chairman: I think it would be helpful if you could, yes[1].

Mr Jeffrey: I think I probably also ought to do the same in relation to Afghanistan. I think it is undoubtedly the case, again as the Committee will know, that we are not completely clear what the nature of any future deployment in Afghanistan will be, but I think I ought to take notice of the question about whether any Afghan deployment, when it comes, will make that situation worse than it already is, and we can provide the Committee with a note on that certainly[2].

[1] *Note:* See Ev 22
[2] *Note:* See Ev 22

Q7 Mr Swayne: The Report tells us at paragraph 113 that Army recruitment has been affected by perceptions of the war in Iraq and issues surrounding Deepcut, particularly parental perceptions, so what actually is being done about that and is it proving effective?

Mr Jeffrey: Well, I think the factors that affect Army recruitment are various. The Secretary of State was asked about this during Questions yesterday or on an earlier occasion and he said that he did not think that Iraq was a particularly significant factor, although it obviously is possibly in the minds of parents and others. I think principally, apart from keeping up a very strong recruitment effort, the steps that are being taken are steps around improving recruitment, training, responding to the Deepcut events, looking at the way in which we support recruits under training through welfare and in other ways and, by these means, giving potential applicants the confidence that they need to put themselves forward, but it has to be recognised that we are operating in quite a difficult recruitment climate with still historically pretty high levels of employment, so the task of the Army recruiters is not straightforward.

Q8 Chairman: Mr Jeffrey, when we went to meet the ARRC, we asked whether it was possible, at the press of a button of a computer, to work out the individual harmony guidelines relating to any individual Service person and we were told that it was not yet possible. Surely that ought to be possible. Do you have any views or comments about that?

Mr Jeffrey: I do not. I have to say immediately that it is probably better to start with this Committee by being entirely straight with it. I am not briefed on that and I think I ought to become so and again, if you would be happy to take a note on that, we will provide one.

Chairman: Yes, I should be grateful if you could provide us with one please[3].

Q9 Mr Jones: Mr Jeffrey, welcome to the Committee and, if you give us straight answers, you will be the first person from the MoD who ever has, apart from, I think, the last Procurement Minister who did when he came before us, so I look forward to these straight and honest answers. Can I just pick this up in terms of the issues surrounding Deepcut. How much damage do you think not just Deepcut, but the related publicity which has taken place over the last few years has done not just to the Army, but generally to the reputation of the Services?

Mr Jeffrey: Well, I find it hard to assess that. There is no doubt that the Deepcut events, which are now some years in the past obviously, attracted a great deal of publicity at the time and in some respects continue to do so. All I can say is that, as a recent arrival in the Department, it is clear to me that everybody from the Secretary of State down, and I have in particular discussed this with the Armed Forces Minister once or twice, is utterly committed to addressing this set of issues around the way in which we care for our military and civilian staff and the nature of the training experience and the culture of training establishments. It is a difficult set of issues and it is hard to say what the impact has been publicly, but I am sure there has been some.

Q10 Mr Jones: So why has your Department ignored one of the main recommendations in our Duty of Care Report, ie, the independent oversight of complaints, which surely would be a method of instilling confidence back certainly in mums and dads who are going to be sending their kids into the Armed Forces?

Mr Jeffrey: I do not think it is fair to say that the Department has ignored that recommendation. It is certainly the case that we have not proceeded with the full-scale, entirely independent system that your predecessor Committee recommended, but there are plans in progress both to have an independent element in redress panels where the Secretary of State appoints an independent person—

Q11 Mr Jones: They are pretty pathetic though, are they not, these panels?

Mr Jeffrey: Well, they are a step in that direction. There is also a proposal to have a form of independent audit of the health of the system where an independent person will be able to look at a selection of cases after the event and advise us on the way in which the system operates. Now, that is not, I am sure, as much as the Committee was looking for and as independent a system as the Committee was recommending, but it definitely does represent an element of independence in the process.

Chairman: Please will you bear in mind, Mr Jeffrey, that the Committee will be worried that the Ministry of Defence is seen from time to time as being judge and jury in its own court.

Q12 Robert Key: Could I turn to civilian personnel management, Mr Jeffrey, and the People Programme. I am very conscious that behind all the uniformed Services, there is a valiant band of people, civilians, on whom the Armed Services depend for the delivery of almost everything, particularly when they are out in theatre. I see it in my own constituency every time there is a little operational flutter when the planes are flying more regularly at Boscombe Down and so on, but I wonder if you could tell me what manpower savings there will be resulting from Project Hyperion? That is very specific and I am asking it for a purpose, because it is a good example of a change which the Army is making to their organisation in Land Command and the Adjutant General's Department which is going to have an effect on recruitment and retention, but it also has an impact on civilian manpower. I wonder if you could tell me what those manpower savings are off the top of your head and, if not, because that is a pretty precise question, could you let us have the figure?[4]

[3] *Note:* See Ev 24

[4] *Note:* See Ev 24

Mr Jeffrey: I am searching for the figure as you speak, Mr Key. I think it might be better for me to undertake to give you a figure for that.

Q13 Robert Key: That is fine.

Mr Jeffrey: I may say I entirely share the sentiment of the first part of your question which is the importance of the civilian element in everything that we do and it is true that, taken across the board, our efficiency savings involve quite significant reductions in the numbers of civilian staff. I cannot speak for the particular programme that you have just mentioned, but we will give you the details.

Q14 Robert Key: I would be very grateful because it illustrates the difficulty for the civilian staff of relocating, for example, from Land Command, Wilton to wherever it is going to be, and the word on the street is that it is Andover, but it might be Solstice Park, who knows, but wherever it is, in terms of the travel-to-work area and so on, you have to manage civilians as well as the military and this is where it gets very difficult because out there, are tens of thousands of civilians who are very worried by what they see as a continuing programme of efficiency mixed with privatisations and PFIs and so on and they feel that the old family of the Ministry of Defence is being diluted and they worry about it very much and so do I. I wondered if you could just give me some reassurance that you do not just see civilian manpower as a management exercise and you really do realise how important they are.

Mr Jeffrey: I do and, if it is any reassurance, all my own history of managing businesses inside the Civil Service has been with a measure of responsibility for significant numbers of civil servants. I take that very seriously and I think, as I said at the beginning, that one of my tasks, working alongside my military colleagues, is to really make the civilians feel that they are as significant a part of this enterprise as anyone else. I will do that in consultation with the unions and with a full appreciation of the fact that the decisions we take, which often do need to be taken for good logistic and efficiency reasons, are ones that also take account of the human dimension because it is very important.

Q15 Robert Key: Indeed and I know that that is how you will seek to manage civilian manpower. In the memorandum we received from the Ministry of Defence on the response to our questions on the Annual Report[5], right at the end where it is talking about civilian manpower on page 26, it is a bit clinical and it says at paragraph 67, "Cashable savings from civilian manpower reductions are made centrally". Now you can see where I am coming from. I asked you about Hyperion because it is all measured centrally, but I am not quite sure that the answer is there and I just wonder if anyone behind you has got any of these figures and can help us, and I know you are going to send them along. I just want really to make the point here that you say in paragraph 68, "There are no quality measures against the reduction in civilian manpower because this is not an efficiency measure in itself, but rather a consequence of other efficiency measures". Again I simply ask: are you quite sure that you are putting people first and not the management machine?

Mr Jeffrey: Our first responsibility, and it comes back to the targets and the high-level objectives in these reports, is to provide defence capability in an effective fashion. That will inevitably sometimes, and there are some recent examples of this, cause us to look critically at the numbers of staff we have and what we have them engaged on, but I certainly would not want to approach any of this without a good appreciation of the impact that the decisions we make have on the people who work for us.

Q16 Linda Gilroy: I am sure that some of our constituents who will be coming to Westminster tomorrow to lobby us from the defence trade unions will welcome the sort of approach you have outlined and I wonder if I could just take that a bit further. Attached to the notes we had was a copy of the MoD Efficiency Programme and in that, paragraph 14 describes how the Department has established an Efficiency Delivery Board to oversee the overall Defence Efficiency Programme. I wonder if I might ask just one or two questions about some of the principles that we might expect to see that Board having in mind in order to follow through some of the approach you have just outlined. The Gershon efficiency savings are set to produce something like 10,000 job cuts or transfers to the private sector, I think, by 2010 and the unions will be telling us, I think, tomorrow that that ranges across agencies like DARA, ABRO, the Defence Information Initiative, Defence Logistics, the Defence Training Review and the Future Defence Supply Chain Initiative. The sort of questions that the unions will be bringing to us and their members, our constituents, will be seeking reassurances about having a level playing field, about consultation, about the possibility of having inhouse options and I just wonder if you might be able to give us a flavour of how the Efficiency Delivery Board takes into account the kind of concerns they express in those respects.

Mr Jeffrey: Well, I do not have a great deal to add to what I said in response to Mr Key. It is a balance and we have a responsibility to our ministers and to the public, as taxpayers, to deliver this extraordinarily expensive business as efficiently as we can. That does mean that we have to keep looking at ways in which we can do so, and the Gershon changes which you have referred to have some impact in the MoD and there is no question about it. As I said in my response to Mr Key, I think that, in working through changes of the kind you have referred to, we have to be sensitive to the human dimension and I am sure that the Board you have referred to will be so, but in the end we also have to achieve the outcomes that our ministers seek and as efficient an organisation as we can provide, so it is the usual difficult balance.

[5] *Note:* See Ev 17

Q17 Linda Gilroy: I think on the Defence Committee we understand the need to look for efficiencies to make sure that we are getting good value for the defence budget. It was really looking for, whether in delivering that, there are principles which guide the Efficiency Delivery Board in how they relate to the workforce and to the trade unions. It might be something that we could come back to in the future, but, if I could just ask a similar question, I think one of the concerns which the trade unions would have, and certainly we had when we were looking at the front-line capability inquiry, was that we could end up with some parts of industry having almost a monopoly situation as far as the provision of services was concerned. One area that I know the unions have concern about relates to the Defence Training Review where there are three consortia bidding for two contracts. Now, if one of those consortia ended up with both of those contracts, over a short period of time the MoD could find itself in the hands of a monopoly supplier and again I wonder if there are principles which the Efficiency Delivery Board have in looking at how they seek best value which takes into account the longer-term position that they might be placing themselves in with regard to private contractors?

Mr Woolley: I actually sit on the Efficiency Delivery Board and I think the first thing I would say is that our goal is very much efficiency as measured in financial terms, and the goal is expressed as £2.8 billion, so we do not have an agenda, as such, to contract out, except to the extent that contracting out services contributes to meeting that goal of £2.8 billion. It is the view of the Department that, as part of the overall Efficiency Programme, the consequence will be, as you say, a reduction of 10,000 civilian staff, but on each case it is a value-for-money judgment and when it comes to the various agencies and the various trading funds, we have taken different positions according to whether or not we think the value-for-money option is an inhouse solution or a sale solution and that has characterised our slightly different approaches to DARA on the one hand and ABRO on the other hand. In the case of the defence training rationalisation contract, this is a long-term PFI contract and it would probably be for a period of 25 years, so we are not looking for a regular competition, but we are looking precisely for a long-term partnership agreement and what the requirements of the Armed Forces will be and what the industrial structure of the United Kingdom will be at the end of that contract is very difficult to predict, but that is in the nature of having a long-term contract. The advantage of having a long-term contract is that it gives a degree of certainty to the private sector partners as to what the requirement is and that the business will be there and, through that, we expect to be able to drive down the costs and provide efficiency. That is an alternative approach to competition and regularly recompeting contracts which does have the advantage of keeping competitive pressure on the contractors, but the disadvantage is that the contractor, recognising the risk he is taking, has effectively to transfer that risk back to the Department and the Department pays a premium as a consequence. Therefore, what I am saying is, I think, that there are different methods by which we can achieve efficiency, the competitive route, but also the long-term partnering route, and in different cases we have to make judgments as to what we think will be the optimal way of achieving efficiencies.

Q18 Linda Gilroy: I think one understands the benefits of long-term partnership. I think what I and some other Members have a concern about is that it can end up, I think, as a break-point in a particular contract of 15 years if by that time there is only one supplier and there is nowhere else you can look. Can they then say to you that they are the only supplier, perhaps they are in significant competition with people for the sort of posts they need to keep filling to provide that service and that, therefore, they are in that monopoly position at that point and there are long-term dangers as well as benefits in that particular approach?

Mr Woolley: Well, I think we do recognise the risks. I think one has to make a judgment in some cases whether the market is such that you really can retain competition for a long period and in some cases I think that the market is not such that you can do that. In the case of the DTR, the sorts of services we are looking for, whilst technical, are not so highly specialised that I think one would be eliminating all possibility of competition in the future.

Q19 Linda Gilroy: Can I just ask you one more question on the Efficiency Review and a different aspect of it to do with relocation and I wonder if you could give us some idea of the extent to which the savings depend on continuing with that programme. In paragraphs 60 and 61, it deals with the moves which have already been made, the relocation out of the South East and, I think, some savings of 1,200 posts from the Army Technical Foundation College, but then that needs another 2,700 to find by 2010. I do not know if you have any information about what that involves, what likely further moves there will be in relocation from London or, if that is not to hand, perhaps you could let us have a note about it.

Mr Jeffrey: I can provide some information about that. The broad position is that we are on course to achieving the overall target of relocating 3,900 posts out of the South East by 2010. The first 1,230 of these were delivered in the last financial year in the way you described when the Army Technical Foundation College closed and was transferred to Harrogate. The other major contributions to achieving the target are: a move of the Defence Medical Evaluation and Training Agency from Aldershot to the Birmingham area, relocating 1,100 posts in 2008–09; the Disposal Services Agency moving from central London to the Bath/Bristol area, relocating 80 posts in 2007–08; the Defence Science and Technical Laboratories relocating 500 staff from Farnborough and Portsdown to Porton Down in 2006–07; and the fact that, when Chelsea Barracks is closed, its units will move to Woolwich, so those currently based there will relocate, 1,000 posts, to a variety of establishments in 2006 to 2008.

It is a mixed picture and, by one means or another, we believe we are on course to meeting the objectives set in the Lyons Review.

Q20 John Smith: This is a general question to Mr Jeffrey, and I know he has not been in post very long, but I think some of us are genuinely concerned that the Ministry of Defence is in danger of knowing the price of everything, but the value of nothing and not knowing the difference between reducing costs and cost overheads, which I think it has been extremely successful in doing, and introducing real efficiency savings. Our most recent report on support for RAF front-line capability, I think, points in that direction[6]. Yes, the savings are going to be made, but in the future we believe there is a very big danger that we are not going to be able to support the front line efficiently, sustainably and reliably. I just wondered whether you had a view on that and I wondered whether Mr Woolley had an opinion in principle and that is: does he believe in principle that it is possible to incentivise a sole monopoly supplier?

Mr Jeffrey: Perhaps I can respond first, and I do so with what I hope is still an open mind, but I am new to this organisation and I am at this stage giving you no more than first impressions. I do not think it is a fair caricature of what I have seen so far to say that this is an organisation that understands the price of everything and the value of nothing. I have been struck by the extent to which considerations about the people we employ and the importance of morale at all levels are the common currency of conversations with my new colleagues, so I do not feel that culturally I have walked into an organisation that is just about slashing and burning and cutting costs all over the place. I do, however, recognise that we are embarked on a pretty demanding Efficiency Programme which will involve some tough decisions and there is no doubt that the reductions that we are committed to make will take some achieving. On the specific point about logistics, all the advice I have had so far is that there are no indications that the pursuit of efficiency has in itself prejudiced the Defence Logistics Organisation's ability to meet the requirements placed on it to support its customers in the front line. That was certainly the message I was getting when I visited the DLO a week or so after I took up my post. One may say, "They would say that, wouldn't they?", but they clearly regard their principal responsibility as being to provide that measure of support for the front line and there was a good degree of confidence that they could carry on doing so in a more efficient context. Trevor may want to respond too.

Mr Woolley: It is certainly possible in principle to, and indeed we do in practice, have ways of incentivising monopoly suppliers. We can introduce into the contract various incentive fee arrangements whereby, if the contractor is able to deliver services for less than the forecast price, the benefits are then shared between the customer and the supplier, we can have open-book accounting arrangements, and we have a pricing and forecasting group within the Defence Procurement Agency whose role is to examine pricing that comes from monopoly suppliers to ensure that it is fair and reasonable. Therefore, we have over the years and over the decades developed various means of doing this, but obviously in this, as in many other areas, there is scope to do it better, there is scope for improvement, there is scope to be cleverer and our commercial teams are working to ensure this.

Q21 John Smith: But the record in terms of dealing with monopoly suppliers in the past has not been a terrific one and previous reports of our previous Committee have alluded to that. There is a difference between a monopoly supplier and a sole monopoly supplier where the capability does not exist within the UK to turn to when that relationship becomes difficult, for the reasons my honourable friend pointed out, so I do think that consideration has to be given to this. I am sure that Mr Jeffrey has been assured that the efficiencies are being achieved, but who does he think should really have apologised when the RAF could not bring our troops back from Iraq, not because our brave aircrews could not get out there or were not committed or were not prepared to do the work, but because the aircraft were not serviced and serviceable, so we could not get out in time to bring back our troops who were out there, courageously and bravely representing this country? We could not get them out of that country because of problems in the logistical chain, so should the RAF have apologised or should it have been the DLO?

Mr Jeffrey: Well, in the particular case you refer to, I am aware of it and the DLO, I know, are working hard to make sure that they can meet these sorts of commitments and it is a question of constant improvement. I am not sure I have an answer to the question as to who should apologise, but clearly it is not an ideal outcome when that happens, far from it.

Chairman: As I understand it, an apology was given.

John Smith: By the Chief of Air Staff, I think, yes, but the concern, Mr Chairman, is whether this is a harbinger for the future. Is this a sign of things to come if we do not understand the real difference between cutting costs and making genuine efficiencies that we all support? I will leave it there.

Linda Gilroy: Perhaps I can just follow on from that to underline the question I asked about what principles the Efficiency Delivery Board use to relate to the trade unions on these issues because tomorrow they are going to be saying to us that Britain's defence is potentially under threat because of some of the Gershon savings. Clearly we will need to listen to what they are saying, but also we will want to listen to what you are saying, but to hear in that that there are some guidelines and principles there that engage in a constructive way in order to listen to the people who are delivering the service.

Chairman: Mr Jeffrey, you have heard what has been said. We will move on now to procurement.

Q22 Mr Jones: Mr Jeffrey, you referred to procurement in your opening statement and I think we can describe it as a scandal frankly, the way it has

[6] *Note:* Defence Committee's Third Report of Session 2005–06, *Delivering Front Line Capability to the RAF.*

been operated in the MoD for the last few years. Can I ask a few general questions and then I have a specific question after that on the Report. In table 19 on page 102, I think it shows that the Defence Procurement Agency has met its targets for 2004–05 for delivering equipment to time and on cost, which I think comes as a great surprise to many who have dealt with the Defence Procurement Agency over the years. How does that fit with the Major Projects Report 2003 and other Major Project Reports which have actually identified slippages and increased costs?

Mr Jeffrey: I recognise what you say about the Major Projects Report and the sense that there is still significant problems of slippage and cost increase which we are trying to address. I am just trying to remind myself of the target as expressed on page 100 and 102. If you look at the beginning of the document where on page 14 there are the main objectives, objective 3 is: "Build for the future—develop and deliver to time and cost targets the military capability for the future", et cetera, and it is acknowledged there that several of these targets were not met and the overall assessment is that that objective was only partly met, so I do not think there is any sense in which the Department is asserting that in the procurement area we are meeting all of our targets.

Q23 Mr Jones: How does that tally with page 102 then where it does say it in the final bit of my notes, table 19?

Mr Jeffrey: I think the reason for the disparity is that the main PSA targets are supplemented by a set of key targets which measure success in the procurement of equipment projects. If you look at the key targets, which are the ones listed on page 102, the DPA met five of six of these, which was an improvement on what they had done previously, but certainly, if you step back from that and look at the PSA target as a whole, the position is, I think, more accurately captured at the beginning of the document in the way that I have described.

Q24 Mr Jones: But is it not that type of transparency that we actually need if we are going to have confidence that the DPA is actually improving? Personally, I would abolish it, but, if people have faith in it, should we not actually have clearer understandings of what those targets are?

Mr Jeffrey: It may be that they could be clarified, but certainly they are measuring different things. The main point I do want to get across to you, Mr Jones, is that this is not an area in which there is any degree of complacency at all.

Q25 Mr Jones: Well, I will come to that in a minute. You have already mentioned the National Audit Office Report in terms of major projects and I think it is something like £5 billion, if you take the 2003 Report and the 2004 Report. In 2003, it was £3.1 billion and I think the increase in costs in the 2004 Report was £1.7 billion. What impact has that actually had on procurement in terms of being able to afford to procure other equipment? Has it actually had a knock-on impact?

Mr Jeffrey: The last NAO Report, which was published shortly before Christmas, on major projects[7] showed that there was within the year that it covered some further slippage in time of the selection of the biggest projects that the NAO look at, but that over that period there had in fact been a reduction of about £600 million, I think, or £500 million.

Mr Woolley: And that reflects the figure in the 2004–05 column.

Q26 Mr Jones: I will come on to that in a minute. Is that the £699 million?

Mr Woolley: The coverage of the DPA's key targets is rather wider than the Major Projects Reports, so they are not directly comparable, but I think it is the case that, just as the Major Projects Report in 2005 shows a reduction in the cost forecast in year, so the wider DPA targets are reporting it in this table on page 102.

Q27 Mr Jones: Yes, but is it not a fact that the reason for the decrease of £699 million is because of the reduction in the amount of equipment that has been ordered? Is that the reason why it is down?

Mr Jeffrey: There is a significant element of it which can be described in that way, though it is not by any means the whole story, but it is a much better position—

Q28 Mr Jones: It is bound to be if you are buying less of something.

Mr Jeffrey:—than in previous reports.

Q29 Mr Jones: I know, Mr Jeffrey, you have not been in post for very long, but certainly the previous Committee and other people look at this, so do you worry about it? I think you have already raised it as an issue yourself, not just in terms of delivering the equipment to our Armed Forces which they need, but also as value for money to the taxpayer. It is a pretty shoddy history. In terms of how it is presented here, is it not important, and I know it is very difficult for the MoD ever to do this, that they admit that they have ever got anything wrong? Is it not about time that the MoD just said, "Hands up, we got things wrong and this is what we're going to do to put things right"? It never, ever does that in this area, but there are always reasons, and I will come on to specific examples in a minute. Would it not be a new breath of fresh air if you, as the new Permanent Under Secretary of State, said to your civil servants, "Come on, if you do something wrong, open up to it"?

Mr Jeffrey: I think there has been a readiness to acknowledge that acquisition of large equipment has not been handled well in the past and part of the reality which I inherited is that there are a significant number of projects from quite a number of years ago which have gone wrong from the outset and

[7] *Note:* NAO report on *Major Projects Report 2005: MoD* (HC 595-I and II).

continue to cause difficulties, and we may even come on to some of those in the course of this hearing. However, my sense of it generally is that there have been some improvements in the way in which acquisition is undertaken. The Smart Acquisition principles are a sensible way to conduct it. The question is whether they actually have been followed through into practice sufficiently, and one of the things I will want to pay a lot of attention to is the extent to which the DPA in particular has the staff it needs, the training it needs and the skills it needs to follow these smart acquisition principles through. The thinking behind—

Q30 Mr Jones: Surely you are not going to expand Abbey Wood, are you? Please do not.
Mr Jeffrey: I was not necessarily talking about expansion.

Q31 Mr Jones: Good!
Mr Jeffrey: The significance of the Defence Industrial Strategy is that it acknowledges that both the industry and the Government need to improve their performance in this area. We have made it very clear, and I think that is certainly something that we will address and the current Defence Procurement Minister attaches a lot of importance to, that we are also up for serious and significant improvement in the way in which procurement is managed by the Department, but, as part of the follow-through to the Defence Industrial Strategy, there is a project which I instituted myself shortly after I arrived in which we will be looking hard at the way in which the procurement function operates, how it is structured, how the processes work, and looking at ways in which we can generally make it work better, and I am utterly committed to that. Equally, I am not in any sense diminishing the progress which has been made because it is clear to me that in the last few years we have got ourselves into a significantly better position than we were. It is not nearly good enough and I am not meeting anyone who is trying to pretend to me that it is.

Q32 Mr Jones: If I can refer to a specific example, it is on page 190 to 195 on losses. This is the issue around the Landing Ship Dock (Auxiliary) Programme which I think refers to a potential payment of £63 million to BAE Systems and Swan Hunter. First of all, why are the MoD picking that tab up and, secondly, are they the only extra costs that have been incurred on this programme?
Mr Jeffrey: That is quite a good example of what I was talking about. It is a programme where the contract was originally awarded in 2000 to Swan Hunter who were building two of these ships and BAE Systems were then brought in to build the other two. It is undoubtedly a project which has had problems arising from the fact, which I think Swan Hunter themselves would acknowledge, that the design that they intended to apply for these ships was less mature than had been assumed. The increases in cost are partly of course reflected in this Report, but there are broadly three elements. In December 2004 there was a renegotiation of the contract which allowed for up to £84.5 million more for Swan Hunter than had previously been—

Q33 Mr Jones: What was the figure again?
Mr Jeffrey: It is £84.5 million. There was also, and this features also in the Report as something notified in a previous year, £63.8 million to BAES arising from the fact that there was slippage in the Swan Hunter part of the operation. To these two elements, there should be added £62 million in addition to enable Swan Hunter to pass design information to BAES, so it is classically one of these projects where the costs have escalated.

Q34 Mr Jones: I am just quickly trying to do my figures. What is the actual total figure?
Mr Jeffrey: The total value of the contract now for Swan Hunter is £309 million and for BAE Systems £176 million[8]. That is the history, but I also have to say, as the Committee may know, that there are discussions going on now about what would be required to completely deliver this project. I really would prefer not to say any more about that because one gets into commercially sensitive territory.

Q35 Mr Jones: So in terms of Swan Hunter's two vessels, looking at a parliamentary answer, they were contracted for £148 million, so they are now costing to date £309 million, but are you saying there are potentially further costs on top of that?
Mr Jeffrey: Potentially.

Q36 Mr Jones: Do they relate to the actual ongoing works or is it work that has to be put right once they actually come back in for refit for the future?
Mr Jeffrey: If you will forgive me, Mr Jones, I think that is where I start to become anxious about the commercial confidentiality of the discussions that are going on now. This is a project with a chequered and difficult history, but it is also the case that what we are doing now is having discussions with both companies about whether there is a way forward that would enable these four ships, which are potentially of considerable value to the Navy and which are quite close to being completed, to be

[8] *Note by witness:* The original contract value for the build of the two Swan Hunter vessels was £148 million. Following the order of a further two ships from BAe Systems, an additional £62 million was added into Swan Hunter's contract for Lead Yard Services and Equipment, enabling Swan Hunter to pass relevant design information and equipment to BAe Systems. Following Swan Hunter's confirmation of its underestimation of the engineering requirement, MoD increased the original contract by up to £84.5 million in December 2004. This, together with the purchase of spares at £11 million and minor variations to the contract, represents the total value of the contract for Swan Hunter of £309 million. The current contract value for the build of the BAe Systems vessels is £176 million, which includes £48.5 million for known claims as a result of the impact upon their programme of the Swan Hunter delays and an additional sum for variations to contract and quantity growth. The £63.8 million provision in the accounts includes a further £15.3 million for potential future claims. The original contract value was £122 million.

delivered in a fashion which represents the best value for money to the taxpayer that can be achieved at this stage.

Q37 Mr Jones: This is not value for money at all, is it? The fact of the matter is that the two Swan ships have still not been delivered. I think *Mounts Bay* has already been delivered to the Navy and you are now saying that potentially, and I accept that it is history, the figures you have given, which amount to nearly £½ billion, it could actually be more than this for four ships?
Mr Jeffrey: It could.

Q38 Mr Jones: Can I ask then why it is that the MoD picked up the liabilities for this and did not actually say to Swan Hunter, who are the lead yard, so there is a contractual obligation for them to provide the things to BAE Systems, but why did they not pick up the tab for this because we have seen here an open-ended cheque book, have we not?
Mr Jeffrey: Well, I think that goes back, does it not, to the nature of the original contract and the reality of the situation as the Department was presented with it by the company over a year ago?

Q39 Mr Jones: But did the original contract more or less give Swan Hunter an open-ended cheque book? I know these ships, I have been on one of them, and I know the ships quite well, and they are not sophisticated vessels, are they, in naval warship terms?
Mr Jeffrey: Well, you have got the advantage over me there because I have not been on one of them, so I do not know quite how sophisticated they are.

Q40 Mr Jones: But why was it not capped? Was that the original contract, that, if cost overruns came in, we just basically keep bailing them out with taxpayers' money, which is what we seem to have continued to do?
Mr Woolley: I think we reached a stage where we had to make a judgment between starting all over again and continuing and paying more and we had to judge what in those circumstances was likely to prove best value for money, and the judgment was to continue.

Q41 Mr Jones: I do not want you to give me the figure, but have you actually made any projection in terms of what the actual ultimate cost is going to be? Is there going to be a time when you just say, "I'm sorry" even at this late stage?
Mr Woolley: Well, at any stage we have to reach a judgment as to what the options are that are open to us when a company comes to us and says that it is unable to complete within the previously agreed price.
Chairman: We will now move on to Defence Logistics and PSA Target 7, David Borrow.
Mr Borrow: Chairman, I think most of the points I was going to raise have already been dealt with in questions.
Chairman: John Smith, question 9.

Q42 John Smith: I will go on to question 9, although I think some of it has been covered and so it may warrant some fairly quick responses. At page 95 of the report it states that over £400 million, nearly half a billion pounds, worth of savings have been achieved in operating costs during one year, which needs to be validated, according to the report. The first question is, has that figure been validated in terms of one year's savings of £400 million; how were these savings achieved and how is the money saved going to be utilised?
Mr Woolley: I believe that they have been validated now.
Mr Jeffrey: In relation to how they have been achieved, I can certainly give some examples of the kinds of projects that have led to the savings. The Tornado Future Support Programme has been simplified and that is yielding over £50 million a year of savings. There has also been work on the Defence Information Infrastructure, which in 2004–05 delivered savings of about £30 million through a mix of more efficient management and improved IT systems. The Harrier Jump Programme—again this is a better way of approaching the support of Harriers—was established in 2004 and is on course to deliver cash savings of some £44 million over the next four years. These are all examples but my sense, certainly from my discussions with the DLO, is that there are many others where they are just looking at better ways of doing the work.

Q43 John Smith: These figures have been validated, the £44m saving on the Harrier Jump Programme, for example, or are they future savings?
Mr Jeffrey: In the Harrier case it is the projected saving over four years, but I think the specific question of how validated are these figures—and in particular the £400 million on page 95 of the report—we probably ought to offer a note on that and address the question of validation across the board.
Chairman: If you could do that, please[9].

Q44 John Smith: Where is this saving being utilised now? Is it going back into the Treasury?
Mr Woolley: All efficiency savings are conceptually recycled within the defence budget. We do not hand anything over to the Treasury; we have a spending review settlement that covers three years, so the more efficient we are in terms of saving money the more resource we have for other purposes. Of course, when we do our planning we plan on the basis that we will indeed achieve these efficiency savings. So it is not as if we are suddenly presented with windfall savings of resources that we can scratch our heads and say, "What are we going to do with this?" They will have been factored into our planning process from the start and therefore they contribute towards all the areas in which we are looking to increase defence capability and other improvements to defence. In some cases the savings

[9] *Note:* See Ev 24

will be needed in the DLO itself to cope with additional requirements placed on the DLO. For example, we are currently in a phase whereby we are introducing into service Typhoon, as you know, and when the Apache Attack Helicopter and new, sophisticated equipment of that sort are introduced into service they often generate a spike in logistics for costs that have to be covered. So it is not necessarily the case that the resources that we are giving to the DLO are reducing in anything like the proportion that the efficiencies being achieved in the DLO might suggest because, as I say, there is not cost growth in the DLO but new requirements that the DLO has to meet and some of the savings have to cover those increases.

Q45 John Smith: But £400 million has been saved in operating costs?
Mr Woolley: Indeed. Some of it may represent output efficiencies, that is to say where there is not actually a cash benefit but where the assessment is that what is being produced for that money is greater.

Q46 John Smith: A naïve question. £400 million in one year is a huge figure. Why was this not done before? Why was there not the scope to make such savings in previous years?
Mr Woolley: I think we have always sought to be as efficient as we can. I think that the PSA Target system and indeed following on from the spending review 2002 PSA Target, the Gershon Efficiency Target has perhaps acted as something of a catalyst. I think the creation of the DLO itself, when the DLO was created as a joint service organisation, committed itself to making over a period of five or six years a 20% reduction in output costs. So it has set itself that target, and I think when you set yourself these demanding targets as an organisation you are more likely to deliver them than if you had not had that same target setting frame of mind before.
John Smith: Half a billion is an enormous figure delivered as a saving within an organisation, according to the accounts, in one year. It does beg the question, what capacity was there, or is there, within the organisation to be able to save the Logistics 10% of its budget in one year.

Q47 Chairman: In the report it says that it is the intention to co-locate the DLO Board with the DPA Executive Board at the earliest opportunity. Is that a precursor to merging the Defence Procurement Agency and the Defence Logistics Organisation?
Mr Jeffrey: It is not; it is what seems a sensible management step to bring the two organisations even closer together than they already are.

Q48 Chairman: But do you not think that that will come?
Mr Jeffrey: That is one of the issues, as I mentioned earlier, we need to address. I am struck, again as an early impression, by the fact that the two organisations do work closely together; the Chief of Defence Procurement and the Chief of Defence Logistics are in constant very close contact, as are their senior teams. There are a number of major projects, where we increasingly think in through-life terms, where the project team in effect accounts to both organisations. So there is a question about how far along the path towards integration one goes, if not actual merger. That issue about what the most appropriate and effective structure for the future, post the defence industrial strategy, would be is the one that we are looking at over the next few months.

Q49 Chairman: One is an agency and one is not an agency.
Mr Jeffrey: That is true.

Q50 Chairman: How has the treatment of agencies in the Ministry of Defence changed since they were first introduced?
Mr Jeffrey: Certainly as a general observation, because we are now some years away from Next Steps and the initial creation of a large number of agencies, the distinction between organisations that happen to be Next Step Agencies and freestanding operations like the DLO is probably less pronounced than it was in the past. What we have certainly been doing in the Department, as I am now beginning to understand it, Defence Agencies have always tended to be internal agencies providing services inside the organisation more than traditional service providing organisations looking outwards. There has undoubtedly been a measure of rationalisation over the period in a number of agencies and the kind of tasks that they do. That, I think, is a continuing process and it has undoubtedly been a very complicated picture. I do not know if that answers the thrust of your question, Chairman?

Q51 Chairman: Does the MoD keep these agencies at arm's length or are they internal? You suggested that they were most internal, I think.
Mr Jeffrey: Most of them—but by no means all of them—are providing services inside the Ministry, and in that sense they differ from an agency like the Prisons Agency, for example, which provides a service for the community as a whole.

Q52 Chairman: So if you have an agency who appoints the Chief Executive?
Mr Jeffrey: They vary and it depends on the significance of the agency. I am not suggesting that the basics of agency status have somehow been changed; essentially each of these agencies will have a framework agreement and a figure within the Ministry to whom they answer and all the business that surrounds Next Step Agencies.
Mr Woolley: I think what has happened is that the pendulum has slightly swung back from a very decentralised model for managing the Ministry of Defence, which was introduced with our new management strategy in the early to mid-90s, and which was very successful in changing the culture in many ways in terms of devolving financial responsibility, making people away from the Ministry of Defence Head Office aware of the concept of targets and aware of the concept of

financial management and so on. But I think that in recent years we have begun to look at whether the overheads that go with a very decentralised structure of having lots of budgetary layers, for example—which although it has management benefits it also creates a certain amount of overhead—whether those are justified in all cases; and I think that approach has also been extended to our agencies where, for example, some of the very small agencies just no longer seem to be of a sufficient size to justify agency status with some of the requirements that go with agency status, such as the requirement to produce agency accounts, and so on. So there has been some rationalisation of agencies in recent years reflecting that more general reassessment of whether the decentralising tendency in the Department went perhaps a little too far in the 1990s.

Q53 Chairman: Do you expect that to happen further?
Mr Jeffrey: I certainly would not be surprised if the number of agencies, which has been falling in recent years, continues to fall, but each case needs to be looked at properly on its own merits.
Chairman: One of the agencies is the Dstl, which you have already mentioned, Mr Jeffrey. Robert Key.

Q54 Robert Key: I think that the statement you have just made, both of you really, about the future of the agencies is very significant indeed, and I would like to turn to Annex E of the Annual Report and Accounts, which is defence agency performance. Dstl is a case in point because if we look at Dstl, if we look at the key targets set and met, in Dstl in both 2003–04 and 2004–05 100% were met, and Dstl is a hugely successful organisation undergoing some fairly major structural changes, co-locating a lot of activities at Porton Down. On the other hand, if you look at the Defence Storage and Distribution Agency, you find that in 2003–04 there were 33% of targets met but within one year they had climbed to 100%. Look at the RAF Training Group, you find there that in 2003–04 it was 71% targets met and in 2004–05 down to 33%. Then Service Children's Education, 2003–04 at 31% and 2004–05 up to 52%, and yet we know that that agency is doing very well when compared in terms of delivery for its children with local authority schools. What I am really saying is that given this mixed picture how can you assess whether the performance of Defence Agencies overall is improving?
Mr Jeffrey: I think it is quite hard to assess it. I was struck myself, when I was preparing for this hearing, by the sheer variety of purposes and the extent to which there is a variety in performance. There is one overall measurement which may or may not be significant, but if you look at the total number of key targets that the agencies have, it was 72% in 2003–04, and it was 78% in 2004–05. Assuming that there has not been some weakening in the standards of the targets that are set or the demanding-ness of these targets, that look like progress in the right direction. But I readily accept that there is a wide variety among the agencies. To some extent I guess—and it is still only a guess—that this just reflects the variety of the tasks they have, the operating conditions they face, how demanding the targets were in the first place. If the Committee would like a fuller note on the explanation of the targets I am sure we could provide one[10].

Q55 Robert Key: I would not wish to burden you any further with this line because I think we probably agree it is a strange sort of area that we are in. I would much rather hear from you that you have some plans to review the way in which key targets for Defence Agencies are set because this huge variety says to me that there is something wrong with the machinery here rather than the delivery. Is there a better way of measuring the performance of these Defence Agencies?
Mr Jeffrey: There may be and I am certainly more than prepared to look at that. I think one has to bear in mind, though, that they are doing quite remarkably different things; the biggest of them are massively bigger than the smallest of them and, as Trevor Woolley was saying, we are looking seriously at whether some of the smaller ones warrant all the paraphernalia that goes with agency status. It may be that this is just a natural reflection of the variety of the businesses that we are talking about, but I am more than prepared to have a look at that.
Mr Woolley: I think it is also worth making the point that most of these targets are, as it were, binary—you either meet them or you do not meet them, and so you either get the tick or you do not. But you may only just miss them in one case or you may have an agency that just misses three targets whereas another agency misses one target by quite a lot, and that will not be reflected in this presentation. Nonetheless, the principle that there should be targets that we set agencies is one, I think, that we strongly adhere to.

Q56 John Smith: Mr Chairman, it is not missing or hitting the targets it is the erratic nature of the figures for the year. RAF Training Group, in one year 71% of its targets were met 2003–04; in the following year it is down to 33%. If I ran an organisation which saw variation like that within its departments, albeit the MoD is quite some organisation, that would be more of a cause for concern than a slight deterioration in performance because at least you would be more confident about being able to address that if it were consistent. It is the erratic nature of these results, as Mr Key pointed out, that is worrying.
Mr Jeffrey: I take the sense of that and I hope what I said earlier implied that. I would quite like to look under the surface of this more than I have. I suspect the reason is the one that Trevor Woolley gives, which is that if a target is expressed in terms that you either meet or you do not meet, and one year a few of them switch the wrong side of that line that can have quite a significant impact on the top line percentages. But I would like to look at it more closely than I have done so far.

[10] *Note:* See Ev 24

Linda Gilroy: In looking at it as well, the British Forces Post Office went down from 11 targets to six targets; the Defence Estates went up from 11 to 15 and the Defence Geographic and Imagery Intelligence Agency from eight to 15. What prompts them to have such major changes in the number of targets might be a useful thing to look at.
Chairman: That is progress. Robert Key, moving on now to QinetiQ.

Q57 Robert Key: On 12 January the Secretary of State announced the flotation. I admit that I was one of those who was opposed to the privatisation of DARA, the break-up into Dstl and QinetiQ, but I know that it has been a great success, the workforce are very happy, they are re-motivated, as far as I can see, and there are a lot of benefits that have come from it. Could you tell us what is the likely date for the flotation?
Mr Woolley: The date will be in February; I cannot give you a specific date but it will be in February.

Q58 Robert Key: What will be the size of the Ministry of Defence's stake?
Mr Woolley: Again, I am afraid I cannot disclose that until the prospectus has been published, and it will be published tomorrow.

Q59 Robert Key: That is fair enough, that is good. Could I turn to something that is simply honest seeker after truth here, trying to understand the difference between the special share held by the Ministry of Defence and the "golden share"? What is the difference between these two because it seems to me that they are both saying the same thing? "The special shareholder," I read, "has the right to require the company to implement and maintain a regime which protects the defence and security interests of the nation." That is the same for both the special share and the preferential golden share.
Mr Woolley: On flotation we will simply have a single special share and that will be designed to protect our security by giving us the ability to prevent the purchase of a significant stake in the company by any foreign body that we regarded as incompatible with our security.

Q60 Robert Key: Thank you. Finally, could I ask about QinetiQ's role in the new Defence Industrial Strategy because clearly it is going to have a very important role in that, and when the Secretary of State launched the strategy, after his statement, during the questioning of the Secretary of State, I raised the interesting point that there is a difficulty with intellectual property here, on the one hand looking towards America and on the other hand, through the DIS, looking more towards Europe. QinetiQ is expanding into the United States and they have taken over Westar and Foster-Miller, and that is very good, but if they are also going to be expanding into Europe what about the intellectual property implication of this? Is it not going to be impossible for companies like QinetiQ to, on the one hand, be expanding into Europe and on the other hand have so much intellectual property bound up in North America?
Mr Woolley: Is your concern in terms of the risk of exporting our intellectual property because in that regard clearly QinetiQ, like any other company, is subject to export and security controls?

Q61 Robert Key: I am talking about the government to government relations and our special relations with the United States here and whether they will be at risk if the United States' government feels that we are moving too close to other companies in Europe, with which they are not in such accord as they are with us?
Mr Woolley: It is obviously something that the government is very conscious of. I do not think in this respect QinetiQ is different from any other defence department; I think the same principles apply. Clearly there have been and will continue to be very strong arrangements in place to ensure that any information provided in confidence and for a specific purpose from the American government to the UK government or one of its suppliers is protected if that is what is required.

Q62 Robert Key: Forgive me, Chairman, QinetiQ is different precisely because of the golden share and the fact that the government can actually stop QinetiQ from doing something it might wish to do, and therefore there is a government veto on QinetiQ's activities, is there not?
Mr Woolley: What there is is a compliance regime that is in place and that is designed to ensure that QinetiQ does not get into a situation in which there is a conflict of interests between its role as an adviser to the Ministry of Defence in the procurement process and a potential role as a supplier to the Ministry of Defence. Clearly one of the roles of the former Defence Evaluation and Research Agency, as well as providing research to the Ministry of Defence, was to do analysis, test and evaluation indeed of products of other companies' ideas, and while much of that role is continued in Dstl it is also, to some extent, performed now by QinetiQ. Obviously there is potential for conflict of interest here, and what has been in operation ever since QinetiQ was vested as a private company is a regime which requires QinetiQ to seek Ministry of Defence clearance before it embarks on contracts that might give rise to a conflict of interest, such that the Ministry of Defence can be assured that arrangements are put in place to ensure that no such conflict of interest will arise, and we in the Ministry of Defence regard that as very important and QinetiQ are entirely comfortable that that regime will continue to operate in the future.
Mr Jeffrey: I do not think it is our view that although it puts it in a different position from other companies it inhibits them from doing defence business in the way that we all hope they will do.
Robert Key: Thank you. I wish QinetiQ well and we watch this space.

Q63 John Smith: Mr Chairman, on QinetiQ, just moving on to a related subject. QinetiQ, as I understand it, are currently bidding for some very large defence contracts and there is this change taking place *vis-à-vis* the ownership and the nature of the government stake in the company. How does the Department guarantee transparency when evaluating bids that companies like QinetiQ are involved in to prevent other bidders for work, given that the preparation costs of submitting for large-scale projects are quite large now? How does the MoD insure itself against claims from unsuccessful bidders that they were treated fairly and on a level playing field, given these links with some of the companies involved in the bids? Do you follow that? Transparency in evaluation of bid proposals without giving away commercial confidentiality, to prevent future legal action.
Mr Woolley: Are you asking in the sense that because QinetiQ is partly owned by the Ministry of Defence the Ministry of Defence might be biased?

Q64 John Smith: How do you ensure that that claim cannot be made? What processes and procedures exist within the evaluation of bids to ensure that those sorts of claims have no substance?
Mr Woolley: First of all, within the Department we have a clear understanding that in relation to QinetiQ there is a separate shareholder interest from a customer interest. I represent the shareholder interest; I am not myself engaged in the process of the awarding of contracts, which is what the customers, such as the Research Acquisition Organisation, the Defence Procurement Agency and other customers within the Department, that is their role, and they are quite clear that they must assess competitive bids purely on the basis of bids that are put forward by the companies and not take into account what the impact of awarding or not awarding the contract might be for the shareholder interest in QinetiQ. So my shareholder team is not involved in any way in discussions about the award of contracts to QinetiQ or not QinetiQ, so to the outcome of competitions in which QinetiQ might be involved. Their duty is to award the contracts on the basis of a best value for money bid and the customers have their budgets, and naturally as customers they will want the best value for money as it affects their budget, even though there might be a different impact indirectly in terms of the shareholding value that the Ministry of Defence has.

Q65 John Smith: But do you recognise that there is an increasing risk as you enter into more and larger longer-term PFIs or partnering agreements that companies may use the courts to challenge awards that have been made, or is that not something you are worried about?
Mr Woolley: We are always concerned about any legal challenge to the basis for which a contract was placed and we have very clear rules; we have very clear evaluation processes that are well-documented; we have a very clear approvals process; and, as far as possible, only a very small number of people evaluating bids actually know which bid is from which company or which consortium so we will give, if you like, code names to the various consortia so that those doing the evaluation are judging between the code names without knowing which is which where it is particularly sensitive. So I think we have robust arrangements in place.

Q66 Chairman: Mr Woolley, a quick question about QinetiQ. You are the shareholder, will you get the proceeds of sale or will the Treasury snaffle them?
Mr Woolley: I personally, sadly, will not get the proceeds! The proceeds will be split between the Ministry of Defence and the Treasury in a proportion that we cannot yet finalise until we know what the size of the proceeds are.

Q67 Robert Key: Chairman, how could that possibly work? How can you not decide in advance what the proportions will be? I find that an extraordinary proposition.
Mr Woolley: As I say, until the flotation takes place we will not know precisely how much the proceeds will be.

Q68 Chairman: You will not know how much the proceeds will be but are you being then promised a set figure by the Treasury as opposed to a proportion of the proceeds?
Mr Woolley: We have been given an indication by the Treasury of the sort of figure that we might be allowed to retain, but it has not been finalised.

Q69 Robert Key: Chairman, may I pursue that for a moment, please? In the Annual Report and Accounts on page 166 it gives some figures here about the amount of money which has been apportioned from QinetiQ in various ways, and it says: "Loans repaid by QinetiQ and subsidiary undertakings, representing the partial original asset value of the business since its formation amounted to £104 million. The cash received on the part disposal of the shares," etc. Where did that money go? How was that apportioned?
Mr Woolley: That has all gone to the Ministry of Defence. Since 2002 the Ministry of Defence has received, I believe, £250 million in various ways from the QinetiQ process.

Q70 Robert Key: Did any of it go to the Treasury?
Mr Woolley: None of that went to the Treasury.

Q71 Robert Key: Can we therefore suppose that 100% will come to the Ministry of Defence once again?[11]

Mr Woolley: We have not concluded an agreement with the Treasury on this.

[11] *Note:* See Ev 31

Q72 Robert Key: How can we help!
Mr Jeffrey: I think you are doing so, actually!

Q73 Chairman: A question about some of the other shareholdings that the Ministry of Defence has. International Military Services Limited, the value of the investment has been written down to nil. When was that written down to nil, do you remember?
Mr Jeffrey: This is a long and complicated story. International Military Services Limited goes back to the early 1960s. It was originally set up as a private limited company by the Crown Agents; it was then transferred to the MoD in 1979. Its purpose was to allow the Department to sell equipment and munitions overseas, but it ceased trading in 1991 following a change of government policy on involvement in overseas military sales. So we would have wound it up years ago but there is an outstanding appeal, a legal claim in respect of the equipment due to be supplied to Iran prior to 1979, which is still before the Arbitration Tribunal in the Hague, and we are not yet in a position finally to wind up this company.

Q74 Chairman: I have one other question about golden shares. My expectation was that it might be the Ministry of Defence that owned the golden share in Rolls-Royce, but is that actually the DTI because I cannot find Rolls Royce and the other investments on page 167.
Mr Jeffrey: I have a feeling that it is the DTI but I think we ought to check and confirm.
Chairman: If you could, please[12]. Brian Jenkins.

Q75 Mr Jenkins: Thank you, Chairman. Good morning, Mr Jeffrey. It has been a long time sitting here before I get the chance to have a question. The reason I am going to take you to the book is because many of the questions have been asked this late on, but there are one or two items I want to flesh out a little bit. On page in the Service Agreement we say that in the RAF that 3.9%, that is 2000 people in the RAF go over their time, and further on I find the type of personnel that go over their time; but it does not mention aircrew, it does not mention pilots and it does not mention maintenance staff, especially fast jet maintenance staff. If you do not have the details to date could you give me a full list of the personnel that do go over or breach the Harmony Guidelines because the term “pinch point” occurs on that type of staff?
Mr Jeffrey: I do not think I have a detailed answer to the question about the RAF. As we were saying earlier in the session, both the RAF and the Army, for reasons that are much as anything to do with existing commitments—

Q76 Mr Jenkins: Let me know the answer, please.
Mr Jeffrey: We will give you that[13].

Q77 Mr Jenkins: On page 14 on the “Not met” on “Objective: Build for the future” we notice that the slippage is getting better now on our new projects. But the first question I ask is, are we actually better at targeting and developing with the producer the time needed to produce the product or are we better now at lengthening the time to take the slippage into consideration?
Mr Jeffrey: The key to this and to avoiding slippage is clearly to have a good realistic plan in the first place and the most significant stage, in my view, in these big procurements is the earlier stage where one does what one can to reduce this.

Q78 Mr Jenkins: We are perfectly *au fait* with the gateway system and the reasons for it. If we are now saying that we are better at targeting and we not just lengthening the time taken, I will accept that we are not going to see slippage in the future or the slippage will be reduced. One of the things I am surprised Mr Jones let go was the projects where we are now £5 billion estimated overrun on the actual target. What effect is this going to have for you on your future ability to manage your programme?
Mr Jeffrey: It has a very significant effect; it is something that we clearly need to take into account.

Q79 Mr Jenkins: Could you do so, please, and could you give me a note on what you see as the effects being on your procurement programme, therefore the slippage and time for each part of it in the next few years.
Mr Jeffrey: We can certainly try to produce that[14].

Q80 Mr Jenkins: Just keep us of informed of the way you are thinking now and what we can have expectations for in the future, and if we have it in black and white I would be very grateful. If I move on to the value for money, we are going to reduce the costs for military training for recruits by 6% and I have seen now that we have scrapped the target entirely. What target is now in place?
Mr Jeffrey: It is not that we have scrapped it; it is that there have been some changes which mean that it can no longer be satisfactorily measured, and we assessed that it would not have been achieved. Do we have another target?
Mr Woolley: No, no replacement target.

Q81 Mr Jenkins: So we had a target and you could not meet that target and so you have not adjusted the target, you have scrapped it.
Mr Woolley: As Mr Jeffrey says, the fact is that it is no longer really possible to measure performance against that target in the way that that was originally envisaged, because the target was very much related to measuring training on a single service basis and because of the creation of more joint service establishments it is not really possible to make the measure on a single service basis any more.

Q82 Mr Jenkins: So you are telling me that no one now can work out that if I have three streams of individual recruits and I put them into a mixed

[12] *Note:* See Ev 25
[13] *Note:* See Ev 25
[14] *Note:* See Ev 26

facility and then I bring them back out at the end of the mixed facility, I cannot cost that process? Are you telling me you cannot do it, or it cannot be done?

Mr Woolley: What we are saying is that it is no longer possible to attribute the costs of joint establishments to single service throughput, and as the measure was on a single service basis you cannot effectively measure the cost on a single service basis.

Q83 Mr Jenkins: So where do you attribute the cost of this multi-service unit to, then?

Mr Woolley: Where do we attribute?

Q84 Mr Jenkins: If you have a multi-service unit where do you attribute the costs? To training?

Mr Woolley: Indeed.

Q85 Mr Jenkins: So part of this also is training and if you divide the amount of the cost of training by the number going through you get a cost per head, do you not?

Mr Woolley: You could get a cost per head of all Armed Service personnel. What we cannot do is have a cost per head for a soldier or a sailor or an airman, which is the way the target was originally expressed.

Q86 Mr Jenkins: It says here, "Reduce the per capita cost of successfully training a military recruit by an average of 6%" and that was your target. It does not say an RAF or an Army or a Royal Marine recruit, does it?

Mr Woolley: But the measure is on a single service basis; the individual measures underline this target.

Q87 Mr Jenkins: But the point is now you have no target at all rather than a military recruit target, do you?

Mr Woolley: Correct.

Q88 Mr Jenkins: Do you find that alarming or are you quite happy to have no target to work to?

Mr Woolley: There are clearly potentially almost an infinite range of targets that we could work towards, and as far as what goes into the PSA we have agreed with the Treasury that this particular target should no longer feature as a PSA target because of the nature and the change of the policy.

Q89 Mr Jenkins: I am going to get no further on that one, obviously I will have to talk to a Minister about why they are quite happy to have no targets for public expenditure on this sort of activity. If I move on to the next one, we are going to reduce our expenditure and the cost of the DLO by April 2006 by 14%, but I do not have a breakdown here. Are we reducing the stockholding, reducing the service times or are we reducing or increasing the efficiency saving in the running of the establishment? What is the main ingredient in the reduction in costs in this area?

Mr Jeffrey: It is principally the performance and efficiency that we were discussing earlier in this hearing, which enable costs to be reduced.

Q90 Mr Jenkins: So we are increasing the efficiency in the running of it? It is just not stock?

Mr Jeffrey: I do not believe so.

Mr Woolley: In some cases reducing stock might be part of the efficiency saving.

Q91 Mr Jenkins: Yes, I know, and last time we asked you, you had a very good trick, when you wrote down the amount of stock I think some stuff went down from about £20 when we bought it in to a value of pennies, and you said, "Look we have reduced our stock." That is why I am always a bit wary about looking at savings in value of stock. Or should we classify stock separately to the actual manning costs and the look at the increased efficiency of the manning costs?

Mr Woolley: What we would score, as it were, to the saving is not the value of the stock as such but the cost of capital on the value of the stock, and that is what would contribute towards a saving in budgetary terms.

Q92 Mr Jenkins: The next item is MoD main buildings. When we modernised it we got a 12% reduction in Head Office and other management costs. Are all these staff functions that were originally in the Head Office still carried out in the main building? The reason I ask you is because we did a PFI on one office and because it was too small we had to move some of the staff out to peripheral offices and then we said that the cost of running the main office had fallen.

Mr Jeffrey: Broadly speaking, my understanding is that we have much the same staff in the main building as we had before. Certainly my experience in other fields is that when you modernise buildings like this there are significant savings to be had simply because you use the space more effectively than you might have done in an older building.

Q93 Mr Jenkins: So all the functions are still carried out in there? Yes? Thank you. If we turn to page 95 in the report, a simple question: at the bottom of that page on logistics we see that we have £21.6 million cash receipts achieved from the sale of surplus equipment. Did we buy any surplus equipment back this year?

Mr Woolley: Did we buy any surplus equipment back this year?

Q94 Mr Jenkins: Yes.

Mr Woolley: Not that I am aware of.

Q95 Mr Jenkins: Can you check please[15]? We certainly did not in the previous years. On page 97, paragraph 210, as we look down to the "Lean" engineering and support facilities for the Tornado we see that in partnership with Rolls-Royce we have produced cost savings of £88 million over four years. This is the year 2004–05 accounts, so the previous four years. When did they start at Marham "Lean" engineering, please, what year?

[15] *Note:* See Ev 94

Mr Jeffrey: I think this is the Tornado future support improvement and efficiency that I mentioned earlier.

Q96 Mr Jenkins: It says, "Produced cost savings of £88 million over four years". So this is an expected result and not an actually achieved result?
Mr Jeffrey: This is a programme on which work began some years ago, in May 2000, to simplify the way in which Tornado support arrangements work. It is partly already producing savings of this sort and partly still to do so.

Q97 Mr Jenkins: I do not understand. The figure here says it has produced cost savings of £88 million and I take that to be a fact. I do not understand it £88 million actually saved but a projection of £88 million. Which is to be, is it £88 million saved or is it £88 million projected savings?
Mr Jeffrey: These are four years in the past since this was produced.

Q98 Mr Jenkins: So I take it has saved £88 million. Could you check on that and let us know?
Mr Jeffrey: Yes, we will.

Q99 Mr Jenkins: I will go to a much more complicated part, unfortunately. Page 139, cost of operations. The figures on your schedule, once again—it always confuses me when figures do not add up—do not add up, and they are qualified in the next page over. Is it my understanding here that we have a baseline of expenditure and we have an operational cost? And whilst we are on operational costs the Treasury pick up all the extra funding that comes in over and above our baseline. On operations, if we crash a vehicle it is replaced, but if we wear it out it is not and that has to come out of the baseline cost. An example would be, if I had a gun the ammunition was paid for out of the contingency fund to fight the war, but if I wore the gun out and I brought it back they would not replace it; the replacement and refurbishment would have to come out of my base budget, is that right?
Mr Woolley: To the extent that we are able to capture the net additional costs incurred by going on operations then we can and do claim that back from the Treasury. So in the example you quote, if we could demonstrate that a gun that had been used on operations had needed to be replaced sooner or it wore out faster as a result of that operation than it would otherwise have done, then indeed we score that to the cost of the operation.
Mr Jenkins: Page 194, please. The third item down there is a loss of £65 million being incurred following the impairment of an operational building.

Q100 Chairman: That is notified in prior years, so presumably it has appeared in these accounts before?
Mr Jeffrey: Yes, it has.

Q101 Mr Jenkins: £65 million. We lost a building or it has been impaired in some way or fashion. Can you tell us why, or if you cannot tell us now can you give us a note on it?
Mr Woolley: This is a building at the Atomic Warfare Establishment that was unable to meet the requirement after it was built for which it was designed. No other use for the building could be identified and therefore it had to be written-off.

Q102 Mr Jenkins: Could you give us a note on that as well? The one that Mr Jones has asked—and I am racing through it as fast as I can—the one with regard to Swan Hunter. Could you send us a note on that, please, giving us the background in the future for that Swan Hunter project and the costs?
Mr Jeffrey: Yes[17].
Chairman: I think that will bring us to an end of this marathon session. I am most grateful to you, particularly—not meaning any disrespect to you, Mr Woolley—to you, Mr Jeffrey, for facing us so soon after you came into the Ministry of Defence and for handling so well some really quite detailed questions. There will be, almost certainly, other things about which we would like to write to you to ask for answers which, in the interests of it not getting too late this morning, we will not pursue now. We are most grateful to you for coming in front of us today. Thank you very much.

[16] *Note:* See Ev 28

Written evidence

Memorandum from the Ministry of Defence

RESPONSE TO DEFENCE COMMITTEE QUESTIONS ON THE MINISTRY OF DEFENCE ANNUAL REPORT AND ACCOUNTS 2004–05 AND AUTUMN PERFORMANCE REPORT 2005–06

Validation of Performance Data and Data Systems

(i) *Pages 12–15 of the Performance Report summarise performance against SR2002 Public Sector Agreement Objectives and Targets. Has work been undertaken to assess the quality of the data systems used to support the measurement of performance against the PSA targets? If so, what were the main findings from this work and how are they being taken forward?*

(ii) *Is any independent assessment undertaken of the performance against PSA targets reported in the Performance Report? If not, are there any plans to do so ie a body such as the NAO validating the reported performance?*

As set out in Annex D of the Annual Report and Accounts, our performance management and measurement approach has been subject to thorough review, in 2002 by the Department's internal auditors, and in 2003–04 by the NAO, which conducted an external review of our SR2002 PSA reporting arrangements. Both reviews provided favourable assurance. The NAO is currently conducting an external review of the data systems that underpin our SR2004 PSA targets. At a more detailed level there has been considerable external work looking at the systems and performance of a number of specific PSA targets. In particular:

- our Conflict Prevention Assessments (PSA Target 2) draw on a wide range of international statistics and reporting. In October 2005 the NAO published a report on Joint Targets, including the Joint Target for Conflict Prevention shared by the MoD, FCO and DfID;
- during 2004–05 the NAO conducted a further review specifically into our arrangements for assessing and reporting military readiness (PSA Target 3), which concluded that we had a good, and continuously improving, system for reporting readiness levels which compares well with that of other countries, such as the United States and Australia, and has been proven over time. We have since made a number of further improvements that were recommended by the NAO in the way we report readiness against our SR2004 target;
- the personnel statistics used to measure performance against out manning balance targets (SR2002 PSA Target 4, SR2004 PSA Target 5) are produced quarterly by the Defence Analytical Services Agency to the standard required for National Statistics;
- the NAO's annual Major Projects Report sets out forecast performance, costs and timings for the MoD's 20 largest equipment programmes (PSA Target 6). The most recent report, MPR 2005, published in November 2005, shows forecast cost savings of £699 million for the MoD's top 20 major equipment programmes; and
- the financial data underpinning assessment of our value for money (SR2002 PSA Target 7) and efficiency (SR2004 Efficiency Target) targets ultimately derives from the Departmental Resource Accounts, on which the NAO has given an unqualified opinion for the last two years.

Conflict Prevention

(iii) *PSA Target 2 (page 12), covers conflict prevention and is a joint target with DFID and FCO. For the second year running, the Target is reported as "not yet assessed" as "data on performance against the target is not yet available". What data is required to measure performance against this PSA Target and when is it expected to be available?*

The way Conflict Prevention performance is measured is set out in the relevant SR2002 and SR2004 Technical Notes (see Ev . . ., and published on the MoD, FCO, DfID and Treasury Websites). The Annual Report and Accounts reported against the SR2002 target. Data produced by the Stockholm International Peace Research Institute (SIPRI), International Institute for Strategic Studies (IISS), United Nations High Commissioner for Refugees (UNHCR), US Committee for Refugees (USCR) and Norwegian Refugee Council (NRC) Global Internally Displaced People project is used to measure performance against the four sub-targets for both the two Conflict Prevention Pools. These are:

- Global Conflict Prevention Pool (comprising Afghanistan, Nepal, Macedonia, Georgia, Israel/Occupied Territories and Sri Lanka):
  - 10% reduction in fatalities from a SIPRI baseline of 7,800 in 2000 to 7,000 by 2006;
  - 10% reduction in fatalities from an IISS baseline of 19,000 in 2000 to 17,000 by 2006;
  - 10% reduction in refugees from a UNHCR baseline of 3,800,000 in 2000 to 3,400,000 by 2006;
  - 10% reduction in internally displaced persons (IDPs) from a USCR baseline of 1,500,000 in 2000 to 1,350,000 (as measured by the NRC) by 2006.
- Africa Conflict Prevention Pool (comprising Sierra Leone, DRC, Uganda, Rwanda, Burundi, Sudan, Angola and Nigeria):
  - 20% reduction in fatalities from a SIPRI baseline of 6,500 in 2000 to 5,200 by 2006;
  - 20% reduction in fatalities from an IISS baseline of 48,000 in 2000 to 38,000 by 2006;
  - 20% reduction in refugees from a UNHCR baseline of 2,400,000 in 2000 to 1,900,000 by 2006;
  - 20% reduction in internally displaced people from a USCR baseline of 10,300,000 in 2000 to 8,200,000 (as measured by the NRC) by 2006;

A time lag of one year before statistical data is available meant that data for 2004 only became available in November 2005. The Annual Report and Accounts, which was published in October 2005, therefore only included narrative reporting. The data for 2004 is set out in the table below. This indicates that the Global Conflict Prevention Pool is on course to meet all four of its sub-targets, and that the Africa Conflict Prevention Pool has slight slippage on two targets and major slippage on the other two. Data for 2005 will be available in November 2006, and a final assessment of performance against the SR2002 PSA target will be produced in late 2007 once 2006 data becomes available. Interim data will be published on the FCO website when it becomes available.

	Deaths (SIPRI)	*Deaths (IISS)*	*Refugee Population (UNHCR)*	*IDPs (USCR/NRC)*
		GLOBAL POOL		
Baseline Figure 2000	7,800	19,000	3,800,000	1,500,000
Target for 2006	7,000	17,280	3,349,973	1,350,000
Afghanistan	1,741	1,550	2,084,925	200,000
Nepal	2,604	2,400	1,416	200,000
Macedonia	–	–	5,106	1,299
Georgia	27	50	6,633	240,000
Israel and Occupied Territories	485	870	351,281	350,000
Sri Lanka	19	100	144,055	347,475
Rounded Totals Sep 2004 (latest available data)	4,800	4,900	2,500,000	1,300,000
% Difference between 2006 target and 2004 actual (minus figure indicates performance within target)	−31%	−71%	−26%	−4%

		AFRICA POOL		
Baseline Figure 2000	6,500	48,000	2,400,000	10,300,000
Target for 2006	5,200	38,000	1,900,000	8,200,000
Sierra Leone	–	–	41,801	–
DRC	–	4,000	462,203	2,170,000
Rwanda	26	–	63,808	–
Uganda	1,600	1,000	31,963	2,030,802
Burundi	415	1,000	485,764	117,000
Sudan	3,247	50,200	730,612	6,000,000
Angola	25	50	228,838	91,240
Nigeria	52	1,350	23,888	200,000
Rounded Totals Sep 2004 (latest available data)	5,300	57,600	2,000,000	10,600,000
% Difference between 2006 target and 2004 actual (minus figure indicates performance within target)	+2%	+52%	+5%	+29%

(iv) *On PSA Target 2, what systems and procedures have been put in place to ensure that the three Government Departments collect the required data and measure performance against the PSA Target in a consistent way?*

The PSA reports are written by the lead Department representative within the Pools and agreed by all Departmental representatives. Therefore, only one performance assessment is produced for each Pool across the three Departments. These are then combined to create a joint Conflict Prevention assessment. Reports are compared with those of previous quarters to ensure that they are consistent. The final assessment is endorsed by senior officials in each Department and considered by Departmental Management Boards before Departmental PSA performance is reported to the Treasury. The MoD's quarterly reports to the Treasury are also published on the MoD website. As noted above, the NAO recently conducted a study into Joint Targets, including that for Conflict Prevention.

SR2002 Value for Money Target

(v) *PSA Target 7 (pages 14–15) covers value for money. The target will not be finally assessed until the end of 2005–06, but the target is assessed as "on course" in the Performance Report. Is the target still considered to be on course some three-quarters of the way through 2005–06?*

As stated in the MoD's Autumn Performance Report (page 18), which is our most recent assessment, this target is still judged as being "on course".

(vi) *Please can you explain what the "organisation changes" were which mean that it is now no longer possible to measure the sub-target of reducing the per capita cost of successfully training a military recruit. Does MoD still see the cost of training military recruits as an area for generating efficiency savings?*

Before 2004, multi-disciplinary specialist training was delivered across 24 different sites with the site controlling training output standards. After the recommendations made in the Defence Training Review (DTR) Report published in 2001, "virtual" Defence Training Establishments were created which realigned the management of training delivery by specialism, not site. Six specialisms were initially chosen and "virtual" Defence Colleges created under a lead Agency for each:

- Defence College of Electro-Mechanical Engineering—Lead Naval Recruiting and Training Agency.
- Defence College of Aeronautical Engineering—Lead RAF Training Group Defence Agency (TGDA).
- Defence College of Communications and Information Systems—Lead Army Training and Recruiting Agency (ATRA).
- Defence College of Logistics—Lead ATRA.
- Defence College of Police and Personnel Administration—Lead TGDA.
- Defence College of Security, Languages, Intelligence and Photography—Lead Defence Intelligence and Security Centre.

The original Training efficiency measure derived a *per capita* cost of training for each Service by relating the overall cost of training to the throughput of trainees. With the rationalisation of training outlined alone, it is no longer possible to identify an overall cost of training by Service nor hence of a *per capita* cost by Service.

Although the creation of these virtual Establishments has not involved the physical relocation of any existing training, it was an important early signal of the Department's commitment to rationalising the number of sites that training would be delivered on in the future. It also defined the transitional federated arrangement under which the existing, geographically dispersed training organisations would operate pending implementation of any final partnered solution(s) that deliver further efficiencies. The virtual establishments have taken forward planning of the changes to structures, budgets, contracts and site development across a number of sites to ensure that once decisions on further rationalisation are taken, they can be implemented on the ground promptly and effectively. We are consequently now well placed to implement quickly any of the partnering arrangements currently under consideration in the Defence Training Rationalistion Programme should they prove to offer better value for money. Under this programme we aim to modernise the delivery of specialist training using best practice learning techniques through newly created national centres of excellence for each specialism and to rationalise and improve the quality of the remaining training estate. Other expected benefits include the transfer of risk for training demand and the increase of first time pass rates achieved by students. We expect the rationalistion process to be completed by 2012, and for the overall programme to produce benefits in the order of £3 billion over a 25 year period. We are currently evaluating several bids and therefore cannot provide detailed figures.

Although this Programme is the main way that training efficiency benefits are now being pursued, all three Services continue to look at ways to improve the management of recruits and to reduce the numbers of recruits choosing to leave, sharing ideas and good practice. If successful, such measures will increase the efficiency of the initial training system. But in the light of the changes made to implement the HCDC, Director of Operational Capability and Adult Learning Institute recommendations into initial training, we are not looking for efficiency savings through changes to supervisory training ratios at training establishments.

SR2004 Efficiency Target

(vii) *Annex A (page 200) to the Annual Report and Accounts sets out the 2004 Spending Review Targets. The Efficiency Target for 2005–06 to 2007–08 is for MoD to realise total annual efficiency gains of at least £2.8 billion by 2007–08, of which three-quarters will be cash releasing. What efficiency gains are expected to be realised in 2005–06, and in what areas will they be utilised?*

A more detailed breakdown of the department's efficiency targets are set out in the attached MoD Efficiency Technical Note, published on the MoD website on 5 December. We plan to deliver over £1.2 billion of efficiencies by the end of the current financial year. The Department's Autumn Peformance Report provides detail of the progress made against this target. All the savings will be re-invested in the defence budget and will help fund the improvements in military capability set out in the Defence White Paper on Future Capabilities.

(viii) *MoD's Autumn Performance Report 2005–06 provides further details (page 19) of the SR2004 Efficiency Targets. As part of its efficiency programme MoD will, by 2007–08, reduce its civilian staff by at least 10,000, and be on course to have relocated 3,900 posts out of London and the South East by 2010. What progress has been made to date in reducing civilian staff and relocating posts out of London and the South East? What are the implications for MoD Main Building ie will there be excess capacity as a consequence of these initiatives? What savings are expected to be made in central London?*

Details on reductions in the civilian workforce and relocations outside of London and the South-East are set out in the Autumn Performance Report. The civilian workforce (including locally employed civilians working in non-operational areas overseas) reduced by 1,230 in 2004–05 and by a further 1,210 up to 30 September 2005. 1,220 posts have been relocated out of London and the South East to sites dispersed throughout the country through closure of the Army Technical Foundation College at Arborfield in Berkshire, its function being absorbed into the Technical College at Harrogate in Yorkshire.

Following on from the significant efficiencies achieved through the rationalisation of central London accommodation and the redevelopment of the Main Building, optimising the utilisation of the remaining three MoD office buildings in central London remains a priority. Work is in hand to determine whether reductions in staff numbers and changes to working practices could allow the Department to reduce to two central London offices, which remains our longer term aim.

Financial Management and Departmental Resource Accounts

(ix) *MoD is expected to have its 2005–06 accounts audited and laid before the Parliamentary Summer recess. Is MoD confident that it will meet the pre-recess deadline for audit and certification of its Resource Accounts? What are the main challenges to meeting this deadline, and how is MoD seeking to address them?*

We recognise that it will be a challenge to complete and lay the 2005–06 accounts prior to the summer recess. The 2004–05 accounts were certified on 15 August, so the acceleration required for the 2005–06 accounts amounts to about a month. Through working with the NAO and planning to undertake an interim accounts closure and an audit as at 31 December 2005 (AP9), we are confident that we shall meet the target. A detailed timetable was agreed and promulgated internally in October 2005, and an internal working group, with representation from Top Level Budget Holders and corporate organisations, has been meeting regularly to identify and mitigate the known risks.

The reduction in the timetable for 2005–06 is the final step in a progressive programme of faster closing of the Departmental accounts that began a few years ago. For 2005–06, time savings will be made primarily at the corporate consolidation level and in the time available to the NAO. Consequently, the NAO will look to take as much assurance as possible from the audit as at 31 December 2005—concentrating on the final quarter transactions during the year end audit.

(x) *The Operating and Financial Review notes that MoD moved to a single platform for all accounting operations during 2004–05. What impact did this have on the accounts production process in 2004–05? What benefits does MoD expect the unified system to yield?*

The move to a single platform for accounting operations (using Oracle 11i) did not have any direct effect on the accounts production process, as the business process was common to all areas of the Department, irrespective of the supporting financial systems. However, the consolidation process within Oracle was generally accepted to be more "user friendly" than it had been with the previous tool.

The main driver for the Oracle Convergence project was a desire to reduce the cost of ownership of accounting operations. In addition we realised a number of intangible benefits, including greater ease of mobility of finance staff between business areas, faster delivery of systems changes and fixes, and the enabling of further strategic developments within the overall finance change programme.

(xi) *Was MoD included in the recent review of financial management in Government Departments undertaken by the Treasury and the NAO? If so, what were the main findings from the review relating to MoD and how are they being taken forward?*

A Treasury team reporting to the Head of the Government Accountency Service undertook a review of the MoD's financial management processes and presented their findings in July 2005. The report said "the overall picture is of positive progress. The Department has or is putting in place the process, systems and standards to deliver an effective strategic financial management function." As well as finding much to commend in our current arrangements, the review supported our plans for the future—including our strategic determination to shift the focus of the finance function from transactional processing to improved support for decision-making at all levels. Specific actions underway include the following:

- Introduction of Biennial Financial Planning to bring greater stability and discipline to the forward Defence Programme and allowing for a more measured timetable and approach to the planning round;
- Implementation of the "Simplify and Improve" programme in finance, which includes:
  - centralising common functions such as account processing and the financial management of Departmental fixed assets (due for completion in April 2006); and
  - the introduction of a new finance information system—the Planning, Budgeting and Forecasting tool—which will help to improve financial planning and forecasting across the Department. This is being rolled out for in-year management of 2006–07 and the 2007 planning rounds.

We have actively engaged other organisations to review our internal performance and plans for simplifying and improving financial processes, structures and systems, including Halifax Bank of Scotland, American Express and Tetra Pak.

(xii) *Contingent Liabilities (page 180) increased in the year. The increase was due to a new liability of some £400 million, for the possible environmental clean-up and site restoration liabilities relating to the British Army Training Units in Canada. What is the nature and extent of MoD's liability with respect to the restoration and clean-up? Is this liability expected to crystallise?*

The Memorandum of Understanding for our use of training facilities in Canada is being renegotiated and we expect to sign a revised agreement in July 2006. We expect this to be open ended, but subject to termination by either party. We have no plans to stop training in Canada, but in the event that UK training in Canada were to stop we are liable to clean-up any sites we vacate to the standards required by Canadian Law. The estimated liability of £400 million is an approximate assessment of the likely costs of such environmental measures, including the removal of unexploded ordnance

(xiii) *MoD identified some £402 million of losses (excluding gifts, special payments and war pensions) in 2004–05. What control procedures were implemented in 2004–05 to minimise losses? Have additional control procedures been introduced in 2005–06 to minimise losses further?*

(xiv) *Many of the losses are constructive losses and relate to changes in procurement strategy or the cancellation of procurement projects, for example, some £51 million relating to a change in procurement strategy for the BOWMAN battlefield communications system. Why does MoD have such a large amount of constructive losses arising from changes in procurement strategy or cancelled defence projects? Are such losses likely to continue, or indeed increase, in future years?*

For 2004–05, £322 million of the total £402 million reported losses related to projects covered by advance notifications in previous years' accounts. Newly identified losses in 2004–05 were £80 million. The losses statement provides a level of visibility and transparency not matched by commercial accounts as private sector organisations are not required to disclose similar information. The size of the MoD and of its capital assets under active management, together with the range and complexity of defence business, means that the MoD also faces a scale of challenge unique in the public sector.

Reported losses are not necessarily indicative of a failure of control, although we obviously seek to identify those that are and learn appropriate lessons. But losses also result from sensible management decisions (such as the £8.995 million increased development costs for Brimstone as a result of trial platforms being unavailable because they were needed for operations in Iraq, or the £6.221 million for cancellation of new aircraft lifts for RN aircraft carriers when increased technical knowledge identified a more cost effective solution).The changes envisaged in the December 2003 Defence White Paper Delivering Security in a Changing World, in the July 2004 Future Capabilities paper, and the significant organisational efficiencies and rationalisations contained in the Department's SR2004 Efficiency programme following the Lyons and Gershon reviews, will inevitably generate further write-offs in future years as force structures and our organisation are adjusted to meet changing circumstances.

The Department is working to improve processes for losses and special payments in three areas:

— greater consistency in recording and reporting, based on a clearer understanding of the purpose of the losses statement in public sector accounting;

— improvements in the identification and dissemination of lessons learned; and

— more systematic review by MoD management boards and audit committees of the information and actions relating to losses, with due regard to materiality and proportionality.

We are also working to ensure that losses and special payments are assessed and closed as early as possible in order to ensure that any lessons arising are learned in a timely fashion. In this respect it is worth noting that the value of our advance notifications has reduced by 12% since last year, and of that value only 15% relates to cases identified during 2004–05 as opposed to a number of long-standing historic cases (see paragraph 108 on page 55). It can take some time to complete write off from the time of advance notification. This can be for a variety of reasons, including legal issues and the valuation of complex cases. The consequence can be to mislead the reader of the accounts as the same losses appear each year until the case in finally closed. The MoD Head Office will review the developing Departmental losses statement for 2005–06 at AP9 as part of the early closing process. This will provide an indication of the position on losses well before year end. Where necessary, action will be taken to expedite any cases that have been outstanding for some time. Any further losses rising in the last three months of the year will then be reviewed at year end. This should help to reduce the number of advance notification cases.

The existing central Departmental guidance on losses and special payments is under review, with the aim of identifying where it can be improved and issuing revised guidance later this year. The Treasury has also undertaken to review the rules on losses and special payments in Government Accounting. The Defence Audit Committee (DAC) is pursuing improvements in identifying and disseminating lessons learned. Further information on this is contained in the DAC's Annual Report, published on the MoD website. TLB Audit Committees are now expected to review losses and special payments, and TLB Holders are required to draw any concerns raised that are significant at TLB level to the attention of the PUS in their annual submissions to him as Accounting Officer that underpin his Statement on Internal Control in the Departmental Resource Accounts. The Defence Audit Committee also reviews losses at the Departmental level as part of the year end process. Individual TLBs have developed specific approaches tailored to their own circumstances, for example requiring cases over a certain value to be addressed personally by the TLB holder. Others are identifying trends and involving their audit committee in commissioning remedial action. Whilst the DAC addresses the spreading of best practice we do not believe it would be right to adopt a "one size fits all" approach as the issues are different in different TLBs.

Most of the constructive losses closed in 2004–05 are not new and reflect earlier decisions such as the change in procurement strategy for BOWMAN made in 2000 and the reduction in the number of Nimrod MRA4 aircraft from 21 to 18 decided in 2002. These have been notified in previous years' accounts. With such a large capital investment programme (£15.6 billion of equipment under development and manufacture as at 31 March 2005) there will inevitably be cases where we decide not to proceed with programmes because of changed priorities or requirements reflecting the wider defence need, or judgements that the technical challenge is too demanding. As part of the Smart Acquisition initiative we have sought to increase the level of investment in the concept and assessment phases of programmes more carefully to bound risk prior to the major investment decisions. In this way we should limit losses arising from a subsequent project failure—but this will not impact on major changes in requirement or procurement strategy.

19 January 2006

Second memorandum from the Ministry of Defence

Following its session on 24 January to take evidence from the Permanent Under Secretary and the Finance Director on the MoD *Annual Report and Accounts 2004–05*, the Committee asked for a range of additional information. This is set out below.

1. *What are the 25 pinch point trades referred to in paragraph 113 of the Annual Report and Accounts, and how is a pinch point defined and identified (Q5)?*

A manning pinch point is defined as "a trade, or area of expertise, where there is insufficient trained strength (officers or ratings/other ranks) to perform required tasks. This might be as a result of adherence to single-Service harmony guidelines, under manning, and/or levels of commitment that exceed resourced manpower ceiling for the trades or areas of expertise involved." The Manning Pinch Point lists comprise the trades that fall within the Manning Pinch Point definition. These lists are dynamic with trades moving on and off them according to the manning situation. Each Service manages its own Manning Pinch Point list and is responsible for identifying a Pinch Point when the criteria are met. The current Manning Pinch Point lists for all three services are shown below.

Paragraph 113 of the Annual Report stated that during 2004–05 there were over 25 Pinch Points Trades in the Army. These were broadly the same as the 24 set out below, but at various times during the year also included Royal Army Veterinary Corps Dog Handlers, Vehicle Electricians, Movement Controllers, Royal Signals System Engineering Technicians, Royal Signals Specialist Operators, and Environmental Health Technicians. Military Engineer (Geographic) was not identified as a pinch point trade during 2004-05, but is part of the current list.

Naval Service Branch/trade	*Army Branch/trade*	*RAF Branch/trade*
Aircrew (Rotary Wing)—Merlin Pilot	Vehicle Mechanic	Squadron Leader Flying Branch
Aircrew (Rotary Wing)—Merlin Observer	Recovery Mechanic	Junior Officer Pilots
Aircrew (Rotary Wing)—Merlin Aircrewman	Armourer	Junior Officer Weapon Support Officer
Fast Jet Pilots	Ammunition Technician	Operations Support Branch (Fighter Control)
Junior Submarine Warfare Officers	Chef	Operations Support Branch (Regiment)
Junior Hydrographical/ Meteorological Officers	Petroleum Operator	Operations Support Branch SB (Provost/Security)
Submarine Steward (required for secondary duties)	Explosive Ordnance Disposal	Engineer
Submarine/Communications Ratings—Petty Officer	Clerk of Works	Administration (Secretarial)
Submarine/Communications Ratings—Leading Hands	Military Engineer—Fitter	Administration (Catering)
Submarine/Communications Ratings—Able Seaman	Military Engineer—C3S	Administration (Physical Education)
Fighter Controllers	Military Engineer—Geographic	Administration (Training)
Surface Ship and Submarine Junior Warfare Ratings	Information Systems Engineer	Medical
Air Engineering Junior Ratings	Operator Military Intelligence	Medical Support
Submarine Nuclear Watchkeeper Senior Ratings	Operator Military Intelligence (Linguist)	Dental
Royal Marines Junior Ranks	Operator Military Intelligence (HUMINT)	Chaplains
Mine Clearance Divers Junior Ratings	Anaesthetist	Legal
	Radiologist	Weapons Support Operator (Linguists)
	Orthopaedic Surgeon	Weapons Support Operator (Air Loadmaster)
	General Surgeon	General Technician Electronics
	General Medical Practitioner	Environmental Health Technician
	Nurse—General Duties Officer	Gunner
	Nurse—General Duties Soldier	Air Traffic Control/Flight Operations Manager/Flight Operations Assistant
	Nurse—Accident & Emergency	Aero Systems Manager/Operator
	Nurse—Intensive Theatre Unit	Air Cartographer
		Medical Administrator/Assistant
		Psychiatric Health Technician
		Staff Nurse
		Dental Technician
		Dental Hygienist
		Laboratory Technician
		Radiographer
		Operating Theatre Technician
		Movements Operator/Controller
		Mechanical Transport Technician
		Mechanical Transport Driver
		Fire Fighter

2. *What impact do these pinch points have on operations and what will be the impact of the deployment to Afghanistan (Q6)?*

We judge that the impact on our planned deployment to Afghanistan and on readiness for future operations is manageable. However, tour Intervals for a number of Pinch Point Trades such as medical, intelligence, helicopter crews, logistic, provost and engineers are likely to breach harmony levels as we increase our scale of effort in Afghanistan. We continue to encourage appropriate contributions from our NATO Allies in Afghanistan in order to take some of the pressure off these Pinch Points.

3. *What computerised management information is available on the situation of individuals in respect of the harmony guidelines (Q8)?*

Individual separated service and breaches of harmony are currently managed under single-Service arrangements using several information systems:

— Naval Service separated service relates to those serving on ships with reports being aggregated manually.

— Army individual separated service is recorded on a system called UNICOM and aggregate data is compiled manually.

— Two systems are used by the RAF—PACMIS (for airmen) and ACMIS (for officers) which record individual separated service and can compile aggregate data.

The Joint Personnel Administration (JPA) change programme is introducing a harmonised personnel administration system for all military personnel that will make it possible to work out the separated service of every individual in the Armed Services using a single IT system. After JPA roll out (starting with the RAF in the Spring), a Unit Separated Service Report will be available giving a breakdown for each individual covering a rolling period (three years for the RN and Army, and two years for the RAF). Individuals will be able to check their own Separated Service records, and reports will be also available for Formation HQs and MoD use.

4. *What is the impact on civilian manpower of the re-organisation of Land Command and the Adjutant General's Department (Q12)?*

Project Hyperion is taking forward the re-organisation of Land Command and Adjutant General's Department and the establishment of a new collocated Headquarters Land Forces. This is expected to generate savings of about 110 military and 240 civilian posts. A decision on the preferred location of the new headquarters should be taken in the late Spring, following which a comprehensive transition plan will be drawn up. This will cover all personnel-related issues in accordance with established MoD relocation procedures, including full Trade Union consultation. There is a continuing internal communication programme providing face-to-face briefings and regular presentations to staff.

5. *Have the £400 million reported savings in the DLO's operating costs been validated and, if so, what was the outcome of the validation (Q43)?*

The DLO efficiency achievement in 2004–05 is still being assessed in an internal audit to review the evidence supporting judgement of the level of benefits realised in the year. It is likely that this will indicate that some of the operating cost savings included in the total of over £400 million reported in paragraph 209 of the *Annual Report and Accounts 2004–05* cannot be validated. Any revision will be reported in the Department's quarterly PSA reports and the *Annual Report and Accounts 2005–06*.

Overall the DLO is making good progress towards its demanding target of achieving a 20% reduction in the cost of its output from its creation in 2000 to April 2006. Since 2004, this target has been taken forward under the Defence Logistics Transformation Programme, which stretches across the whole Defence logistic process from industry to the front line. This is a very complex programme embracing several hundred individual projects. The measurement of overall efficiency performance is challenging, but systems for identifying and tracking input benefits are in place and continue to evolve to provide more robust evidence-based demonstration of benefit achievement.

6. *An explanation of the process of target-setting for Agencies, and their apparent variability (Q54). It would be helpful if this could include an explanation of the change in number of targets (Q56)*

The MoD currently has 20 On-Vote Agencies and five Trading Funds. These vary enormously in size and role and cover a wide variety of different types of outputs. Details of individual agency objectives and performance including information relating to key targets can be found in individual agency Corporate Plans and reports and accounts and on the MoD's internet site. A summary is published in Annex E to the Department's *Annual Report and Accounts*, including a table on key targets achieved that is intended to be reviewed in the context of the supplementary commentary.

The Process of Target Setting

Defence Agencies' key targets are drawn up as part of the wider business planning process. Targets for Defence Agencies are formally set by Defence Ministers, assisted by senior advisors within the Department responsible for scrutinising individual agency key targets prior to submission to Ministers. These advisors are in turn usually helped by Boards comprising key stakeholders including major customers who can advise on strategic direction, operational demands, possible targets and performance measurement in relation to a particular agency. The specific process used varies from agency to agency but it often makes sense for an individual Agency to put together draft key targets in the first instance. Following discussion and scrutiny between senior departmental officials and individual agency Chief Executives, key targets are then recommended to the relevant Minister for approval. This is normally done on an annual basis. Such recommendations include details of the proposed key targets, past performance, a supporting rationale and information about how targets will be measured. The rationale will normally include relevant contextual information, such as how the proposed key targets relate to the outputs of the agency, the relationship between the key targets and any higher level targets (eg Top Level Budget Holders' Service Delivery Agreements, the Defence Change Programme, and Public Service Agreement targets), and how the chosen targets will drive and facilitate the monitoring of performance improvement. Once the Minister has agreed an Agency's Key Targets these are announced in Parliament and formally incorporated into its Corporate Plan. All those involved in the process of drawing up agency key targets are expected to draw on identified best practice, including the Treasury's November 2003 guidance "*Setting Key Targets for Executive Agencies: A Guide*" and supplementary internal guidance issued by the Directorate of Business Delivery.

Changes in Targets

Key targets seek to represent the main business of the organisation concerned. In line with HMT best practice, Defence Agencies typically have between five and 10 key targets. Precise numbers vary depending on the size and complexity of the agency concerned and challenges it faces in a particular year. We recognise that in judging performance it is preferable to have a run of comparable data over a number of years. However, a balance needs to be struck between continuity and the need to improve and amend targets to reflect new or evolving priorities. Any changes to key targets or the way they are measured will be set out for Ministerial consideration. Ministerially endorsed changes to Agency key targets are normally then explained in Agency Corporate Plans and published on Agency web-sites.

As an example, Ministers agreed to increase the number of key targets relating to Defence Estates from 11 to 15 in 2004–05. This followed a major review in 2004 which assessed the relevance of the existing targets to the Department's and Defence Estate's business and the decision to merge the organisation with the Defence Housing Executive in a single Agency. In light of that Ministers approved the integration into Defence Estate's targets of a number of the Defence Housing Executive's previous key targets, the rolling forward and updating of some key targets from Defence Estate's Corporate Plan 2003, and the introduction of a new customer satisfaction target.

7. *The nature of the Government's Golden Share in Rolls Royce (Q74)*

The Treasury Solicitor, as nominee for the Secretary of State for Trade and Industry, holds the Government's Special Share in Rolls-Royce Group plc, going back to when the Company was privatised in 1987. This is one of a small number of special shares that the Government holds in UK companies.

The purpose of the Rolls-Royce special share, which has a nominal value of £1, is to protect the UK's national security interests. These include security of supply issues associated with its nuclear business (nuclear propulsion for Royal Navy submarines) and for other defence equipments (mainly aero-engine and ship propulsion). The provisions of the special share are tailored as narrowly as possible and kept under review.

Key features of the Rolls-Royce special share include:

- A 15% limit on the percentage of foreign shares in Rolls-Royce Group plc (the holding company) that can be held by a single foreign shareholder, or foreign shareholders acting in concert. (A foreign shareholder includes an EU national.)
- A requirement that the Chief Executive and the majority of directors of Rolls-Royce Group plc (the holding company) are British.
- Requirement that disposals of the whole or a material part of the nuclear business, or the Group as a whole, require the consent of the Special Shareholder.

8. *A breakdown of the RAF personnel who exceed the target for detached duty, referred to on page 13, target 4 (Q76)*

The breakdown of RAF personnel who exceeded the guidelines for individual separated service is as follows:

Trade	*Number of personnel*	*Trade*	*Number of personnel*
	OFFICERS		
Pilots	60	Engineer	26
Navigators	23	Supply	28
Air Electronics Operators	1	Administration	1
Air Engineers	1	Admin Secretariat	16
Air Load Masters	3	Admin Caterers	1
Air Traffic Controllers	12	Admin Physical Training	1
Fighter Controllers	10	Admin Training	2
Intelligence Analysts	16	Medical	21
Regiment	35	Dental	2
Flight Operations	9	Legal	2
Provost and Security	3	Princess Mary's Royal Air Force Nursing Service	4
	OTHER RANKS		
Aircraft Engineering Technician	10	Aerospace Systems Manager/ Operator	12
Aircraft Engineering Technician	16	Fighter Controllers	1
Aircraft Technician (Mechanical)	80	Survival Equipment Fitter	18
Aircraft Technician (Avionics)	70	Painter and Finisher	3
Engineering Technician Airframe	61	Intelligence Analyst (Imagery)	7
Engineering Technician Propulsion	32	Photographer	3
Engineering Technician Weapon	91	Air Cartographer	1
Engineer Technical (Avionics)	41	Pharmacy Technician	1
Engineer Technical Air Electrical	31	Operating Theatre Technician	1
Engineering Technician Electronics	107	Environmental Health Technician	1
General Technician Electrical	32	Medical Administrator	16
General Technician Ground Service Engineers	37	Staff Nurse (RGN)	17
General Technician Workshops	6	Dental Nurse/Administration	4
General Technician (Mechanical)	8	Dental Hygienist	1
Aerial Erector	14	Personnel Administrator	35
Mechanical Transport Driver	99	Movements Controller/Operator	83
Mechanical Transport Technician/ Mechanic	21	Supplier	133
RAF Police	68	Chef	35
Gunner	276	Catering Account	1
Fire-fighter	25	Steward	6
Air Traffic Controller/Flight Operations Assistant (ATC)	7	Musician	2
Flight Operations Manager/Flight Operations Assistant	29	Air Engineers	4
RAF Physical Training Instructor	11	Languages	3
Intelligence Analyst (Voice)	25	Air Load Masters	21
Intelligence Analyst (Communications)	9	Air Electronics Operators	7
Telecommunications Controller/ Operator	51		

As at 30 December 2005 4.0% of RAF personnel exceeded the guidelines for separated service.

9. *The impact of the c.£5 billion project cost increases reported in MPR 03 (£3.1 billion) and MPR 04 (£1.7 billion), and the project time slippage reported in MPR 03 and MPR 04, on MoD's current and future procurement programme (Q79)*

Cost growth on specific equipment projects inevitably has undesirable consequences for the overall Equipment Programme, because, over time, it reduces the available provision for equipment. This is, however, only one of many variables and does not always create short-term problems. It is impossible to hypothecate the impact of changes in the estimated costs of individual projects to specific changes in the overall programme. As part of the Department's routine planning process we review the underlying plans and assumptions which make up the Equipment Programme. This takes into account changes in the strategic background, fresh operational experience, alterations to project plans, assumptions and threats—which may include both increases and decreases in forecast costs—and pressures elsewhere in the Department, with reference to the outcome of Spending Reviews. All these factors have to be weighed and our plans and assumptions about the Equipment Programme adjusted accordingly to ensure that we are still able to deliver the balanced military equipment capability our forces require within the funds available for Defence. Consequently, whilst it is inevitably the case that if we have to spend more of our resources on one project, less will be available for other purposes, there is not a simple relationship between historic cost-growth on one project and reduced spending elsewhere; the adjustments we make are the result of the interplay of a wide range of issues across the Defence Budget as a whole. What we can say is that the analysis we undertake after the conclusion of the planning cycle demonstrates that we will continue to deliver to our forces the military equipment capability they require.

We continue to work to reduce cost-growth on equipment projects because widespread and unchallenged cost growth puts pressure on the total capability we can deliver. We are making progress on this. The National Audit Office (NAO) noted in the Major Projects Report 2005 that "There has been further progress on measures to improve performance within the Defence Procurement Agency and elsewhere in the Department. These improvements focus on the following areas: performance of key suppliers; the skills and development of staff; project and risk management; increased use of trade-offs between time, cost and capability of equipment; better joint working of those responsible for acquisition within the Department; and stronger project scrutiny at all levels." The NAO added that "It will take some time before the full impact of these measures will be felt on the large and lengthy projects within the Major Projects Report". Ministers and senior officials will continue to drive forward the necessary changes.

10. *Confirmation that MoD did not buy back any surplus equipment in 2004–05 (Q94)*

We have identified buy backs of the following equipment in 2004–05:

— the Sea King Integrated Project Team purchased minor parts costing £500;

— the Maritime Logistic Support Integrated Project Team purchased minor spares for workshop based repairs costing £72,836. These replaced items that had previously been sold under a stock rationalisation programme on the basis of low usage but were then subsequently required.

11. *An explanation and annual breakdown of the reported cost savings of £88 million in respect of Tornado, referred to in paragraph 210 (Q98)*

The figure in paragraph 201 comprised:

	FY 2003–04	*FY 2004–05*	*Total*
Reductions in Tornado Propulsion Flight Local Unit Establishment:		£4 million	£4 million
Reduced engine rejections: (approx 200 fewer rejections a year @ £250k per rejection)	£21 million (part year)	£50 million	£71 million
Introduction of pilot contract with Rolls-Royce Defence Aerospace in October 2003:	£4 million (part year)	£9 million	£13 million
TOTAL:	**£25 million**	**£63 million**	**£88 million**

12. *An explanation of the loss of £65 million relating to the impairment of an operational building, referred to on page 194, including an explanation of why MoD incurred the loss if the building could not meet the requirement for which it was designed, and the future plans for the building (Q102)*

The project to which this refers originated in a commitment by the then Secretary of State for Defence in 1978 to replace inadequate waste management facilities and overhaul safety procedures at the Atomic Weapons Establishment (AWE) Aldermaston. As part of this, work to build a substantial facility for treatment of radioactive liquid waste was taken forward during the 1980s. However, despite considerable further modifications during the 1990s it proved impossible successfully to commission the facility and bring it safely and effectively into service. The plant was eventually formally declared unfit for purpose in 2000 and a commercial settlement was reached with the contractor in 2003. No viable alternative use was identified for the plant or the dedicated building containing it, and the facility was formally written off in 2005. Further details are set out below. AWE has continued successfully to meet its safety and environmental obligations by other means despite this facility never entering service.

There are two separate related entries in the *Annual Report and Accounts 2004–05* in respect of this loss:

— "A loss of £65,000,000 has been incurred following the impairment of an Operational building. (DPA)" (Page 194). This advance notification refers to building A91 at AWE, which was completed in the late 1980s to house an integrated Radioactive Liquid Effluent Treatment Plant (RALETP).

— "A loss of £82,000,000 has been incurred in respect of plant and equipment. (DPA)" (Page 195). This advance notification refers to the RALETP that was designed during the 1980s and integrated into building A91.

The Radioactive Liquid Effluent Treatment Plant (RALETP) was declared unfit for purpose in 2000 and was the subject of a contractual dispute with the operations and management contractor, Hunting Brae, in which £13 million was recovered. However as most of the problems stemmed from before AWE was contractorised in 1993, and there being no reasonable prospect of rectifying the technical problems within any practicable timescale, we decided in 2002–03 that there was no future for the facility, generating an impairment of £82 million. A91 was built to house RALETP. The building (excluding RALETP) was valued at £65 million in the 1998 opening MoD Balance Sheet. Since 2000, AWE have examined various options for its use. The following considerations were taken into account:

— The defective plant was integrated into the fabric of the building. Numerous structural columns exist which would make the design and installation of any significant plant very difficult.

— The building is a lot larger than any future facilities would require so that the building would not be economical to run over the longer term.

— By the time it could be converted to a new facility, the standards to which it was built would be 20 years out of date.

Given these considerations, we decided there was no possibility of alternative uses. It was therefore necessary to write off the £65 million value of the building.

The RALETP and the building (excluding RALETP) are shown separately in the accounts because in 2003–04 the NAO were content that the Note to the Accounts on losses and special payments included the building only. In 2004–05 it decided that the Note should also include the £82 million write off for RALETP itself, and that these should jointly be considered as one loss. The total write-off of £147 million was approved by the Chief of Defence Procurement on 22 November 2005.

The Department acknowledges that this project was handled badly in a number of significant respects. Lessons have been drawn from the experience, procedures have been changed, and the Department is determined to avoid any recurrence.

13. *An explanation of the loss of £63.8 million on the Landing Ship Dock (Auxiliary) programme, and the latest estimate of the cost of the programme compared to the contract price agreed with the contractor (Q102–Qq 32–41 also refer)*

Losses reported in Departmental Resource Accounts 2004–05

There are two separate losses related to the Landing Ship Dock (Auxiliary) (LSD(A)) programme detailed in the *Annual Report and Accounts 2004–05* under Advance Notifications:

Page 194 Advance Notifications	
Slippage in the construction programme for two Landing Ship Dock (Auxiliary) caused delay in supplying design information and equipment to a contractor. This resulted in a claim on the MoD relating to the associated delay and dislocation costs. In 2003–04, an amount of £40,000,000 was included in Advance Notification as an estimate of the likely amount of the claim. (DPA)	£63.8 million
Page 195 Advance Notifications	
HM Treasury has agreed an ex-gratia payment of up to £84,500,000 to Swan Hunter subject to completion of certain contractual conditions relating to the construction of two Landing Ship Dock (Auxiliary) LSD(A). Total paid to date is £38,000,000. (DPA)	£38.0 million

The £63.8 million provision is to meet delay and dislocation claims, against the MoD, from BAE SYSTEMS following the impact of the technical difficulties encountered by Swan Hunter in the relaying of design information and equipment. The MoD has to date paid £37 million against the existing provision. The scope and scale of any additional costs are being negotiated with BAE SYSTEMS.

The £84.5 million is the cost of the re-negotiated contract amendment with Swan Hunter, agreed in December 2004, for the design and build of the Landing Ship Dock (Auxiliary) vessels, as a result of the technical difficulties encountered by the company.

LSD(A) Project background

The Landing Ship Dock (Auxiliary) project is for four ships to replace the current Landing Ship Logistics capability provided by RFA of Sir Geraint, Sir Percivale, Sir Galahad and Sir Tristram. The prime contractor and design authority is Swan Hunter (Tyneside), responsible for the build of RFA Largs Bay and RFA Lyme Bay at its Wallsend shipyard. It also provides design information and equipment to BAE SYSTEMS for the build of the two follow-on ships, RFA Mounts Bay and RFA Cardigan Bay at BAE SYSTEMS (Govan and Scotstoun yards). A contract was placed in December 2000 with Swan Hunter and the follow-on contract with BAE SYSTEMS to build an additional two LSD(A)s was agreed in November 2001. Swan Hunter won the original competition with a modification to an off-the-shelf design—the Dutch HNLMS ROTTERDAM and Enforcer Class vessel by Royal Schelde. Subsequent difficulties have shown that the design was not as mature as the company believed at the time.

Swan Hunter confirmed, in September 2003 it was unable to meet the original programme requirements for the design and build of the two ships. The company accepts that its initial programme was optimistic and underestimated the extent of the development issues inherent in the building of a new ship. The delays caused by the build programme rework, as a result of the modifications of the Royal Schelde design to the MoD specification, led to an underestimation of the price of the overall contract. The slippage to Swan Hunter's programme delayed the delivery of design information to BAE SYSTEMS which impacted upon that company's own build programme. Under the terms of the Swan Hunter contract, this design information is defined as MoD Government Furnished Asset and enables BAE SYSTEMS to claim against MoD for the additional costs incurred as a result of the Swan Hunter delays and subsequent impact upon their build programme.

The effect of the delays on the programme, together with a range of options for the completion of Largs Bay and Lyme Bay, were re-assessed by the MoD during 2004. The conclusion was that further investment in the LSD(A) contract was the most effective way of protecting the investment to date and in delivering this much needed capability. Therefore the retention of Swan Hunter as the lead yard offered the MoD and taxpayer the best value for money solution for delivering this new capability. Re-approval was sought for the resultant increased costs and revised In-Service Dates. These were approved by the Minister for Defence Procurement and the Chief Secretary to the Treasury and an £84 million contract amendment was agreed on 9 December 2004.

All four ships have been successfully launched. RFA Mounts Bay, the first of the BAE SYSTEMS vessels, was accepted off contract on 15 December 2005 and is now undergoing her Stage 2 trials (capability) in readiness for meeting her In-Service Date in late 2006.

Current contract values

Swan Hunter: The original contract value for the build of the two Swan Hunter vessels was £148 million. Following the order for a further two ships from BAE SYSTEMS, an additional £62 million was added into Swan's contract for Lead Yard Services and Equipment, enabling Swan Hunter to pass relevant design information and equipment to BAE SYSTEMS. Following Swan Hunter's confirmation of its underestimation of the engineering requirement MoD increased the original contract by £84.5 million in December 2004. This together with the purchase of spares at £11 million and minor variations to contract, means that the total value of the contract for Swan Hunter is £309 million.

BAE SYSTEMS: The current contract value for the build of the BAE SYSTEMS vessels is £176 million, which includes £48.5 million for known claims as a result of the impact upon their programme of the Swan Hunter delays and an additional sum for variations to contract and quantity growth. The £63.8 million provision in the accounts includes a further £15.3 million for potential future claims. The original contract value was £122 million.

Additional cost increases: Swan Hunter confirmed in June 2005 to MoD that it cannot complete its two vessels for the cost agreed in December 2004. BAE SYSTEMS have also notified MoD of likely cost increases, primarily as a result of the delays to their programme caused by the further Swan Hunter delays. MoD is currently in commercial discussions with both companies as a result of these declared cost increases. All options are being assessed and in view of the commercial sensitivities it would be undesirable to give any further details at this point.

14. *An explanation of the basis on which PSA target 1 has been judged to have been met, and why no supporting measures are given in Table 1*

The success of an Operation is judged against the Military Strategic Objectives given to the UK commander by the Chief of Defence Staff. It is formally assessed using military judgement by a group chaired by the Deputy Chief of Defence Staff (Commitments). Every Operation has been judged to have met its Military Strategic Objectives over the period covered by this assessment (April 2003–March 2005). There are no supporting measures in Table 1 to the *Annual Report and Accounts 2004–05* because the Technical Note for PSA Target 1 contains no supporting performance indicators.

15. *A note on Private Finance Initiative commitments. Please explain the difference between "on" and "off" Balance Sheet transactions (as referred to on page 177, paragraph 22.1), and why they appear to be accounted for differently. What assessment has MoD made of whether the PFI projects listed on pages 178–179 are delivering the expected levels of service? And to what extent do these substantial long-term financial commitments impact upon MoD's future financial flexibility?*

"On" and "Off" Balance Sheet

PFI transactions are accounted for in accordance with UK Generally Accepted Accounting Practice and Financial Reporting Standard (FRS) 5, Application Note F—*Reporting the Substance of Transaction: Private Finance Initiative and Similar Contracts*. The purpose of FRS 5 is to identify:

- whether the purchaser in a PFI contract has an asset of the property used to provide the contracted services together with the corresponding liability to pay for it or, alternatively, whether it has a contract for services; and
- whether the service provider has an asset of the property used to provide the contracted services.

Under the general principles of the FRS, a party will have an asset of the property where the party has access to the benefits of the property and exposure to the risks inherent in those benefits. The reason that some PFI deals are "on" Balance Sheet while others are "off" is due to the nature and type of risks that each party has retained or transferred in the transaction. The main difference between an "on" and "off" Balance Sheet PFI is that an "on" Balance Sheet PFI scores against Capital Departmental Expenditure Limit (CDEL) on the Control Total Framework and therefore incurs cost of capital charges up front whilst an "off" Balance Sheet PFI does not. The Department only undertakes PFI when it delivers Value for Money and not to secure a particular balance sheet treatment to address affordability concerns. The NAO audit all MoD PFI accounting transactions.

This is illustrated by way of a couple of examples. A major factor in determining whether a PFI is "on" or "off" our balance sheet is residual value risk. Main Building PFI is "on" our balance sheet because the department has retained the residual value risk for the building. In other words, the department has retained the risk for delivering the required facility. At the end of the PFI contract MoD will own the building. By contrast almost all of our Defence Housing PFI contracts are "off" our balance sheet as the residual value risk has been transferred to the contractor. At the end of the contract the MoD can choose to buy the properties at market value or walk away.

Private Finance Initiative level of service

In August 2005 the MoD Private Finance Unit initiated a review of operational Private Finance Initiative (PFI) projects to assess how PFI has performed to date, both in construction and in the early years of operation, within the MoD. The structure of the review was developed with the National Audit Office (NAO) and Partnerships UK. The comprehensive review of all PFI projects as defined by HM Treasury with total contract costs in excess of £19 Billion concluded that:

- PFI in the MoD substantially delivers projects on time and within budget. All projects were delivered on budget. All except three were delivered within two months of the agreed date;
- PFI projects in MoD are performing well and are delivering the services required. All of the project teams surveyed reported that the performance of their PFI project was satisfactory or better. Three quarters of project teams rated the performance of their PFI project as good or very good; and
- long term PFI contracts in MoD are flexible enough to accommodate future change and to deliver on a sustained basis. The review identified that 85% of projects reported that their PFI contracts were suitably flexible to accommodate change and had effective change management mechanisms.

The review was published on 12 December 2005. This is available on www.mod.uk, and a copy is attached. It has been received well. The NAO said "We welcome the MoD's review which provides new insights into defence PFI and the conclusions of which chime with many of our own findings across government."

Impact upon MoD's future financial flexibility

To date, we have signed 54 PFI deals that have brought over £4.3 billion of private sector investment into Defence. A further 12 PFI projects are in procurement, and are expected to inject up to a further £6 billion. We use PFI as a core procurement tool to deliver our investment programme and deliver key services for which we know there is a requirement over the long-term when it is the best way to deliver value for money. Thus our financial flexibility is not constrained by the use of PFI as a procurement tool per se, but by the fact that there is a long term requirement for the service contracted for. It is also commonplace for PFI projects to have a change mechanism set into the contract in order to allow for evolution of the underlying requirement. The review of operational PFI projects referred to above confirmed that long-term PFI contracts in MoD were sufficiently flexible to accommodate future change and to deliver on a sustained basis.

16. *A note on nuclear decommissioning liabilities. Is MoD confident that the current estimate of its nuclear liabilities (page 175) will not increase substantially in the future, or the estimated timescales over which the costs will need to be incurred change significantly? How will MoD fund liabilities of this scale when they arise?*

Almost two thirds of the MoD's nuclear decommissioning liabilities transferred on 1 April 2005 to the Nuclear Decommissioning Authority. These related to facilities used for the production of Special Nuclear Materials by British Nuclear Fuels Ltd and its predecessor the UKAEA. In respect of the liability that remains on our balance sheet, we are confident that the current undiscounted estimates for cost and for timescales will not change significantly. Work is in hand to produce revised estimates for the five-yearly review due in 2007; so far these are in line with previous ones. The change in the Treasury discount rate from 3.5% to 2.2% will however cause an increase of some £0.7 billion in the stated provision in the 2005–06 Departmental Resource Accounts. How such liabilities will be funded will be the subject of negotiation with the Treasury as and when the circumstances arise.

17. *The Committee would also like to be kept informed on the progress of negotiations with the Treasury on the division of the proceeds of the flotation of QinetiQ (Q71)*

We have agreed with the Treasury that we will retain £250 million of the receipts from the QinetiQ IPO for reinvestment in the defence programme. The remainder of the receipt from the IPO will go to the Exchequer.

27 February 2006

Departmental Minute from the Ministry of Defence concerning the gifting of operational ration packs to the Government of the United States of America

It is the normal practice when a government department proposes to make a gift of a value exceeding £250,000, for the department concerned to present to the House of Commons a Minute giving particulars of the gift and explaining the circumstances; and to refrain from making the gift until 14 days (exclusive of Saturdays and Sundays) after the issue of the Minute, except in cases of special urgency.

The gifting of humanitarian assistance, in the form of operational ration packs (ORPs), by the Ministry of Defence (MoD) to the Government of the United States of America was a case of special urgency. Hurricane Katrina caused widespread devastation and significant loss of life, which at the time of the gifting was estimated to be in the tens of thousands.

In the early hours of 4 September the UK Government received an urgent request for critical assistance from the US Federal Emergency Management Agency (FEMA) for 500,000 meals ready to eat (the US term for ORPs) to help the immediate relief effort. The MoD was asked to consider urgently the provision of ORPs to meet the FEMA request. Ministerial approval to meet this requirement was given during the course of 4 September for the ORPs to be sent to the US by the most direct route to ensure they met the US request for urgent and critical assistance.

The ORPs were delivered to the United States between 5–7 September. The total value of the 475,182 ORPs was £3,114,845.

The Treasury has approved the proposal in principle. It is normal practice to allow a period of 14 days (exclusive of Saturdays and Sundays) beginning on the date of which the Minute was laid before the House of Commons, for Members to signify an objection by giving notice of a Parliamentary Question or of a Motion relating to the Minute, or by otherwise raising the matter in the House, and to withhold final approval of the gift pending an examination of any objection. However, in view of the particular need to respond to a request for critical assistance in the immediate relief effort following Hurricane Katrina, the department made the gift as soon as practicable and therefore apologises for not being able to give a period of notice during which objections may have been raised.

6 February 2006

Letter from the Ministry of Defence Liaison Officer to the Clerk of the Committee

Gift of Operational Ration Packs (ORPs) to the USA

Thank you for your letter of 14 February in which you seek additional information following receipt of our Departmental Minute of 6 February, concerning the gifting of ORPs to the Government of the USA.[1]

The response to your specific questions are detailed below.

1. *Why did it take the Department five months to inform the House of this gift?*

Given the unusual nature of this transaction, there was some debate within the MoD and with HM Treasury on how best to account for the ORPs that MoD provided to the US to assist with the Hurricane Katrina relief effort. The conclusion reached was to gift the ORPs, hence the Departmental Minute submitted on 6 February, and to write off the transport costs in the Department's 2005–06 accounts.

2. *What was the total cost of the gift, airlift costs included?*

The cost of providing the ORPs to the Government of the USA was £5,130,971, of which £3,114,845 represented the value of the ORPs gifted and £2,016,126 was the cost of airlift.

3. *What are the Department's observations on media reports that delivery of the packs was delayed, once they had arrived in the USA, because of US Department of Agriculture objections to EU products? Does the Department have any information on whether, and how, the packs were eventually used?*

At the specific and urgent request of the US authorities, the MoD delivered around 475,000 ORPs between 5–7 September 2005. The US Federal Emergency Management Agency (FEMA) then began to distribute the ration packs to the disaster area. This process was stopped on 8 September when the US Department of Agriculture realised that the ORPs did not comply with their regulations concerning the import of processed meat, and a ban on the import of ruminant products from Europe, including the UK, introduced after the BSE crisis. The UK was not aware that there was a danger of the packs being impounded until after they had been delivered and, once informed of the problem the UK stopped any further deliveries.

The remaining ration packs, approximately 330,000, were initially impounded in Arkansas. However, the Department understands that the US Authorities have been in touch with various international and non-governmental organisations on ways to make use of the ration packs outside the US. A number have already been distributed, to NGOs for distribution to populations in need and to the OSCE for use in Georgia; we understand that the US authorities expect all the ORPs to be distributed this way.

I hope that this provides you with all the information you need.

6 March 2006

[1] *Note:* See Ev 31

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