



House of Commons  
Committee of Public Accounts

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# Delivering Multi–Role Tanker Aircraft Capability

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**Second Report of Session 2010–11**

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

*Ordered by the House of Commons  
to be printed 8 September 2010*

## The Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine “the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit” (Standing Order No 148).

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### Committee staff

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

### Contacts

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## Summary

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In March 2008, the Ministry of Defence (the Department) signed a private finance initiative (PFI) contract with AirTanker Ltd, for the Future Strategic Tanker Aircraft (FSTA) to provide air-to-air refuelling and passenger transport services. FSTA is based around 14 modified Airbus A330s and will replace the 24 Tristars and VC10s that form the RAF's current fleet.

Under the contract, AirTanker owns the aircraft and will provide them to the Department when required. AirTanker will also provide the associated aircraft support, maintenance and infrastructure, making the scope of the deal broader than any other defence PFI contract to date. The value of the contract, worth £10.5 billion over 27 years, also makes it the largest signed.

PFI works best where activities and demand are predictable. This is clearly not the case for FSTA. For instance, it is simply astonishing that the Department did not decide until 2006 that FSTA should be able to fly into high threat environments such as Afghanistan. Yet the Department is inhibited from changing the specification because of the implications to the cost of the PFI. Just two years after the deal was signed, the forthcoming Strategic Defence and Security Review is likely to change the demand for the services AirTanker has been contracted to deliver. As the Committee's previous work shows, dealing with changes on PFI deals is expensive and the Review may question whether this PFI deal is sensible or affordable. The fact that no other country has chosen to procure air-to-air refuelling and passenger transport using PFI type arrangements is further indication that PFI is not a suitable procurement route for such important military capabilities.

There are significant shortcomings in the Department's procurement of FSTA and we do not believe the procurement was value for money. The shortcomings include:

- assuming that PFI would be the right solution from the outset without a sound evaluation of alternative options;
- running only a limited competition;
- never developing a realistic fallback if the PFI solution proved unworkable;
- failing to have a clear understanding of the full costs of running its current aircraft fleets and failing to secure visibility of sub-contractor cost data, meaning the Department was unable either to compare costs with the price being offered by AirTanker or determine whether the PFI option was good value for money;
- not fixing the requirements until late into the process so that the negotiations themselves took over nine years to complete, more than double the expected four years. This delay in turn led to a considerable cost increase against initial estimates.
- not having the right skills and experience in place and failing to provide firm leadership until the later stages of the procurement to effectively manage the procurement, and

- not making timely decisions on fitting the necessary protection equipment to enable the aircraft to fly into high threat environments like Afghanistan, a task that the Tristar may have to continue doing until 2016.

In order to obtain best value going forward, the Department must retain contract expertise and ensure that staff make decisions regarding FSTA in the full knowledge of the financial implications. Without this action, the risk is that extra demands will be placed on AirTanker which result in additional, and unnecessary, payments being made by the Department.

On the basis of a Report by the Comptroller and Auditor General,<sup>1</sup> we took evidence from witnesses from the Ministry of Defence on: why PFI was used to procure FSTA, shortcomings in the procurement process, availability of cost data, how the deal was managed and risks in the transition from the current fleets.

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1 C&AG's Report, 2009–10, *Delivering Multi-Role Tanker Aircraft Capability*, HC 433

## Conclusions and recommendations

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1. **The use of PFI to deliver a vital military capability like FSTA was inappropriate. In 2004, even the project team recommended abandoning the PFI solution in favour of a conventional procurement. Military needs are not like hospitals or schools where activity is predictable and more suited to PFI.** The Department, working with HM Treasury, should set out clearly when PFI is appropriate for defence and the characteristics of a successful defence PFI deal.
2. **The prevailing support for PFI at the time is not a justification for the Department's decision in 1997 to commit to a £10.5 billion project to deliver a vital military capability without knowing whether it was the best value option. HM Treasury should also have challenged the Department's selection of PFI as the preferred option without conducting a robust evaluation of alternatives.** HM Treasury should publish the basis upon which it reviews the value for money offered by the contracts the Department proposes to enter into, and the robustness of the option appraisals underpinning the initial choice of procurement route.
3. **The final decision to commit to FSTA in 2007 was made using a Public Sector Comparator which was not a realistic or affordable alternative to the PFI and the outcome was highly dependent on which discount rate was used. Nor did the Department develop a robust fallback plan which could have provided a more realistic alternative way of delivering the capability.** At the outset of all future major investments the Department should identify:
  - a realistic alternative against which to assess the value for money of its preferred solution, and
  - the latest point at which it would be credible to adopt the fallback option so that a realistic comparison of the relative value of alternative ways of delivering a capability can be made.
4. **It took over nine years, more than twice as long as expected, to place the FSTA contract. The Department incurred extra costs over this period and the last aircraft will not be delivered until 19 years after the procurement began. FSTA was undermined by a series of procurement mistakes. We have criticised the Department before for such failings but FSTA demonstrates that action is still needed to prevent their repetition.** On future projects, we expect the Department to demonstrate it has truly learned and successfully applied the lessons from its repeated procurement failings.
5. **The Department did not understand the costs of the deal it was negotiating as it did not obtain access to detailed industry cost data. This meant it could not gauge the whether the deal was value for money. In particular, it could not determine whether profit margins were appropriate or the premium it was paying to transfer risk to industry.** We were not persuaded by the Department's generalised assurances that it had got a grip on this problem on current procurements. The Department should agree with its commercial partners a framework against which to

assess what constitutes appropriate access to cost and other data in differing procurement circumstances and ensure it enforces its access rights rigorously.

6. **The Department can only make sensible decisions with robust financial and performance data. In this case, the Department did not have data on the performance of its current aircraft fleets, the cost breakdown of the deal or the potential costs of alternatives so it could not either compare costs or know whether the PFI option was value for money. We believe FSTA is illustrative of a wider problem for the Department which if it is not addressed will fundamentally affect its ability to deliver value for money.** The Department should set out clearly its financial and performance data needs, how it will develop the underpinning management information systems, how long this will take and how it will change the culture of the organisation to place a premium on generating and using such information.
7. **The progress of the procurement improved only when the Department applied enough of its scarce staff with PFI and commercial skills to FSTA.** The availability of sufficient commercial experts and a more general awareness of commercial issues in the wider defence community underpin successful acquisition. The Department should develop a more comprehensive training and development programme to ensure there are sufficient skilled individuals to support all of its complex projects. The Department should also ensure that all staff involved with FSTA are fully aware of the financial implications of any decisions they make.
8. **For much of its procurement the FSTA project lacked leadership. In the early years the project averaged a team leader a year and a Senior Responsible Owner (SRO) was not appointed until 2007.** The Department accepted this failure but stated that all major projects do now have someone with an overview of the various elements of the project and influence over them. This is not the same as strong leadership. The Department should take action to ensure its managerial and budgetary structures enable SROs to act as empowered leaders able to drive the delivery of defence equipment capability.
9. **In 2006 the Department recognised the need for additional protection to enable FSTA to fly into high threat environments such as Afghanistan but failed to include this in the contract negotiations. Four years later it has still not decided whether to fit the necessary equipment. The Department urgently needs to find a robust long term solution to this issue. Otherwise, the aircraft will enter service without being able to replace the Tristar in its current role of flying personnel in and out of Afghanistan and the Department will incur extra costs finding alternative ways of providing the capability.** The Department should report back to us within six months of the completion of the Strategic Defence and Security Review explaining what solution it has chosen and why, and what the operational consequences are.

# 1 Why PFI was used to procure FSTA

1. In March 2008, the Ministry of Defence (the Department) signed a private finance initiative (PFI) contract with AirTanker Ltd to provide an air-to-air refuelling and passenger air transport service. This Future Strategic Tanker Aircraft (FSTA) contract will be based around 14 Airbus A330-200 aircraft and will replace the capability currently provided by the Department's existing fleets of 24 Tristar and VC10 aircraft.<sup>2</sup> The contract arrangements are highly complex as the scope of the deal is broader than any other defence PFI contract to date, with AirTanker providing not only the aircraft but also the associated aircraft support, maintenance and infrastructure (**Figure 1**).<sup>3</sup> It is also the largest signed, worth £10.5 billion over 27 years.<sup>4</sup>

**Figure 1: Services provided through the FSTA Contract**

Service	Details
Aircraft	<p>Availability of up to 14 Airbus A330s.</p> <p>Air-to-air refuelling capability:            Fuel capacity of 111 tonnes for dispensing to aircraft;            All aircraft capable of simultaneously refuelling two fast jet receivers, and Seven aircraft capable of, and five fitted for, refuelling large aircraft.</p> <p>Air transport capability:            Seating capacity for 290 passengers;            Various configurations for medical evacuations of up to 40 patients, and Commercial standard freight-carrying capacity.</p> <p>Able to operate in military and civilian roles.</p>
Crewing services	<p>14 Sponsored Reserve pilots able to operate on military and civilian flights;</p> <p>48 qualified cabin crew.</p>
Infrastructure at RAF Brize Norton	<p>Maintenance hangar capable of servicing two Airbus 330 aircraft.</p> <p>Flight operations, storage and office facilities.</p> <p>Training building.</p>
Training services	<p>Training for military and AirTanker flight and cabin crews, technical and support personnel.</p> <p>Provision and support of FSTA flight simulator.</p>

Source: C&AG's report, para 2, Fig 1

2. The use of PFI in this situation is a significant departure from convention, as no other nation has chosen a PFI or leasing solution for its own air-to-air refuelling and passenger

2 C&AG's Report, para 2 and 1.1

3 Qq 28 and 80; C&AG's Report, paras 1.2 and 1.4

4 Qq 3, 47 and 103; C&AG's Report, Figure 1

air transport arrangements.<sup>5</sup> While PFI may be suitable in areas such as hospitals or schools where there is a clear specification, defence programmes are more complex which makes it difficult to define the specification across a long period.<sup>6</sup> The Department evidently did not have a full understanding of what it wanted from FSTA and found it was at the limits of PFI in terms of complexity and scale.<sup>7</sup>

3. The Department also ignored advice from its own project team in 2004, who recommended abandoning the PFI option in favour of a conventional procurement, as a result of significant concerns over the AirTanker bid.<sup>8</sup> The Department's explanation for not accepting this advice was that it believed the bid was not the final and best offer from AirTanker and instead obtained concessions by threatening AirTanker with cancellation of the project.<sup>9</sup> However the value of these concessions, £330 million, is tiny when compared with the £10.5 billion value of the contract overall.<sup>10</sup>

4. The Department presumed from the start that PFI would be the option used to procure FSTA when it first started budgeting in 1997 and it did so without sufficiently examining alternative solutions at this stage to consider if PFI was the most appropriate option.<sup>11</sup> The Department considered, however, that it would have been very difficult to persuade HM Treasury why it was not using PFI, given the strong expectation across government at that time that PFI should be used for capital projects.<sup>12</sup> The Department's current practice is to now examine all the potential procurement routes, including PFI, to see which would be value for money.<sup>13</sup>

5. The Department did not assess whether PFI was value for money until ten years later in 2007, when it compared the AirTanker bid with a Public Sector Comparator.<sup>14</sup> The Public Sector Comparator was based on the costs of the Department buying conventionally either Airbus 330s or Boeing 767s as the aircraft and providing all the other services itself as well. However it would have been very difficult for the Department to afford a conventional procurement of this type and so neither comparator was a realistic alternative to the PFI option.<sup>15</sup>

6. The results of the comparator showed that the PFI option was not always the cheapest option depending on the level of risk being incorporated and discount factor rate being used.<sup>16</sup> The Department however judged the PFI option to be value for money based on the 6% discount factor and a number of other factors such as affordability and adverse

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5 Q 2

6 Qq 3 and 29

7 Qq 3, 114 and 187

8 Q 5; C&AG's Report, para 1.14

9 Q 5

10 Qq 67–75

11 Qq 2, 9, 18, 66, 171–172, 177 and 183

12 Qq 2, 4, 18, 66 and 183

13 Qq 18, 66 and 172

14 Qq 6–7 and 13–14

15 Qq 6, 14–15, 17, 38–39, 67, 160 and 177

16 Qq 12, 163, 178–182

operational implications.<sup>17</sup> Since 2004, the HM Treasury discount factor has been set at 3.5% for these circumstances. However as the project had begun before the change in rate from 6% to 3.5% in 2004, the Department were allowed to continue using the 6% discount factor, following Treasury guidance.<sup>18</sup> The Department's own Chief Economic Advisor concluded that had the new discount rate been used, the PFI solution would have been uneconomical.<sup>19</sup>

7. Throughout the procurement process, the Department failed to develop a realistic alternative to the PFI solution. Whilst it did finally develop fallback plans in 2007, none of them were fully worked up to a mature level.<sup>20</sup> In their 2008 lessons learnt exercise, the Department identified the need for an alternative fallback strategy and to revisit it regularly as a procurement of this kind advances.<sup>21</sup>

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17 Q 16

18 Qq 8, 12, 162 and 181

19 Qq 5–6

20 Qq 9–10, 11, 67 and 176; C&AG's Report, para 1.25

21 Q 94

## 2 Shortcomings in the procurement process

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8. The National Audit Office was unable to conclude whether FSTA was value for money. At the outset, the Department entered into a deal which did not enable it to consider alternative procurement options. There were also a number of shortcomings in the management of the project.<sup>22</sup> The Department has recognised a number of these through three lessons learnt exercises completed in 2001, 2007 and 2010 and is confident that it will be able to better manage or mitigate these today. However we have raised these shortcomings in a number of previous reports, including our annual review of the Department's Major Projects.<sup>23</sup>

9. It took the Department almost ten years to reach contract signature from the initial assumption of PFI in 1997, as a result of the complexity of the deal.<sup>24</sup> The Department had originally expected that it would take less than half that time at three years, ten months and FSTA is now expected to come into service five and a half years late in October 2011, with the last aircraft not expected to come into service until August 2016.<sup>25</sup> The delay also caused the Department to incur hidden additional costs from needing to run on the current, ageing fleets, the increase in internal staff time and the longer use of external advisors during this period.<sup>26</sup>

10. The Department only received two bids in response to its Invitation to Tender in 2001, which meant that competition was limited. The Department then failed to make the most of what competitive tension there was by selecting AirTanker as the sole bidder in 2004. This was far too soon, given that the Department subsequently took four more years to negotiate the contract to signature.<sup>27</sup>

11. The Department did not have a clear understanding of the requirements at the start and significantly added to the project delays by not finalising requirements until close to the end of negotiations.<sup>28</sup> This failure to fix requirements quickly is a common problem across the Department's equipment procurement activity and the Department is now seeking to define requirements as early as possible, and to discourage subsequent changes, as part of the Defence Acquisition Reform Programme.<sup>29</sup>

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22 Qq 161 and 176–177

23 Qq 88, 94 and 162; C&AG's Report, para 1.5

24 Qq 102–103, 106 and 108

25 C&AG's Report, para 1.19

26 Q 103; C&AG's Report, para 2.1

27 Q 176; C&AG's Report, para 1.10, Figure 3

28 Qq 3 and 114; C&AG's Report, paras 1.20 and 1.21

29 Qq 114–115

## 3 The risks in the transition from the current fleets

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12. Currently, FSTA is unable to fly into Afghanistan as it does not have the necessary protection equipment to fly into high threat environments.<sup>30</sup> The United Kingdom started operations in Afghanistan in 2001, when the requirements for FSTA were still immature. However the Department did not recognise the need for such equipment until 2006 in their Concept of Use document for FSTA and took the decision not to include it in the contract negotiations to avoid further delays, given the advanced stage negotiations were already at. The Department's explanation for the delay in recognising such a need was the significant difference in operational conditions between 2001 and 2006, in particular the scale of the challenge in Afghanistan.<sup>31</sup>

13. However, four years after this recognition, the Department has still not yet decided whether it will install this equipment on FSTA, citing that the need for FSTA to fly into high threat environment is not completely self-evident.<sup>32</sup> The Department has also only indicative costs from AirTanker over how much the modification work would cost and no funds have been ring-fenced for such work. Given the proximity of the forthcoming Strategic Defence and Security Review, the Department is now awaiting the outcome to see if it concludes there is such a need and what funding will be available before making a final judgement.<sup>33</sup>

14. Furthermore if the Department does decide to install this equipment, these are not quick modifications to make. On security grounds the Department did not wish to provide a clear indication of the time it might take, but estimated that a modification developed from scratch would typically take at least two years.<sup>34</sup> In the meantime, the Department is extending the life of the Tristar to allow it to fly into high threat environments, such as Afghanistan, up to 2016 and at a cost of £23.5 million.<sup>35</sup> Until a decision is made to install this equipment, FSTA will not be able to replace the Tristar fleet in its current role of flying personnel in and out of Afghanistan.<sup>36</sup>

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30 Qq 97–98

31 Qq 118–119; C&AG's Report, para 3.3

32 Qq 116 and 125

33 Qq 124–125 and 127

34 Qq 126–127

35 C&AG's Report, paras 2.1 and 3.5

36 Q 190

## 4 Availability of cost data

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15. The Department failed to obtain visibility of the costs of the subcontractors, in particular costs of EADS as the aircraft supplier.<sup>37</sup> AirTanker Limited is a consortium of five companies, including EADS, who are also sub-contractors to AirTanker.<sup>38</sup> This lack of cost visibility meant that the Department was unable to determine whether it was paying an appropriate level of profit margin compared to the level of risk being transferred, and therefore whether EADS was making excessive profits. The lack of cost visibility caused difficulties during contract negotiations and the Department has since put in place a policy of introducing mechanisms within bidder documentation to ensure transparency of all costs. However there are commercial limitations that currently prevent the Department from achieving full transparency.<sup>39</sup>

16. The Department did not have sufficient data on the full costs of the current air transport and air-to-air refuelling fleets. It could not, therefore, perform a like for like comparison with the services being provided by AirTanker under the deal, and so could not properly assess value for money. The Department explained this lack of comparison on the grounds that it is very difficult to compare the costs of purchasing aircraft now 30 to 40 years old against a PFI deal that provides the aircraft as a service. Nonetheless the National Audit Office was also unable to perform such a comparison because the Department could not split out costs necessary to inform a robust estimate.<sup>40</sup>

17. It is expected that the forthcoming Strategic Defence and Security Review will affect how much the Department will require the use of FSTA in the future. The contract does have flexibility to deal with some changes in requirement without the Department necessarily incurring penalty costs but a significant change in the requirement would trigger a review of the payment levels.<sup>41</sup> Past experience from other PFI projects suggests that significant changes after contract signature would cost more to implement compared to a conventional procurement.<sup>42</sup>

18. The Department was not clear as to the likely cost of changes as the complexity of the deal means that determining the cost of variations to the usage levels and other more significant changes is not straightforward. Nevertheless, we would have expected the Department to have made some estimates based on the impact of possible outcomes of the Strategic Defence and Security Review.<sup>43</sup>

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37 Qq 82 and 86

38 C&AG's Report, Figure 2

39 Qq 81–86

40 Qq 152–161

41 Qq 19–21, 62 and 146–147; C&AG's Report, Figure 13

42 Q 89

43 Qq 63–65

## 5 How the deal was managed

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19. The Department failed to properly resource its project team with the appropriate experience until late into the procurement, in particular around PFI.<sup>44</sup> Instead, to compensate for this lack of experience, it relied extensively on external consultants to assist the project team at a cost of £27 million. Later the Department also brought in its own specialist unit on PFI, the Private Finance Unit, when it was created in 2005.<sup>45</sup> The Department subsequently identified the creation of the Private Finance Unit as being a key way of avoiding the shortfalls in procuring FSTA in the future. Despite its importance, the Private Finance Unit is small, with a complement of only nine staff currently, and its role is primarily focused on providing assurance to senior management and advice to project teams rather than managing the contracts themselves.<sup>46</sup>

20. Both we and the National Audit Office have raised in a number of previous reports the need for better commercial skills across the Department and more widely across the whole of Government. The Department has been working to develop greater financial project management skills in their procurement teams and there are visible outputs to confirm improvements.<sup>47</sup> Building up commercial skills however is more difficult given the market competition for such skills, but the Department is taking steps to improve this and it now has more staff who are confident to work in this area.<sup>48</sup>

21. The broad scope of the contract means that a wider range of Departmental staff and RAF personnel will be involved with FSTA than for a conventional procurement.<sup>49</sup> To ensure effective management of FSTA when it comes into service, the Department will need to educate all staff engaged in the workings of the contract. In particular, all staff will need to be fully aware of the financial implications of any decisions they make to prevent the Department from paying more than it needs to, a necessary task given the complex nature of the contract arrangements.<sup>50</sup> The continuity of such knowledge was also significantly lacking during the early stages of the procurement, an issue the Department has since recognised. The Department is now taking steps to improve staff and knowledge continuity across Defence procurement and particularly for the management of this contract going forward.<sup>51</sup>

22. The project team had frequent changes of leadership, with four different project team leaders in as many years, between 2000 and 2004.<sup>52</sup> The typical tenure for a project team leader is now 3–4 years which the Department accepts is still not long enough.<sup>53</sup> There is

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44 Qq 89 and 176

45 Q 80; C&AG's Report, para 1.27

46 Qq 76–80 and 87–88

47 Qq 95 and 142

48 Qq 141–142

49 C&AG's Report, para 3.15

50 Qq 89, 95 and 189

51 Qq 88 and 177

52 Qq 143 and 176; C&AG's Report, para 1.26

53 Q 90

also a particular problem with military staff in project teams, since they are usually only in post for a few years. Whilst the Department is addressing this issue, it is taking time.<sup>54</sup>

23. The Department did not appoint a Senior Responsible Owner (SRO) for the project until 2007, ten years after the start of the project, and the Department could offer no mitigating reason for this.<sup>55</sup> This is despite the fact that we raised the need for such a single accountable owner in previous work in 2003 and again in 2007.<sup>56</sup> The Department's major programmes, defined on the basis of scale and complexity, all now have such appointments. The number of projects it runs prevents the Department from appointing an SRO for all of them, but instead it ensures that all projects at least have a single point of responsibility in the spirit of the concept.<sup>57</sup>

24. The Department's view of the SRO concept is that there should be someone who is well enough placed within the organisation to have an overview of all the connected elements of the project and to have influence over them.<sup>58</sup> It was not clear however how the Department will ensure this will lead to the active management and leadership necessary to manage projects effectively.<sup>59</sup>

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54 Qq 91 and 104–105

55 Q 143

56 Qq 128–129 and 143; Committee of Public Accounts, Forty-sixth Report of Session 2002–03, *Building an Air Manoeuvre Capability—The Introduction of the Apache Helicopter*, HC 533, and Fourteenth Report of Session 2006–07, *Delivering digital tactical communications through the Bowman CIP programme*, HC 358.

57 Qq 92, 93, 129 and 134–140

58 Q 144

59 Q 145

# Formal Minutes

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**Wednesday 8 September 2010**

Members present:

Rt Hon Margaret Hodge, in the Chair

Mr Richard Bacon

Stephen Barclay

Jackie Doyle-Price

Matthew Hancock

Chris Heaton-Harris

Joseph Johnson

Rt Hon Mrs Anne McGuire

Mr Austin Mitchell

Nick Smith

Ian Swales

James Wharton

Draft Report (*Delivering Multi-Role Tanker Aircraft Capability*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 24 read and agreed to.

Conclusions and recommendations 1 to 9 read and agreed to.

*Resolved*, That the Report be the Second Report of the Committee to the House.

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

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

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

[Adjourned till Tuesday 14 September at 9.30 am

## Witnesses

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**Monday 26 July 2010**

*Page*

**Sir Bill Jeffrey KCB**, Permanent Under-Secretary, **Vice-Admiral Paul Lambert CB**, Deputy Chief of Defence Staff (Capability) and **Mr Tim Rowntree**, Director, Air Support in Defence Equipment and Support, Ministry of Defence

Ev 1

## List of written evidence

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- 1 Ministry of Defence
- 2 HM Treasury

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## List of Reports from the Committee during the current Parliament

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First Report	Support to incapacity benefits claimants through Pathways to Work	HC 404
Second Report	Delivery Multi-Role Tanker Aircraft Capability	HC 425

# Oral evidence

## Taken before the Committee of Public Accounts on Monday 26 July 2010

Members present

Margaret Hodge, in the Chair

Mr Richard Bacon  
Stephen Barclay  
Jackie Doyle-Price  
Matthew Hancock  
Chris Heaton-Harris

Eric Joyce  
Mrs Anne McGuire  
Ian Swales  
James Wharton

**Mr Amyas Morse**, Comptroller and Auditor General, **Gabrielle Cohen**, Assistant Auditor General, and **Mr Tim Banfield**, National Audit Office, gave evidence.

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

### REPORT BY THE COMPTROLLER AND AUDITOR GENERAL DELIVERING MULTI-ROLE TANKER AIRCRAFT CAPABILITY [HC 433]

*Witnesses:* **Sir Bill Jeffrey KCB**, Permanent Under-Secretary, **Vice-Admiral Paul Lambert CB**, Deputy Chief of Defence Staff (Capability) and **Mr Tim Rowntree**, Director, Air Support in Defence Equipment and Support, Ministry of Defence, gave evidence.

**Q1 Chair:** Welcome to all of you. This is a new Committee. I think probably Richard Bacon is the only Member of the Committee you will know.

**Sir Bill Jeffrey:** We know Mr Bacon.

**Mr Bacon:** And I know you!

**Q2 Chair:** Welcome. I have not met you before so I am very pleased to welcome you. I gather we will be doing quite a lot of business together so I hope that we can come out with some constructive findings from our various inquiries into value for money. We are considering today the FSTA tanker. If I may, may I start the first question, which is, looking at this from my experience of government, I was amazed really that you went down the route of a PFI for defence equipment. No other country uses PFI as a way of funding for defence equipment but you decided to do so. Why?

**Sir Bill Jeffrey:** I think if I may say so, Chair, that is at the root of this Report and this issue. To answer the question I think one needs to go back to the point at which the key decisions were being taken around this project, which was the late 1990s, around about 2000. The principal criticism of the NAO is that at that point we did not examine sufficiently alternative means by which we could have procured this capability. The point I would make is that was in fact the high point of the PFI and there was a very strong presumption across government that PFI would be used.

**Q3 Chair:** Let me come back to you on that because of course I know there was a strong presumption and I can see why there was a presumption for PFI in schools, hospitals, offices, roads and things like that where you can do a pretty clear specification, but it seems to me in this instance when you were

obviously unclear about the specification that going down the PFI route was bound to lead you into trouble. This is completely different from schools and hospitals. There must be a reason why no other country employs this financing mechanism for defence equipment.

**Sir Bill Jeffrey:** I accept that analysis. Personally, looking back at this in preparation for this hearing, I would say that this project in terms of complexity and scale was certainly at the limits of what one could expect to do through the PFI.

**Q4 Chair:** Within the limits or without the limits?

**Sir Bill Jeffrey:** It is a matter for judgment. One has to bear in mind that at the time when the key decisions were taken on this, for example, I was elsewhere in government at the time, I was not in the Ministry of Defence, but I remember how it felt. It felt, for example, that the Treasury would be, to put it no higher, extremely reluctant to allow capital funding for projects that might be done through the PFI.

**Q5 Chair:** But in 2004 and 2007 there were two reviews which suggested that you were getting advice to abandon PFI. In 2004 the project team recommended abandoning it. In 2007 the Chief Economic Adviser found it uneconomic with this rather odd discount rate. There were two clear points when you could have said, "PFI is a nonsense, we will go down the conventional purchase route".

**Sir Bill Jeffrey:** By 2004 we were well down the track. There was a point at which the project team themselves said they doubted this could be delivered. The view was taken by the Chief of Defence Procurement at the time on the advice of our senior commercial advisers that this was not the final and

best offer from the consortium and, therefore, in a way that I think the NAO finds creditable we went back and got a better deal.

**Q6 Chair:** You never, ever had a Comparator to go against. Whenever it was—1998—you decided PFI but you never thought of another procurement method. It just seems potty. No other country does it. You get 2004 advice not to do it, you get 2007 advice not to do it, and you bang on with it.

**Sir Bill Jeffrey:** The technique one needs to apply in making a judgment on whether a project like this represents value for money is to analyse it by reference to the Public Sector Comparator. We did that. We compared it with the cost of providing the service, by procuring either Airbus 330s or Boeing 767s, and managing them ourselves.

**Q7 Chair:** When did you do that?

**Sir Bill Jeffrey:** This was the Public Sector Comparator which is referred to in paragraph 1.16, figure 4, at the point of final decision. At that stage, with respect, I do not think it is fair to say that it was found to be poor value for money.

**Q8 Chair:** Because of the discount?

**Sir Bill Jeffrey:** It depends on which discount factor one takes. It was perfectly well established and, indeed, Treasury policy at the time that if there was a change in the discount factor from the point at which a competition was initiated then one—

**Q9 Chair:** But you never did an evaluation of an alternative way of purchasing this plane.

**Sir Bill Jeffrey:** We developed fallbacks latterly but the criticism that I accept entirely, and it is at the root of the NAO Report, is that at the very beginning alternative procurement options were—

**Q10 Chair:** When did you develop an alternative?

**Sir Bill Jeffrey:** We looked at fallback certainly in 2007 and I think a little earlier.

**Q11 Chair:** That is not clear to me. Were there alternatives?

**Mr Banfield:** Yes, in 2007.

**Q12 Matthew Hancock:** Can I just come in on that. In paragraph eight on page six in the summary it is very clear that the conventional Treasury discount rate would have rendered this project unaffordable or the use of PFI unaffordable. If I use the phrasing in here, “It should not go ahead”. But then the recommendation based on the alternative Treasury discount rate was based on a value for money judgment against the Comparator using the agreed discount factor, which is the unusual one, on the A330 aircraft, “. . . together with affordability issues and the adverse operational implications of adopting an alternative procurement route at such a late stage”. So seven years after starting out, when you finally did the Public Sector Comparator, one of the reasons that the PFI was value for money was that the alternative was very expensive but of course

it was more expensive because you were seven years into the project. Would you be able to comment on that?

**Sir Bill Jeffrey:** At the heart of this is the comparison in figure four of the Report. We did actually look not just at the 6% discount rate but at the 3.5% that it had recently been changed to, and we looked at two levels of confidence of delivery, 50% and 90%. The significance of these is they are the way in which we assess the likelihood that a particular cost will materialise. On only one of these eight comparisons did the PFI deal come out poorer than the Public Sector Comparator, and that was where one assumed that we acquired Airbus 330s and took as the basis for comparison the 50% confidence level.

**Q13 Matthew Hancock:** Could you confirm this was done in 2007.

**Sir Bill Jeffrey:** It was, yes.

**Q14 Matthew Hancock:** So the Public Sector Comparator in this includes affordability issues and the adverse operational impact of adopting an alternative procurement route at that late stage?

**Sir Bill Jeffrey:** It was a comparison of the cost that we knew at that stage a PFI deal would entail with the cost of providing an equivalent service ourselves. Had we decided that it did not represent value for money indeed we would have had to address very difficult issues of affordability and alternatives.

**Q15 Matthew Hancock:** Of course, but this is a question of whether you tried to change it at that late stage. Is it true that the Public Sector Comparator line there, the 2.49, 2.73, et cetera, includes the cost of the fact that you were making this comparison at a late stage?

**Sir Bill Jeffrey:** No, it does not. It is a straight comparison between what we had established the PFI deal would cost us and what it would cost to provide the service ourselves.

**Q16 Matthew Hancock:** So are you saying that paragraph eight is wrong because it says that the comparator included “. . . the affordability issues and the adverse operational implications of adopting an alternative route at such a late stage”, which is referring to the 2007 comparison which you just said is the comparison represented in figure four?

**Sir Bill Jeffrey:** I think what that sentence says is: “This recommendation was based on a value for money judgment against a Comparator using the agreed 6% discount factor and an A330 aircraft, together with . . .” Undoubtedly in reaching the final decision we did factor in affordability issues and adverse operational implications. I do bring you back to figure four.

**Q17 Matthew Hancock:** I cannot understand because that says, as you just read out, the Comparator includes the fact it is obviously more expensive to change financing horses seven years into a project than at the start of it and yet you have

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told me the Public Sector Comparator line does not include the fact that it is more expensive to change procurement methods at a late stage.

**Sir Bill Jeffrey:** I think the operative word in this sentence is “recommendation”. The recommendation that was accepted was that we should go ahead with this on the basis of a comparison with the Public Sector Comparator and also taking into account the fact that had we decided that it did not represent value for money, as we might well have done, we had a very difficult issue of affordability and changing horses in midstream to face.

**Q18 Matthew Hancock:** Exactly. So had you made the judgment against the Public Sector Comparator at the start it would not have included the adverse operational implications. Do you think there is a chance that you might not have gone down the PFI route if you had done that comparison at the start?

**Sir Bill Jeffrey:** That is why I said a little earlier I think it is entirely fair to say, as the NAO do, that at the very beginning of all this alternative procurement routes should have been examined more than they were. I think it has got a lot to do with the climate in which PFI was being pushed at the time. Our current practice would be to examine all the potential procurement routes and to explore the PFI only if it appeared to be an approach that would provide better value for money.

**Q19 Chair:** Could the PFI cope with any changes that could come out of the Defence Review?

**Sir Bill Jeffrey:** Could this project cope?

**Q20 Chair:** Could this PFI cope with any changes?

**Sir Bill Jeffrey:** Tim Rowntree might want to respond to that. We believe it could.

**Mr Rowntree:** Yes, the contract has flexibility to vary the output rate of hours from the expected rate of about 18,000 hours a year down to 9,000 hours.

**Q21 Chair:** Without a penalty clause?

**Mr Rowntree:** There is no penalty clause although the cost per flying hour would increase because you are utilising the asset less vigorously and, therefore, there is a cost model which actually changes, so it is less value for money to use an asset less actively.

**Q22 Chair:** The cost would go up by what?

**Mr Rowntree:** That would apply to the capital programme. If we had bought the A330s and used them less than we planned that would also cost more per flying hour.

**Q23 Mr Bacon:** Mr Rowntree, how much would it have cost you to have just bought the A330s?

**Mr Rowntree:** The capital cost element of the contract is £2.6 billion and I think that is the number that is in the NAO Report.

**Q24 Mr Bacon:** That is for how many aircraft? How much is one aircraft?

**Mr Rowntree:** On the cost model it is around about £150 million including the air-to-air refuelling capability that is added on.

**Q25 Mr Bacon:** £150 million?

**Mr Rowntree:** Yes.

**Q26 Mr Bacon:** £150 million for somewhere between nine and 14 aircraft, is that right?

**Mr Rowntree:** Yes.

**Q27 Mr Bacon:** So £900 million plus £450 million, it is about £1.35 billion up to—I do not know my 14 times table. Basically you are saying £150 million times 14 gives you £2.1 billion, £150 million times nine gives you—

**Mr Rowntree:** Do not forget that—

**Q28 Mr Bacon:** I have not forgotten anything, I have not come on to it. You are saying that the capital cost per aircraft at £150 million, including the refuelling capability, gives you £150 million times nine aircraft which would give you £1.35 billion and times 14 aircraft would give you £2.1 billion roughly, forgetting for the moment the cost of running them thereafter. Is that right?

**Mr Rowntree:** There are also infrastructure costs that include the training facilities, simulators, maintenance infrastructure. I do not think there is any controversy over the £2.6 billion cost of the capital.

**Sir Bill Jeffrey:** If one breaks down the total cost of the £10.4 billion, something in the order of £2.6 billion is the capital cost of the aircraft and the rest is attributable to financing costs and operating costs. The thing to bear in mind, as Mr Rowntree says, is we are acquiring an entire service here and in doing so transferring quite a substantial risk to the private sector.

**Q29 Chair:** What risk?

**Mr Rowntree:** We have the risk of building the aircraft, integrating the military capabilities, which includes the control systems, the military communications, the air-to-air refuelling equipment itself, and delivering that on time. Beyond the actual acquisition programme, as you know in the complexity of defence programmes it is not unusual that we do have some cost growth and delays. We have passed all that risk to industry. Of course, once we have the aircraft then we pay only when the service is being delivered, so the risks of buying the spares, maintaining the aircraft, making sure they are available and serviceable at the moment we want to go and fly them is passed to industry. There is a service credit regime whereby the contractor is penalised if the availability of the aircraft is not ready when we need it to operate.

**Q30 Chair:** We will have to come back to your costs. You came to £2.3 billion, is that right?

**Mr Rowntree:** £2.639 I think.

**Q31 Mr Bacon:** That is including all the extra infrastructure costs and the capital costs.

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*Mr Rowntree:* Yes.

**Q32 Chair:** All the other infrastructure servicing costs—

*Mr Rowntree:* The operating costs come to £4.2 billion.

**Q33 Chair:** Over what period?

*Mr Rowntree:* Over the 27 years of the contract.

**Q34 Chair:** So 4.2 plus 2 point whatever and we are paying 12.3.

*Mr Rowntree:* We are paying £10.4 billion.

**Q35 Mr Bacon:** With the £60 million extra for fuel and stuff that comes to £12.3 billion, does it not?

**Chair:** £12.3 billion is the figure we have got in the report

*Mr Rowntree:* £12.3 billion is the cost of the entire programme. The contract cost is £10.4 billion. That is the cost of the deal with AirTanker.

**Q36 Chair:** The cost if we had bought it upfront is four whatever?

*Mr Rowntree:* The contract cost is £10.4 billion. If we break that down, that is £2.6 billion, £2.639 billion, capital costs and £4.2 billion to operate the service, which leaves £3.559 billion for the financing costs. If we had borrowed the money obviously that would not have been a zero cost element either.

**Q37 Matthew Hancock:** What would it have been?

*Mr Rowntree:* It would have been £2.6 billion. You could say that the cost of the risk we have transferred is around about a billion-ish. You could look at it that way but it is not a particularly accurate way of looking at it.

**Q38 Chair:** Two questions arise for me out of that. Sir Bill, I think you said right at the beginning you had assumed this was off-balance sheet, that at an early stage you took this off-balance sheet, so you could never have afforded to bring it back on-balance sheet, you would have had to knock something else out.

*Sir Bill Jeffrey:* We would have had to knock something else out, yes.

**Q39 Chair:** So you never had a choice really if you wanted this.

*Sir Bill Jeffrey:* I know this Committee wants to learn lessons from these sorts of events. One of the features of the PFI is that it does present the issue that if at any stage down the track you decide not to go ahead with it you are aware these things are off-balance sheet and you are faced immediately with a substantial issue of affordability.

**Q40 Mr Bacon:** You said the financing cost was £3.559 billion. What is the financing cost for AirTanker? They are going out into the market and borrowing this money, are they not?

*Mr Rowntree:* Yes.

**Q41 Mr Bacon:** What are they having to pay?

*Mr Rowntree:* I do not have those exact figures. That cost model is transparent.

*Sir Bill Jeffrey:* We ought to be able to provide the Committee with a note.<sup>1</sup>

**Q42 Mr Bacon:** If it is transparent you should be able to tell me that, should you not? I do not really want a note, I would like the answer now. It is £390 million a year, is it not? That is the annual unitary charge in effect.

*Mr Rowntree:* At the expected usage rate of 18,000 hours, yes.

**Q43 Mr Bacon:** £390 million a year. How much of that £390 million is the annual cost of running the planes?

*Mr Rowntree:* To AirTanker? The cost to the contractor of running the planes?

**Q44 Mr Bacon:** Yes. AirTanker is not going to spend 390 million on running the planes, are they?

*Mr Rowntree:* The cost will be £390 million less the cost of the—

**Q45 Mr Bacon:** That is what I am asking, how does the £390 million break down? You have just given us how the £10.4 billion breaks down. We have seen this many times before with different contracts. If you take the annual unitary charge you can split it up into different elements, most of which goes for the financing, some of which goes for the operations or the infrastructure or whatever, the different services that are often included. How do you break the £390 million down? What does it look like?

*Mr Rowntree:* I do not have those details with me but we can send you a note on that if you would like.<sup>2</sup>

**Q46 Mr Bacon:** I do not understand why not. Who is in charge of this contract?

*Mr Rowntree:* We are in charge of the contract.

**Mr Bacon:** Why would you not know something as basic as how the £390 million breaks down? It is quite basic, is it not?

**Chair:** It says in the Report £80 million for operating the service.

**Q47 Mr Bacon:** £80 million, is that right?

*Sir Bill Jeffrey:* It does, and I think that is a reasonable indication of what the actual running costs are. Again, one has to come back to the fact that what one is acquiring, apart from the staff and other costs that are mentioned at the beginning of the Report, is not nine or even a dozen aircraft, it is an entire defence capability, and what has been charged into these figures are the operating costs and, indeed, the sunk costs of the infrastructure.

**Q48 Mr Bacon:** Financing the profit, the capital cost. I am grateful to the Chairman for pointing that out. The answer to my question, which Mr

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<sup>1</sup> This answer is classified.

<sup>2</sup> Ev 21

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Rowntree was unable to give me, is £80 million leaving £310 million to cover financing, profit and the capital cost of the project. How does the £310 million break down into those three things? How much of the £310 million is financing, how much is profit and how much is capital cost?

**Mr Rowntree:** I do not know. I do not have it with me.<sup>3</sup>

**Q49 Chair:** Can we have that before we do our report?

**Mr Rowntree:** Of course.<sup>4</sup>

**Q50 Matthew Hancock:** The two financing costs that you gave, the first is that the public sector financing costs are £2.6 billion as in a non-PFI and £3.55 billion of the PFI funding costs. You are going to provide us with the figure of the external financing costs of the contractor. Do you have those in percentage terms as well? At what rate is the £2.6 billion? When you borrow money you borrow it at an interest rate.

**Mr Rowntree:** Yes. We can give you that.<sup>5</sup>

**Q51 Matthew Hancock:** You do not have those figures?

**Mr Rowntree:** I might do. Give me a moment.

**Sir Bill Jeffrey:** I think we ought to offer the Committee a note.<sup>6</sup>

**Q52 Matthew Hancock:** Looking at those two raw figures, the two that you have been able to give me, it appears that the risk premium is approximately two-fifths of the total cost of the financing.

**Mr Rowntree:** Sorry, how would you derive a risk figure from—

**Q53 Matthew Hancock:** I subtracted 2.6 from 3.55 and divided by 2.6 because that is the element over and above the public sector cost.

**Mr Rowntree:** I am sorry, I do not think that works.

**Q54 Matthew Hancock:** Do you not understand how a risk premium works? The 2.6 is the risk-free rate to borrow this amount because that is the rate at which you could have borrowed in the public sector. You paid £3.55 billion. Lots of people will be asking what the £950 million was spent on since you did not get anything in return, what you got was a risk transfer.

**Mr Rowntree:** That is right.

**Q55 Matthew Hancock:** £950 million is a big whack on £2.6 billion.

**Mr Rowntree:** Over 27 years.

**Q56 Matthew Hancock:** It does not matter how many years it is over. As a proportion it is a very significant sum. I wanted to get into the question of whether that was a reasonable risk premium to pay on the borrowing, but since you do not have those figures in percentage terms could you—

**Sir Bill Jeffrey:** We concluded at the time that it was and, indeed, if you look to the relevant bits of the Report the NAO's conclusion is that the financing of this was done on a reasonable basis.

**Q57 Chair:** Can I ask Treasury at this point is this PFI deal acceptable to Treasury for defence equipment and is the risk factor, which is crudely 10%, an acceptable proportion of the overall contract?

**Mr Gallaher:** I think each PFI contract or deal has to be looked at on its own merits.<sup>7</sup>

**Q58 Chair:** That is not an answer. Is it acceptable to Treasury to have a defence procurement under PFI and is this proportion of the cost, about 10%, which is the risk factor, and it is probably more than that, acceptable to Treasury? Can you just answer yes or no.

**Mr Gallaher:** It would be disingenuous to give you a yes/no answer.

**Chair:** Will you write to us and provide an answer to both those questions: should we be going into PFI for defence equipment and is this element of additional cost because there is a so-called transfer of risk acceptable? I would like an answer from Treasury on that.<sup>8</sup>

**Q59 Eric Joyce:** I hope this is not too theological, it is just a general question about risk. The Chair asked earlier what would happen if the future Defence Review decided to use these things less and you said it would cost more per unit or per capita, whatever the term is. You said the reason for that was because the assets would be getting sweated less, but they are not our assets. I would accept that if it were the case that we had bought them and therefore we were sweating them less and then the cost apportioned per use would be our cost, but in this case they are not our assets. It occurs to me if they can use the assets doing something different why would we be paying more. I assume that they may be able to.

**Mr Rowntree:** Because we have a clause in the contract that means the assets are available as and when we need them.

**Q60 Eric Joyce:** So if they were using the assets to do something different would we then get a reduction?

**Mr Rowntree:** Certainly, on the five we have a third party revenue deal where that becomes part of the cost model so there is a benefit in third party usage.

**Q61 Ian Swales:** If the planes are not being used do AirTanker have an incentive to do that?

**Mr Rowntree:** Yes, they do. At our expected usage the contractor makes a loss of around 2% unless they are actually bringing in third party revenue.<sup>9</sup> That was part of the final negotiations of the deal to make sure that incentive was in there.

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<sup>7</sup> Ev 22

<sup>8</sup> Ev 22

<sup>9</sup> Note by Witness: CORRECTION This loss, at around 1.75%, would in fact apply if the contract were running at the guaranteed minimum usage rate of 9,000 hours, rather than the expected usage of 18,000 hours.

<sup>3</sup> Ev 21

<sup>4</sup> Ev 21

<sup>5</sup> This answer is classified.

<sup>6</sup> This answer is classified.

**Sir Bill Jeffrey:** The other thing that is relevant to the SDSR question is that there is within the deal an understanding that if there is any strategically significant change in our requirement there is a preset means by which we would address that with the contractors.

**Q62 Chair:** But pay for it as well because it would be a change in the spec.

**Sir Bill Jeffrey:** It is laid down already what the process we would follow would be. As Mr Rowntree has brought out, there is a good deal of flexibility at the moment in the contract and it does mean that we pay for what we use essentially.

**Q63 James Wharton:** My question is in respect of the annual cost in terms of hours. The Chairman asked the question earlier about the Strategic Defence Review and flexibility and perhaps we did not explore it as much as we could because the answer was, "Yes, we can reduce our hours, we have got flexibility", and you did not seem particularly concerned about that. I understand from the other statements and comments you have made that there are a number of factors, such as how much it can be leased out when it is not being used by the Ministry of Defence and so on if we are not using it, but I just wonder if you have any indicative idea. Let us say our 18,000 hours a year was reduced to 9,000 hours a year, what would the cost difference be? Is it still going to cost us £390 million? Are we going to pay twice as much per hour? To me that would not be flexibility, that would just be we are using it less but still paying for it.

**Mr Rowntree:** Clearly it costs us less. It is a complicated model.

**Q64 Chair:** You will give us an answer to if we halve the hours what the total cost would be and what the total cost per hour would become?

**Mr Rowntree:** Yes, that is quite straightforward.<sup>10</sup>

**Sir Bill Jeffrey:** The basic model is one on which the minimum usage level is 9,000 hours and at the moment we are using 25,000. In steadier circumstances than now we expect to use something like 18,000. The minimum level is well below current expectations of usage. The question which I do not think we have an immediate answer to is just how does the cost change as you get towards the 9,000.

**Q65 James Wharton:** It is more about the cost of that flexibility to us and how that will factor into that £390 million a year.

**Sir Bill Jeffrey:** It is undoubtedly the case that at lower levels of usage, notwithstanding the fact that the aircraft are available for other purposes, the cost does increase a bit.

**Chair:** We want to know how much.<sup>11</sup>

**Q66 Mrs McGuire:** Picking up on some of the Chairman's earlier questions, did the MoD feel that they were a bit of a guinea pig in pursuing PFI as an option for defence procurement?

**Sir Bill Jeffrey:** I do not know the answer to that question because I was not there at the time, and I know that is not for this Committee an excuse but it is an explanation. As I said earlier, my own sense of this from having been in government at the time was that the expectation was that PFI would be used as much as it could be and, therefore, there were very strong pressures to explore this route. I suspect these led to our not examining as closely as we might alternative methods of procurement. All I can say is that our approach now would be completely different, we would start by looking at the whole range of potential methods of procurement and within that we would see whether PFI makes value for money sense.

**Q67 Mrs McGuire:** Using your extensive knowledge gleaned over many years as a senior civil servant, would your assessment be that AirTanker would know that you had very few other options? Linking into the Chairman's question about not having a fallback position, would that not have made the negotiations really quite interesting from AirTanker's point of view perhaps knowing that the MoD did not have any other options? Certainly none that were worked up to any degree of flexibility.

**Sir Bill Jeffrey:** I think they would have known that had the deal collapsed at a later stage we would have had to consider some pretty unattractive courses. We would have had to find the money against other projects, as the Chairman said earlier, and we would certainly have had to contemplate how to meet the capability while we were doing so. I do come back to the fact that first of all on returning to AirTanker at a point when, let us not forget, they had invested a lot of money and effort into this and did not want it to collapse we did manage to get quite significant concessions from them that in our view, although I heard what the Committee was saying earlier, meant that on the basis of the figures in figure four we could actually stack this up against the Public Sector Comparator and conclude that it represented value for money.

**Q68 Mrs McGuire:** I would really be worried what the picture would have looked like without the concessions then if you are saying that we had significant concessions.

**Sir Bill Jeffrey:** If these concessions had not been made it would have collapsed. It was the knowledge that that was the case that enabled us, in my view, to extract from the consortium the many concessions that when we did the analysis did bring it within value for money as portrayed in figure four.

**Q69 Chair:** Which saved you what? What sort of percentage?

**Sir Bill Jeffrey:** It depends on which of the Comparators one takes.

**Q70 Chair:** You did this exercise, figure four, you then went back and negotiated and it enabled you to be tougher on the consortium. How much did you save percentage-wise on the whole contract?

<sup>10</sup> This answer is classified.

<sup>11</sup> This answer is classified.

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**Sir Bill Jeffrey:** As the Report brings out in paragraph 1.14 we certainly reduced the price to a figure below the Public Sector Comparator.

**Q71 Chair:** But how much?

**Sir Bill Jeffrey:** And they took on more risk.

**Q72 Chair:** How much?

**Mr Rowntree:** There was £230 million once we had closed the competition and then a further £100 million once we had got to preferred bidder.

**Q73 Chair:** £230 million on what figure because we are playing around with figures here? £230 million on what?

**Mr Rowntree:** £10.5 billion.

**Q74 Chair:** On the £10.4 or £10.5 billion?

**Mr Rowntree:** Yes. Small in percentage terms.

**Q75 Chair:** Tiny.

**Mr Rowntree:** Yes.

**Q76 Stephen Barclay:** Can I just return to the issue of costs around the AirTanker financing. Part of it perhaps is just the understanding from the Private Finance Unit itself and how on top of the game they were, but is it the case as of September 2009 there were just nine staff in the MoD's Private Finance Unit and 100 in the Media Department?

**Mr Rowntree:** I have no idea.

**Q77 Stephen Barclay:** How many staff are there in the Private Finance Unit?

**Sir Bill Jeffrey:** I think it is more than nine. I do not have the figure in front of me. It is a unit which is very significant in the life of the Department.

**Q78 Chair:** I think you do have the figure. It is in here somewhere. Tim, can you help us?

**Mr Banfield:** The exact number of people in the PFU is not in the Report itself.

**Q79 Stephen Barclay:** You checked it this morning?

**Mr Banfield:** Yes. The last figure that we could find was nine.

**Q80 Stephen Barclay:** Just for a contract of this size, the biggest the MoD has on PFI given that the MoD has 50 PFI contracts underway, coming back to Mr Bacon's point around the AirTanker financing costs and whether there is clarity on that, I am trying to get a handle on how many people there are in the Finance Unit looking at this.

**Sir Bill Jeffrey:** I will check the figure.<sup>12</sup> You are right, it is a small unit. It is a highly specialised unit at the centre of the Department. It is not managing these contracts. What it is doing is providing assurance for our Investment Approvals Board and, indeed, the Treasury about the methodology that has been applied in pursuing them and also significantly providing advice of a fairly high quality, professional financial kind to those who are doing this work.

**Q81 Stephen Barclay:** Related to that, could we just have a look at the subcontractor costs. One thing I was a little unclear on is whether as part of the lessons learned you feel that the subcontractor costs will be the same between competitive and non-competitive tenders moving forward.

**Mr Rowntree:** How do you mean the same?

**Q82 Stephen Barclay:** I was reading appendix two, which is the final page of the Report, which says, "Lessons have been learned since FSTA and subsequent deals have introduced mechanisms within bidder documentation to ensure transparency of all costs".

**Sir Bill Jeffrey:** The point here is the Report draws attention to the fact that despite trying, although we had full visibility and have full visibility of AirTanker's internal costs, profit margins and all the rest, we were not able to have access to EADS' cost information on a similar basis. I think we concluded after a lot of negotiation, some at the highest level with EADS, that we had a straight choice between walking away or not doing so and concluded it was better to stick with it. What appendix two is saying is that in future, and indeed at present if the situation arose, we would be trying to inject into the invitation to tender documentation a requirement of full visibility, not just of subcontractors' costs but of prime costs as well.

**Q83 Stephen Barclay:** Is that realistic, Sir Bill, to say you will have full visibility of subcontractors' costs? In his evidence to me last week Sir Leigh Lewis, who is a very distinguished Permanent Secretary, said in answer to question 171, when I asked, "Did you have complete line of sight over all subcontractors", this was obviously on a DWP project, he said, "No, we did not because our primary line of sight is the primary contractor and we do not pursue right down the subcontracting chain". When I pressed him as to whether this was possible he said, "If you reach a contract with a prime provider in which you are holding the prime provider accountable for everything that is delivered in their name for what you are paying you are entitled, I think, to hold them to account for everything which is done by them". That just seems at odds with what you have put in appendix two, that you will have transparency over all costs for subcontractors.

**Mr Rowntree:** I think what we are saying there is that it will be our policy to try and get in and do that deal if we can.

**Q84 Mr Bacon:** It does not say that, if I may interrupt you. It says "to ensure". It does not say, "We will do it if we can". It does not say, "We will have transparency of all costs if we can", it says, "to ensure the transparency of all costs", does it not? We are still on page 38.

**Sir Bill Jeffrey:** Yes.

**Q85 Mr Bacon:** Presumably that means what it says, does it not?

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**Sir Bill Jeffrey:** Subject to the point that has been made about what is commercially feasible in any particular negotiation. The odd thing about this case—

**Q86 Chair:** You cannot face both ways in this. I do not know how many contracts you are running at the moment—about 50—but in all those contracts are you now ensuring transparency of all subcontractor costs, yes or no?

**Sir Bill Jeffrey:** I would be surprised if we were, frankly, but the aspiration is to avoid getting into the position that we did in this case where we had not addressed the issue of visibility, not so much of the subcontractors' costs but the supplier of the aircraft's cost, and therefore got into difficulties when we came to negotiate the contract.

**Chair:** I think you need to let us know how many you think you have got it on out of your 50, if that is not too big a task, so that we know to what extent you are responding to your own policy.<sup>13</sup>

**Q87 Stephen Barclay:** If the fast jets are cut then presumably the nine-person unit and the contract relationship managers as part of the very complex management of this contract will have to have even more understanding of the subcontractors' costs?

**Mr Rowntree:** Yes. I would not want the Committee to go away with the impression that we have nine people working on PFI contracts.

**Q88 Stephen Barclay:** I did not say that. But appendix two, with respect, in a number of sections, not just on the issues, says, "The Private Finance Unit is a centre of expertise." and under estimation of project complexity it says it is the Private Finance Unit that was established in February 2005, which was when you came onboard pretty much as Permanent Secretary. On the first one, lack of analysis of alternative procurement, it is the Private Finance Unit that is cited again. That suggests that the Private Finance Unit is central to the management of these contracts.

**Sir Bill Jeffrey:** It is central to the assurance of them on the part of senior management and it is central to giving advice to those who are managing the contracts, but there are substantially more people who are actually managing the contracts. The noticeable thing about this Report is that when it comes on to the future looking aspects of the matter it acknowledges that in particular we are taking sensible steps to address continuity of knowledge and staffing, but the complexity of the project demands that we have learned lessons and put in place the best organisational arrangements to manage the transition to FSTA. I think we are in a stronger position than our predecessors probably were to manage changes in the operation of this contract as we go forward. What is entirely clear from this Report is that it is a complicated contract and we will need the skills commercially and financially to manage it effectively.

**Q89 Chris Heaton-Harris:** You mentioned the complex nature of the contract and the summary of this Report made fantastic reading for you because it talks about the poor project resourcing and governance, that until 2004 the project team had insufficient staff with PFI experience and your Department did not appoint a Senior Responsible Owner until January 2007. I got from how you opened up that you are not fantastically comfortable with what went on pre-2007 in the way that this PFI was managed. I cannot say some of the answers have given me fantastic confidence that the PFI team that you have established in your finance team will be able to manage such a complex contract. How can you give me the assurance that future changes to this project will not be similar to other PFI projects where if you go against conventional procurement you have less cost against PFIs? How can you give me the assurance that you are going to manage this from this point onwards in a much better way than it has been managed up to now?

**Sir Bill Jeffrey:** I would argue that it has been managed pretty well recently and the Report bears that judgment out. The Report, by the standards of these things, is almost glowing about the way in which the final deal was reached and the agility that we showed in reaching it.

**Q90 Chair:** Crumbs, we are worried if you say that. This is our first one and I think we were all a bit shocked.

**Sir Bill Jeffrey:** You can only judge as time passes, I am sure. I entirely take the point that managing this in the future will require deep skills and a degree of continuity and staffing which the MoD has not always achieved in the past. What we are now consistently achieving is continuity of staffing. I asked before this session what the typical tenure of our project team leaders is and it is between three and four years, which in my view is not quite enough yet but it is a long way from the rapid fire changes in the early days of this project that this Report describes. I accept without reservation that we have got to work hard at the skills necessary to run this contract effectively in future, but it will be being run from within the project team, not centrally from the private finance unit.

**Q91 Stephen Barclay:** Can you be confident with military personnel, that they are going to be in post for so long? This has been running for so long and yet military personnel are usually in post for a couple of years.

**Sir Bill Jeffrey:** As Mr Bacon knows, this is an issue we have been working on over the last few years. We are gradually improving although because the military personnel system is as deliberate as it is, if I can put it neutrally, it is taking a bit of time. We are certainly moving to establish more of a cadre of military officers who choose to spend a large proportion of their career in acquisition. As a consequence of that it is becoming more common for key people in project teams with a military background to be there for significantly longer.

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**Q92 Chair:** Can I just ask you two questions on that particular point. In the Report somewhere, I do not quite know where, it says that this Committee did a Report in 2007 where it said you have got to have an SRO in place early on. That was three years ago. Have you taken that onboard? Is there an SRO in all of your projects now who is there consistently?

**Sir Bill Jeffrey:** There is an SRO in all of our major projects. There is an issue that I think is unique to the MoD, which is the sheer number of projects if you add them all up.

**Q93 Chair:** Maybe you are doing too much.

**Sir Bill Jeffrey:** On the smaller projects, the person doing the equivalent role to the Senior Responsible Owner is one of Admiral Lambert's staff in the capability area who is usually a military officer with background in the capability in question. One way or another the spirit of the Senior Responsible Owner requirement is being met.

**Q94 Chair:** At the beginning of 2008 you undertook a lessons learned project on this. I understand the Comptroller and Auditor General has not received a copy of the outcome of that. Can we have a copy of that?

**Sir Bill Jeffrey:** We can certainly provide a copy of that. The principal lessons will not be a surprise to this Committee having read this Report. They were around having an alternate fallback strategy and revisiting it regularly as a procurement of this kind advances, having an SRO for all our most serious projects, as we now do, and there was also a lesson around the use of a project funding responsibility matrix to manage the funding.

**Chair:** It would be very helpful to have a copy of that. Thank you very much.<sup>14</sup>

**Q95 James Wharton:** We have touched on the issue of having people in place for long enough to properly manage these sorts of contracts and obviously there is an issue that you are aware of there. What concerns me a bit is with a contract which I think we all acknowledge is very complex there are a number of different clauses and potentially additional charges which are going to be incurred and there are two points within that. Firstly, what steps are you taking to ensure that whoever has ultimate responsibility for making decisions is aware of the impact through the contract and the possible cost implications of those decisions, but also within that, and working in the environment that the Ministry of Defence has to, that at the same time decisions will not be unduly delayed because you are having to work through a very complicated contract and get approval at certain levels in order to manage it effectively? It seems to me particularly for the Ministry of Defence and the need to make rapid decisions in certain circumstances that a more flexible, more straightforward approach to procurement could deliver real benefits.

**Sir Bill Jeffrey:** I agree. I think a lot of this comes down to skills within the procurement function. That is the issue on which we have been working probably

hardest over the last few years building commercial financial project management skills because it is only by these means that one will get the grip on individual projects that you are asking for. In terms of time taken, sometimes it is about over-elaborate procurement processes. Certainly in recent years we have tried to simplify the scrutiny and assessment stage that all projects have to go through within the Department, although I would not want to overdo that as Accounting Officer because we need to examine all business propositions carefully. In this case, frankly, I think this took as long as it did because it was as complicated as it was. That is one of the weaknesses in the methodology.

**Q96 James Wharton:** That is an important point but it is slightly drifting away from where I would like to go, if I can redirect you a little bit. If I am working in the Ministry of Defence and I need to make an urgent change to one of these aircraft there are two factors: one is the cost impact of the change that I need to make or the use change that I need to make, and somebody needs to be able to make an assessment whether that is something you can afford to do, and also how long it is going to take to make that change and to go through that assessment process. What measures are in place to ensure sufficiently robust management structures are in place?

**Sir Bill Jeffrey:** I may not have followed you completely, Mr Wharton. What kind of changes are you postulating?

**James Wharton:** I do not presume to second-guess the type of change you might make.

**Q97 Chair:** At the moment this aircraft cannot go to Afghanistan as I read the paper. You might have to change it.

**Vice Admiral Lambert:** If I can start on this one. The Chair of the Programme Board, in effect the SRO, has the advice of all the owners of the various lines of development and he calls them together whenever they need to so the decision about it can be made reasonably quickly. Can this go to Afghanistan or not? The answer to the question might be we change our tactics and techniques and procedures rather than add additional equipment to it.

**Q98 Chair:** Yes, you can fly into Turkey and get another plane to fly them on, which seems potty to me.

**Vice Admiral Lambert:** It might well be. One can attack these problems from a variety of ways and the answer is not always to add additional equipment. It might be to change the way we operate them. It might be the way we support them. At the moment the tanker is capable of doing the tanking role in all of the circumstances. Whether it can go into the highest threat areas, we have got to look at the whole gambit of what aircraft we have got and see whether this is best suited for it.

**Q99 Ian Swales:** We keep talking about how complicated this is. Just suppose you needed these aircraft in a hurry, let us say a wartime situation or whatever, known airframes, air-to-air refuelling is

<sup>14</sup> This answer is classified.

not an exactly new idea. If you forget all the PFI complexity and so on, how fast do you believe you could have got these planes from the original decision?

**Sir Bill Jeffrey:** If we had decided to simply acquire these A330s ourselves it would have been some years.

**Q100 Chair:** How many years?

**Sir Bill Jeffrey:** I said some years, but then I was trying to avoid being quite so specific.

**Mr Rowntree:** It was not a question of just buying the A330, there was quite an extensive modification. I guess the best benchmark for that would be the Australian MRTT programme which is a similarly capable aircraft and we can find out the exact timelines on that and send that to you if that is of interest.

**Q101 Chair:** The exact cost?

**Mr Rowntree:** I cannot send you the exact cost because I am sure the Australian Government would find that quite a sensitive issue.

**Q102 Ian Swales:** The reason I ask the question is because trying to unpick where the complexity is in all this and why it took nine years, what the critical path was, if you like, you needed the aircraft in a hurry in some years but how many is “some years”?

**Sir Bill Jeffrey:** The complexity arises from the PFI process because one is not only acquiring aircraft from somewhere but—

**Q103 Ian Swales:** So in addition to the financial costs of the PFI process would it be right to say there are a lot of other hidden costs due to delay, staff time, advisers and so on beyond what appears to be the cost of PFI?

**Sir Bill Jeffrey:** I think it is the factor that led as much to delays to the extent that this project was delayed. It arises from the fact that if one is going to contract for a service, and there is quite a lot of experience of this elsewhere in terms of support for fast jets, for example, then one needs to be absolutely clear what the specification is and what the requirement is and there then need to be quite exhaustive discussions with the potential suppliers of the service about what will happen in what situation and what the terms of trade are. Given the complexity of this, the fact that it was not just aircraft, it was not just air-to-air refuelling, it did involve the building of substantial infrastructure in this country, et cetera, that was why this was so complicated. Nevertheless, it would have been quite complicated to provide it ourselves but I think probably less so.

**Q104 Eric Joyce:** I have two very quick points. This is on a point Sir Bill made and possibly for Admiral Lambert as well about expertise and developing longer periods of time, I guess, of military personnel or naval or air force personnel in situ. The counter-tension to that is I like to see military people commanding units in the field and naval people in boats and air force people in planes, so the more you develop a level of expertise and keep them there

longer the less they are doing the other stuff. Is there not a general focus there which tends to lead us towards using military personnel, Armed Forces personnel, less in that capacity much as the Grey Report has hinted?

**Sir Bill Jeffrey:** The Admiral may want to comment on that. I think we get benefit in the procurement function in particular but also in his central capability function from having service personnel who really understand about end use. It is also the case as a matter of fact that the country has a considerable resource in those officers of all three services who have chosen to—

**Q105 Eric Joyce:** I could not agree with that more, but if the calibration is towards having more expertise and having people do it longer then they are away from the field.

**Vice Admiral Lambert:** When it comes to project management it has to be the best person for the job. One has to weigh that up with how long they can do the particular task for. It will be one of the balances when CDM chooses whoever he wants running a particular programme.

**Q106 Chris Heaton-Harris:** Admiral, forgive me, I have just finished reading *Fisher's Face* about Admiral Jackie Fisher and I am looking at this Report at a nine year lead-in to 14 aircraft and wonder what he might have thought of that sort of lead-in for essential military equipment. We have all talked about the complexity of the contracts and have read some very interesting stuff about third party leasing or whatever. Who designed the project to make it so complex?

**Sir Bill Jeffrey:** In a sense it was the product of—

**Q107 Chris Heaton-Harris:** Was it MoD designed?

**Sir Bill Jeffrey:** The initial invitation to express interest and then to tender was designed by those managing the project at that stage within the Department.

**Q108 Chris Heaton-Harris:** The Department designed such a complex procedure and contract that it is very difficult to manage.

**Sir Bill Jeffrey:** It was not that the procedure was designed. Decisions were taken, as they normally would be, on the capability that was required and there was then an invitation to the market to make its best proposals. To an extent the detailed ramifications of that were then worked out through the subsequent negotiations between the Department and the various consortia who expressed interest and then eventually bid. The question that is an interesting one is whether the complexity that we ended up with through that process was inevitable or not.

**Vice Admiral Lambert:** When this started a series of operational analyses would have been conducted to see how many aircraft were needed for each circumstance. What you normally find is you need a lot of aeroplanes for very short periods of time and you need a few aeroplanes for most of the time. One can follow the logic which took us down that

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particular route, that somebody would come along and find a solution that paid for the aircraft when we were not using them. You get it with a lot of military equipment. You need to hold quite a lot of military equipment just in case. One can see that in the past somebody would have thought this was a good idea of using aircraft in the interim and that starts the complexity.

**Q109 Chris Heaton-Harris:** I have been very lucky, I have been to Brize Norton and flown on one of these air-to-air refuellers, an old Victor, and I saw there some C-17s. They were brought in because we had a gap in capability. Just looking at the gap in capability we have now, or potentially will have, why was that sort of option not considered? Is that a hideously expensive thing to rely on the assets of our partners?

**Vice Admiral Lambert:** I think at the time when we looked at the whole of the aircraft fleet that we required the FSTA would be coming in at about the right time. Do we need additional aircraft now? We have filled up some of the gaps, as you said, with C-17s.

**Q110 Chris Heaton-Harris:** The Report does tell us that 17% of planned air-to-air refuelling flights from Brize Norton were cancelled in 2008–09. That is a decent percentage, is it not?

**Vice Admiral Lambert:** It is, but it is all a matter of priorities and the priority at the moment is to ensure that we keep the logistic line to Afghanistan open. When we look at Afghanistan at its range and the fact that it is a landlocked country, et cetera, it is how many aircraft do we have to be able to do that again or do we want the flexibility to use those aircraft for other things.

**Q111 Chris Heaton-Harris:** Just on the C-17s, because I am fascinated by these huge beasts that can fly in the sky, how much do they cost us to fill in the gap?

**Mr Rowntree:** That is commercially sensitive but it is in the order of 200 million an aircraft very broadly.

**Q112 Chris Heaton-Harris:** I am just trying to make a comparison with what we are talking about now.

**Mr Rowntree:** For through life cost? I think we sent some questions in response to a parliamentary question recently and the per hour cost of the C-17 is I believe higher than that of the Future Tanker if you worked it on an equivalent basis. They are expensive aircraft.

**Sir Bill Jeffrey:** The C-17 is serving important purposes in theatre now. It is not, I would have thought, subject to the Admiral's views, best suited for this function partly because of its very scale.

**Q113 Chris Heaton-Harris:** I would not want to get involved in your procurement policy, but we have a short-term fill-in, as it were, with these C-17s and we have got problems in capability as it stands now because of—

**Vice Admiral Lambert:** I think you are absolutely right that quite a lot of our programmes in the past have taken too long. It is one of the things we are looking at within defence and within the acquisition reform part of defence as to whether we can reduce some of those timelines.

**Q114 Mrs McGuire:** I get a sense both from reading the Report and perhaps misinterpreting what the Admiral has said that the process for coming to a point where somebody says “Snap, that's what we want”, takes forever because it is about pulling together anyone that may have an interest in a particular embryonic idea and then the changes that need to be made as other people become involved. It is often said that when the Americans procure, and I hate to bring in another nation's activities in this way, they get to a point and they make a decision and that is what is ordered. The difficulty that we have had with the MoD in the past, and hopefully not in the future if what Sir Bill says is correct, is that as the opportunity for the spec to improve has been out there then that has been added on to the initial spec when the contract was originally thought of. Is that what happened there, that it was a case of, “We're not going to say ‘snap’ because there's always something better coming over the hill to make the shape of this contract” and I do not mean the shape of the aircraft, “a better one at the end”? I just get the feeling that at the beginning nobody quite knew what it looked like and nobody therefore could make any estimate of what it should cost as opposed to what it ultimately did cost. Am I being unfair?

**Sir Bill Jeffrey:** I think that is a fair reflection of what happened through this project, although to some extent the occasional changes in requirements were a function of the sheer time it was taking frankly. What we are trying to do now is to pin down requirements at as early a stage as possible and to be much more formal within the organisation about what happens when—

**Q115 Mrs McGuire:** And actually saying to the military people, “You've got a window here and if you don't get your bid in for how high this spec has got to be at 31 July 2010, tough, that's what we are going to order and that's what we are going to embark on as a project”.

**Sir Bill Jeffrey:** That is the spirit of the changes that we are introducing now that the Admiral referred to in the Acquisition Reform Programme that was established earlier this year. It includes what internally we are calling a terms of business agreement between the various players in procurement inside the Department, the central capability function, the frontline commanders and the procurement organisation itself, which makes it entirely clear what happens at each stage and if there are changes in requirements how they are to be proceeded with, with a very strong discouragement to change requirements after the point when they should have been fixed.

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**Q116 Chair:** Do I get from that that on this particular one we are considering now you are not going to change it to make it able to fly to Afghanistan?

**Sir Bill Jeffrey:** That is not yet decided.

**Q117 Chair:** So there are changes in requirements.

**Sir Bill Jeffrey:** The NAO Report concluded that we had taken the right approach to this in the sense that when it became clear that if we were to take these aircraft into theatre, and it had not initially been intended that they should be—and they were, let us remember, essentially and primarily an air-to-air refuelling capability as originally conceived—

**Q118 Chair:** Even when you conceived them we were in Afghanistan. You might have thought about it.

**Sir Bill Jeffrey:** But in very different conditions from the ones that are being experienced now. If you look at the Report, what the NAO says is that in 2007 when we addressed the question of whether to change the requirements it was right not to alter them at that stage because of the negotiations that were still continuing.

**Q119 Chair:** We went into Afghanistan in 2001, you started negotiations in 1999 and in my very simple way I just cannot see it.

**Vice Admiral Lambert:** We were not flying the levels into Kandahar and Bastion that we are now. In 2001 we had sufficient in the logistics chain. Making changes halfway through a programme is always a balance and it is whether you take that financial risk or the operational risk, and it is something we are considering at the moment.

**Sir Bill Jeffrey:** If I may, Chair. The move to what we describe as theatre entry standards for aircraft flying into theatre is a relatively recent development. It was in late 2006, early 2007 that the sheer scale of the challenge in Helmand in particular became evident because we had reinforced early in 2006 and then discovered just how challenging it was late in 2006. It is perhaps not surprising that the issue of whether to not just equip these aircraft with defensive aid suites, which they are, but add to that what is necessary to meet what are known as theatre entry standards did not really come into the frame until 2007 by which time we concluded it was better to leave it until later.

**Mr Morse:** Our conclusion was that at that stage in the programme that was a perfectly fair judgment to make. If I may, just one other thing, and I think Sir Bill has mentioned it several times but I am not sure if people are necessarily spotting it sufficiently clearly. The real point about a lot of the difficulty has been that it has been in such a crowded programme of other things competing for very limited amounts of money. When you draw a comparison with the Americans, the reason they just decide to do something and get on with it is because they are spending almost twice per capita the amount on defence that we are. We are in a position where we have got the whole defence community looking at the budget every year and wondering every time there is a cost increase what is going to happen. I am

not saying it in a combative way but that is the reality against which a programme like this runs. In long running programmes it does lead to people agonising over each phase in the programme because of the consequences of any decisions that they might make. I do not know if that is fair.

**Q120 Mrs McGuire:** Can I just clarify. The comparison that I drew with other countries, and it so happened I just used America and probably could have used other countries, was not about the size of the budget but was the point at which “snap” was called on any project.

**Mr Morse:** I agree.

**Q121 Mrs McGuire:** With the MoD, and frankly when I did the Armed Forces Parliamentary Scheme with the Navy, one of the criticisms that I heard from the boys and girls who were out there on the frontline at senior level was that everything took just so long because the spec kept rising as new technology became available and there was not a point where a line was drawn to say, “This is what we are going to do and then we can build on it once it is delivered”. That was the point I was making, not about the budget.

**Mr Morse:** I was offering that from my past experience there is some element of that perhaps but remember they are always struggling to stay within the budget and the two things interact and it is not possible to say which is which.

**Chair:** Every department struggles to stay within its budget and has to take sensible decisions to do so.

**Q122 Stephen Barclay:** Admiral, you drew the distinction, which I think is a fair distinction, between when the contract was signed, and the Report gives credit for the need to close the deal given where the final markets were, and now. Can I just turn to now given what we know of our commitments in Afghanistan. Do you have a complete understanding of what needs to be done with these planes in terms of equipping them for a high threat environment or is further research still required?

**Vice Admiral Lambert:** We have a complete understanding and we are assessing what we are going to do and will do that over the next few months.

**Q123 Stephen Barclay:** When you say “assessing”, do you know fully what the costs of these changes are going to be?

**Mr Rowntree:** We are in constant dialogue with the AirTanker consortium and we have proposals and are working through those. Obviously to get to a final cost which is of a fixed price kind of granularity is an advanced stage of the bidding process so one has to be sensible about the interchange between moving from indicative prices and then deciding which ones you want to absolutely finalise to move forward. What we are in at the moment is the interchange of indicative prices so that we can look at different options. I would say that the threat environment is a constantly evolving thing and,

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therefore, this is not possibly as simple as it looks around this table. Obviously we cannot share that with you because of security aspects.

**Q124 Stephen Barclay:** If the requirements are evolving and the cost depends on which options, first of all I come back to the original question: do you know exactly what it is you are going to need to change with these planes? Secondly, how have you got it fully budgeted for if you do not know what the costs are? Third, do you know how long those changes are going to cost given the huge pressures on the existing planes?

**Sir Bill Jeffrey:** The point to make here is that this is not about whether these aircraft should be fitted with defensive aids suites—they are—it is about the degree of protection and in particular whether one applies fuel tank inerting, which we have been doing with the fleet which flies into theatre for other purposes, the air transport fleet. The judgment about the cost of that, which I think we have some sense of although not in huge detail yet, and where that settles itself within the other demands in the defence programme is something that ministers have still got to conclude on.

**Q125 Stephen Barclay:** So 13 years in is the money to make these changes for a high threat in essence ring-fenced or is that up for play along with everything else?

**Sir Bill Jeffrey:** It is an issue that will need to be addressed in the SDSR. Again I come back to the point I made earlier that it is not completely self-evident that these planes need to fly into very high threat environments.

**Q126 Stephen Barclay:** Just in terms of giving a sense of the difficulties ministers may face with that, if we take the TriStar could you give us an idea of how long the longest adjustments or amendments to one of those has taken in order to make it fit for purpose?

**Mr Rowntree:** The TriStar has had an evolution of modifications. The reason I am hesitant is not because I am trying to be difficult, it is because we are on the edge of what we can disclose in this Committee because we are talking about the defensive capability of the aircraft and, therefore, the protection of our people. Two to three years might be typical for a particular development and then embodiment of the modification really depends on how you plan that embodiment. So you might do certain things when an aircraft comes in for major maintenance or you might consider something important enough that it is worth recovering the aircraft into workshops and doing it immediately. There is a trade-off there between risk and various other factors.

**Q127 Stephen Barclay:** In essence what you are saying is these are not quick changes. If you decide not to do the modifications because of the Defence Review or there is a delay in clarifying with contractors what those modifications are then these are not quick changes to keep the existing fleet going.

**Mr Rowntree:** Do not forget that we are not starting from zero in terms of the designs of these, so design solutions are already fairly mature for most of this stuff, it really is now into the discussion of which particular blend of equipment we will go for. Of course, the Defence Review is very key to settling that at the optimum point.

**Q128 Stephen Barclay:** Could I just return to one other area which one of my colleagues touched on before, which was the Senior Responsible Owner which took ten years to get in place on the MoD's biggest PFI project. Could I ask Sir Bill, when you came into post in 2005 were you made aware of the Report into the Apache helicopters? The NAO did a Report in October 2002 and this Committee met regarding the Apaches and the importance of a Senior Responsible Owner.

**Sir Bill Jeffrey:** Yes, I was.

**Q129 Stephen Barclay:** In March 2007 the PAC reported on the Bowman communication systems, and Richard may want to come in on this as I am sure he was on the Committee. When I had a look this morning at this Report, at page five of its conclusions, and I do not know whether in preparing for this Committee you had a chance to look at the Report, it says, if I quote paragraph one of the conclusions and recommendations: "In applying the Senior Responsible Owner concept the Department should equip those appointed to such challenging positions with the funding authority and trust to fully discharge their responsibilities in line with the guidance issued by the Office of Government Commerce". Would you say that is 100% in line with what is at appendix two where it says: "The appointment of Senior Responsible Owners is a key consideration in developing the governance structure and such appointments for major military capability and business change programmes are appointed by and accountable to the Permanent Secretary . . ."? Would you say that is fully in line with this Committee's earlier recommendation?

**Sir Bill Jeffrey:** I would say it is consistent with it. In this case I think it is more than regrettable that we did not appoint an SRO until 2007 and I am not going to defend that because when I came into this post at the back end of 2005 it became clear to me that this was one of the issues where we were in a different position from the rest of Whitehall. By and large I think we have made arrangements to comply with the OGC requirements on this. I cannot explain why it took so long in this case. What I would say though, so I am not at risk of misleading the Committee, is we are appointing SROs to the biggest and most complex projects, the ones that we describe as Category A and B.<sup>15</sup> There is a larger population of

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<sup>15</sup> Note by witness: It is common practice in Defence for groups of projects which relate to a single Defence capability to be managed together as a programme. In these cases, it makes sense, and is entirely consistent with OGC guidance, to appoint someone in the role of SRO for the programme rather than the individual project. It would therefore be more accurate to say that someone fulfilling the role of SRO has been appointed to all equipment programmes which include one or more Category A or B projects.

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projects where the sensible place to locate the same function is in the Admiral's area in the Directorate of Capability.

**Q130 Mr Bacon:** Could you just remind us what Category A and Category B is?

**Sir Bill Jeffrey:** They are by value.

**Q131 Mr Bacon:** It is £100 million and £400 million, is it not? Can you just remind us which way round it is?

**Sir Bill Jeffrey:** Cat A is more than £400 million and Cat B is more than £200 million.<sup>16</sup>

**Q132 Mr Bacon:** When Sir Kevin O'Donoghue gave evidence recently I asked him this question and I am sure he said £400 million and £100 million. You have just said £200 million. I would like to know.

**Sir Bill Jeffrey:** We will check.<sup>17</sup>

**Q133 Mr Bacon:** I would like to know now actually. At that hearing, which was the one we had on the MoD Projects Report, I made the point that I had been at a breakfast the previous day where John Hutton when he was Secretary of State for Defence had spoken about the way in which ministers and civil servants casually refer to £100 million or £200 million as if it is not a large sum of money and he contradicted this and said actually it was. I then asked the question because Kevin O'Donoghue mentioned this in passing about Cat A and Cat B, not flippantly but in very quick passing. I still do not know. I am pretty sure he said at the time that Category A was £400 million and Category B was £100 million. You are now telling us that Category A is £400 million and Category B is £200 million. That kind of bears out what the former Secretary of State was saying.

**Vice Admiral Lambert:** It is not just a financial issue, it is also an issue of complexity. We have some Category A programmes which do not fit the financial piece that has been described but are so complicated for one reason or another they are at the Category A stage and they will have an SRO.

**Sir Bill Jeffrey:** I am operating on memory of what these boundaries are. I had better check.<sup>18</sup>

**Q134 Mr Bacon:** One of my questions following on from Mr Barclay was going to be about where the thresholds are for when you appoint a Senior Responsible Owner. You actually said "we are appointing" and that suggests some of these projects do not yet have Senior Responsible Owners. Is that correct?

**Sir Bill Jeffrey:** I do not believe it to be correct in relation to the biggest projects that we have been discussing.

**Q135 Mr Bacon:** I am talking about the whole shebang. The phrase that I was interested in was when you said, "we are appointing". That is not a phrase that one would use about something that had

been completed, it is what in English is called the present continuous which suggests it is not finished. Is it still ongoing? Is there still appointment to be done that has not been finished yet?

**Sir Bill Jeffrey:** I should have said "we have appointed". What I wanted to qualify was in the particular MoD context with a number of projects we are talking about the right place to locate this general responsibility is in the Admiral's area and in that sense, although we may not always call them SROs, there is always somebody with the span of control and influence to enable them to exercise the SRO function.

**Q136 Mr Bacon:** That was what you meant when earlier you said one way or the other the SRO spirit will be maintained?

**Sir Bill Jeffrey:** Yes.

**Q137 Mr Bacon:** That is in place for all Category A and Category B projects?

**Sir Bill Jeffrey:** Yes.

**Q138 Mr Bacon:** What value do you not do this at? How far down the scale do you go where you say, "It is not a serious enough or big enough project for us to worry about appointing an SRO" or an equivalent to SRO?

**Vice Admiral Lambert:** Every programme will have a single point of accountability. Even the smaller programmes will have a single point of accountability who is responsible for both the funding line, ensuring the equipment comes in on time and looking at it after all those lines have developed.

**Q139 Mr Bacon:** All of them—

**Vice Admiral Lambert:** Will have a single point of accountability.

**Q140 Mr Bacon:** That is now clear policy?

**Vice Admiral Lambert:** Yes.

**Mr Bacon:** I just wanted to clarify that.

**Q141 Ian Swales:** We are on the people issue here. Can I ask how you feel about the commercial skills and what the lessons are from this project about the commercial skills? I do not know if it is true but I saw in the media in the last few days that the MoD has 29,000 procurement staff, which I found stunning. It may be wrong but it was reported in the media. What proportion of those would you describe as having commercial procurement skills and what proportion would perhaps be more military experienced?

**Sir Bill Jeffrey:** The 29,000 is misleading. It is the previous level of staffing of the whole of the Defence Equipment and Support Organisation, which includes the project teams. The bulk of the staff in that function is to do with logistics and logistics support. When we formed Defence Equipment and Support we amalgamated the previous procurement organisation and the logistics organisation. The actual number of staff engaged on project

<sup>16</sup> Ev 21

<sup>17</sup> Ev 21

<sup>18</sup> Ev 21

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management is less than 10,000 I would say and falling because the CDM has been working the numbers down quite significantly. They cover not only the initial acquisition of equipment but its support through life because we have been trying to integrate our teams so that they can cover both aspects of the issue. The real effort in the last few years has been to build project management skills and I believe we can point to figures that suggest we are doing so. Commercial skills are more difficult and we have more staff than before who can operate confidently commercially. To some extent one is operating in a market for these skills and we cannot always pay as much as others can. The C&AG's successor, and indeed the C&AG before him, has been working on trying to develop a more effective commercial cadre within the Department.

**Q142 Ian Swales:** The NAO have picked up this point in previous Reports, I believe, in the Ministry of Defence. Given the amounts of money we are talking about I would have thought it is very important that we have a strong team in the Ministry of Defence on this.

**Sir Bill Jeffrey:** I agree. When Amyas Morse came to his present role, after a little while finding him, I recruited from the private sector a successor who is heavily engaged in exactly this, trying to build up the Department's commercial capability. If I may say so, it is not just people with deep commercial skills, it is as much as anything to my mind about the overall commercial astuteness of the organisation. They may not be commercial officers but the people who are working in project teams are in practice engaged in many of the discussions with our suppliers. One of the issues, and it is not always easy within government, is to build the commercial astuteness of that group of people.

**Q143 Jackie Doyle-Price:** I just want to come back to this issue about the Senior Responsible Owner again, if you do not mind. The fact is for me this Committee has found on a number of occasions when looking at MoD projects that that kind of leadership has been missing. This was a project that was seen as very high risk. You said it was regrettable that one was not appointed earlier, but why was it not hoisted onboard earlier when you had four different project teams in as many years? Who was actually given ownership as opposed to accountability on that occasion?

**Sir Bill Jeffrey:** The project role throughout on the kind of model that the Admiral described has been the responsibility of a senior figure in the central requirements capability group in his predecessor's area, so it is not that there would not be a senior person with that overview. The failing was not to appoint an SRO earlier. I cannot explain that and very much regret that we did not get on to that case earlier.

**Q144 Jackie Doyle-Price:** We seem to have two competing things here. We have got the nature of the product you are trying to commission here but you

also need the commercial accountability and somewhere down there it has fallen between two stools. Are you satisfied that you have got the measures in place to give some real leadership so that they have got control in future on these things?

**Sir Bill Jeffrey:** I believe so. Underlying the Senior Responsible Owner concept is that there should be somebody who is well enough placed within the organisation to have an overview of all the connected elements of the project and to have influence over them. In a complicated organisation like the MoD that is not always straightforward. Normally for equipments it makes sense for that person to be in the Deputy Chief of Defence Staff (Capability) area because that is where our requirements for equipment are generated and the senior person there has the best view of whether the requirement is actually being met through the project that is being undertaken. I am reasonably confident that for all our projects there is someone with that degree of overview and influence chairing the Programme Board and able to oversee the project. The other significant change in recent times is that in relation to the programme as a whole, and you are talking about top leadership and management of this, we have established a sub-committee of the Defence Board, which I chair with the Vice Chief and Chief of Defence Staff and the Second Permanent Secretary and several others, which was not the case before, managing actively the whole of the equipment programme because, as the Comptroller and Auditor General was saying earlier, we have experienced some quite significant cost pressures within that programme.

**Q145 Jackie Doyle-Price:** Is not the difficulty there that you can have too much reliance on process to deliver that accountability rather than on active management and leadership?

**Sir Bill Jeffrey:** They are both important. I am not for a moment suggesting that active management and leadership is not important. The line of questioning that the Committee has embarked on, which is to do with the extent to which we have given reality to the SRO approach, is ultimately about process. Of course if we are to manage this stuff effectively we need to show leadership and get beyond process.

**Q146 Chris Heaton-Harris:** I love the complexity of the calculations that you had to make. You talk about the minimum number of hours in the contract at 9,000 as an annual minimum and we are running on 25,000 now. What was the range that was negotiated as a maximum for the contract for running hours with the nine plus five aircraft? If we run over that is there a cost?

**Sir Bill Jeffrey:** It is significantly more than the 25,000 but I cannot remember exactly how much more.<sup>19</sup>

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<sup>19</sup> Ev 21

**Q147 Chris Heaton-Harris:** Was it 30? The question I wanted to ask really was whether nine plus five aircraft would have the capability of running the maximum hours in the contract, which I assume would be yes.

**Sir Bill Jeffrey:** Yes.

**Q148 Chris Heaton-Harris:** I have done an awful lot of work with the freight industry in the past with a previous hat on and I am interested in the fact that when the extra five aircraft are not being used there is the model that AirTanker have brought to the table which we discussed slightly earlier and if there is no extra cost coming in I think you said they are losing 2% on the deal.

**Mr Rowntree:** The 2% is if you are running at the expected usage rate and there is no third party revenue.<sup>20</sup>

**Q149 Chris Heaton-Harris:** Is the market still there for this given the current economic circumstances for them to achieve that?

**Mr Rowntree:** That is one of the benefits of a PFI. That is AirTanker's risk.

**Q150 Chris Heaton-Harris:** Should AirTanker have a problem in the future we have got various buyouts, have we not, in this contract? I think there is an option where we can buy aircraft at 75 million out of the contract. Is that not right?

**Mr Rowntree:** I do not believe there is. What there is if our defence planning assumptions change beyond certain bounds is the contract has a framework in it called strategic change so you can re-baseline the whole deal at a lower or higher level. If you did go beyond the framework of the current contract you would not be starting with a blank piece of paper and therefore vulnerable to whatever the other side could negotiate. There is a starting point framework which sets the basic parameters and assumptions on that cost model.

**Q151 Chris Heaton-Harris:** If you were to terminate the contract, and I assume you have looked at that, I wondered what the costs would be. I notice in the Report it does say at page 34 that there is a cost of buying out each aircraft at 75 million quid. I just wondered how that works in value for money terms for us.

**Mr Rowntree:** It would not be good value for money to terminate for convenience if you have set out on a 27-year PFI. That is the risk that you take. If you set out on a 27-year PFI you need to be pretty sure that you are going to need that capability for the next 27 years.

**Q152 Chair:** Can I ask you a question arising out of that? I could not get out of the Report, and it may be that I did not read it carefully enough, using your TriStar and VC10 aircraft, what the current costs are to you per whatever, per 100 people transported or

whatever base you want, and what the costs will be when the new aircraft come in in 2012, which I have worked out would be 450 per annum. A per annum cost might be the best way of doing it. What is the difference?

**Sir Bill Jeffrey:** Figure seven gives the costs of providing TriStar and VC10 capability now.

**Q153 Chair:** Where is it? Figure seven on page?

**Sir Bill Jeffrey:** Page 25. It would be a mistake to compare that directly with the £450 million because it does not include any of the—

**Q154 Chair:** That is the £105 million but what does that cover, or the £221 million, whatever you choose? Somewhere else I saw £175 million spent in 2008–09 on passenger transport on top of that.

**Mr Rowntree:** The £175 million is the cost of charter, which takes us from the 16,000 hours to the 25,000 hours. That is because we do not have enough capacity to take everything we need.

**Q155 Chair:** Because these things were either not working or—

**Mr Rowntree:** No. The fleet just is not big enough to cope with the current operations.

**Q156 Chair:** What do I compare the £450 million per annum with which it will cost you to run this new aircraft? Give me a comparison.

**Mr Rowntree:** When the NAO were working on this, and Tim was working this, we did try to make an apples with apples comparison and the NAO Report itself acknowledges that trying to make an apples with apples comparison over capital acquisition costs using aircraft that are now 30–40 years old and then trying to compare that on like-with-like with a PFI for a service is a very difficult thing to compare to find an exact equivalent of that 400 million.

**Q157 Chair:** You must do because it is part of the assessment. You must do. You have got to think, "It will cost me X today. It will cost me Y tomorrow". You must be able to do that figure.

**Sir Bill Jeffrey:** I make two points. The £222 million for 2008–09 is the cost of providing TriStar and VC10 capability in that year. To that I think one would need to add—

**Q158 Chair:** Then you have to add the £175 million.

**Sir Bill Jeffrey:** A portion of the £175 million because I suspect we would still carry on using the charter for some purposes. I think the point Tim Rowntree was making is that it does not include any element for aircraft depreciation, nor indeed does it factor in the original costs of the aircraft. For the purpose of taking the decision the correct comparison was the one we made, which was given that we have a fleet that is on its last legs if we did not embark on this PFI what would we do and the answer is we would acquire A330s or Boeings and run them ourselves.

**Q159 Chair:** If you were not able to look at your current costs in that way there was no way of assessing value for money.

<sup>20</sup> Note by Witness: CORRECTION This loss, at around 1.75%, would in fact apply if the contract were running at the guaranteed minimum usage rate of 9,000 hours, rather than the expected usage of 18,000 hours.

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**Sir Bill Jeffrey:** I think that did assess value for money. The key figure that I have been trying to draw the Committee's attention to draws that out. It is a comparison with what I think the Treasury and everybody else acknowledged was the right thing for us to be comparing it with. On the one hand we had the PFI deal on the table which costs this much and, on the other hand, we might have chosen to acquire some aircraft ourselves and run them ourselves. We compared these two and on all but one of the eight comparisons at a level of confidence in delivery that we do not normally experience, frankly, the PFI came out on top.

**Q160 Stephen Barclay:** You are saying it was value but does it not say at paragraph 18: "We cannot conclude that the Department has achieved value for money"?

**Sir Bill Jeffrey:** I think that the NAO has stopped short of endorsing this as value for money because they felt, if one goes back to the very beginning of the discussion, they could not be confident that it was value for money because we did not explore the alternatives adequately at the outset. I do not think they are asserting it was not value for money. Frankly, if we had not thought on the basis of the comparisons in figure four that this did represent value for money, uncomfortable as it would have been, we would have had to take a different course of action.

**Q161 Chair:** I think you decided there was no other way of funding it.

**Mr Banfield:** The reason that we cannot conclude this is value for money is because there was no comparison at the outset and because of the amount of time and difficulties with the process that the Committee has explored. What I wanted to do was clarify where some of the numbers have come from that the Committee was just talking about. The 220 million for operating the current fleet, and this is at paragraph 13 on page seven, is a mixture of 105 million supporting the fleet and 117 million on personnel, fuel and simulators. Mr Rowntree is absolutely right, that does not include sunk costs for very old aircraft but nor does it include some of the related training and infrastructure costs because we could not split those out and relate them specifically back to the TriStar and VC10 aircraft. It is an apples and pears comparison if you try to do it because all of the data is not there.

**Q162 Stephen Barclay:** Aside from paragraph 18, if one looks at the footnote on page five, which goes back to the 2009 Report, it says: "Our latest Major Projects Report shows that affordability remains a problem, with the defence budget currently overcommitted and the Department continuing to make decisions on individual projects which represent poor value for money . . ." In essence, is it not just a simple fact that there was not the money in the budget and, therefore, you went for an alternative funding option relying on a Treasury discount for something that would have cost £1

billion, 5% of your budget? It was not affordable and, therefore, that lack of affordability pushed you into a decision which was poor value for money.

**Sir Bill Jeffrey:** No, I would not agree with that. First of all, the discount factor we used was as the Treasury would have wished us to. It was not that they made a concession to us. It was because the competition had started under that discount factor that that was the one that we were expected to use.

**Q163 Chair:** Yes, but you were given that as a concession. You do not have to be a total brain box to think if you had used the one that they were using you would have found it was not that—

**Sir Bill Jeffrey:** We did use it. If you look at the bottom part of figure four we did use the 3.5% discount factor. We found that the PFI was advantageous at the 90% confidence level of what we would spend ourselves, which is much closer to our actual experience. You might say it is a matter for criticism but it is a matter of fact that we much more commonly deliver projects at something like the 90% confidence level than at the 50% confidence level. At the 90% confidence level on a 3.5% discount factor the PFI comes in 1.5% better than the Public Sector Comparator on the Airbus model and 9.7% on the Boeing 767 model. It is only if one makes the somewhat improbable combination of assumptions that we operate on a 50% delivery confidence level and a 3.5% discount factor and acquire Airbus 330 that it looks disadvantageous. I think there is a perfectly respectable argument that this was value for money. I do not deny for a moment that if we had not reached that conclusion it would have been very inconvenient for us.

**Q164 Matthew Hancock:** I am terribly sorry I have been away but I have come back and found we are having exactly the same conversation as when I left. There is obviously a difference of understanding and I would just like to understand. Figure four is based on numbers that were valid in 2007, is that correct?

**Sir Bill Jeffrey:** Correct.

**Q165 Matthew Hancock:** Your argument is that in 2007 the PFI represented better value on seven out of eight comparators than the Public Sector Comparator. Is that correct?

**Sir Bill Jeffrey:** Yes.

**Q166 Matthew Hancock:** But the decision to go with the PFI was taken in 2000, is that correct?

**Mr Rowntree:** No.

**Q167 Matthew Hancock:** When was the decision taken to go with the PFI?

**Mr Rowntree:** The initial assumption was taken much earlier.

**Q168 Matthew Hancock:** So you started looking at PFI in 2000.

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*Mr Rowntree:* Slightly before that I think.

**Q169 Matthew Hancock:** Did you compare to a Public Sector Comparator at the point when you first looked at doing this?

*Sir Bill Jeffrey:* No.

**Q170 Matthew Hancock:** I understand your argument that it was value for money in 2007 because by that stage the Public Sector Comparator had a load of costs in it because you were so far down the track. Do you accept that? That is in paragraph eight on page six.

*Sir Bill Jeffrey:* What I certainly accept is that the reason the NAO felt they had to withhold a judgment that this did represent value for money goes back, as Mr Banfield said, to the fact that we did not do an adequate comparison of alternative procurement methods way back in 2000. In 2007 we were where we were and we had to make our value for money judgment as between the proposal that was on the table and the alternative method of providing the same service.

**Q171 Matthew Hancock:** I entirely understand that. I think that is why we have been talking at cross-purposes. We are looking at something and asking the question was this value for money as a deal and as far as I can see the deal started soon after 1997 and the PFI was the track that you started going down soon after 1997. By the time you evaluated it against the alternative, which is figure four, that was 2007, nearly ten years into the project. Figure four is a bogus comparison because the Public Sector Comparator included a load of costs that were there because you had already been going down this route. You are nodding. Do you accept that?

*Sir Bill Jeffrey:* I accept that is what we were doing in 2007. I accept also, with the benefit of hindsight, that it would have been better if at the very beginning of this process, as the NAO observe, we had examined alternative procurement routes and formed a judgment at that stage. I have to say that the ultimate judgment on value for money is one that could only have been made when we knew what the various private sector consortia's best and final offer actually was and that was in 2007 because we had been through the process of negotiation, we had a proposition on the table and we made the only comparison we could.

**Q172 Matthew Hancock:** What do you think about this value for money test, which is the cost the whole project would have cost had it been procured from the start as you set out to my colleague earlier versus the cost that it took in the end? The cost that it took is about double the cost that it could have taken had you started with a better procurement procedure right at the start.

*Sir Bill Jeffrey:* I do not think one can be confident of that. As I have said throughout, I certainly acknowledge that at the very beginning better practice, the practice we would have adopted now and the practice which would have been extraordinarily difficult to apply then given the

climate in which the PFI was being pursued, would have been to examine properly alternative procurement routes and we did not. When one comes to 2007, which was the point at which we knew what the best offer of the private sector was, we made the only sensible public sector comparison. I think the Treasury agree with that and, in fact, the NAO agree with that. It showed the results that figure four demonstrates. The NAO can speak for themselves, but I take the NAO to be saying that because of this earlier history they cannot attest to the value for money of the eventual decision. I do not think they are saying it is poor value for money either.

**Q173 Mr Bacon:** I find this extraordinary. I do not want to misquote you but a minute ago I think you said it was not until 2007 that you actually got to the point where you could establish whether it was value for money or not. Is that right?

*Sir Bill Jeffrey:* 2007, or it may have been late 2006.

**Q174 Mr Bacon:** Basically as you got to the point of best and final offer was when you could establish it. What you are saying is once the decision was taken to go with this project it took the best part of ten years, one and a half times or more the length of the Second World War, before you could establish whether going down this route was value for money or not. That is what you said, is it not?

*Sir Bill Jeffrey:* That is—

**Q175 Mr Bacon:** Yes?

*Sir Bill Jeffrey:* Yes.

**Q176 Mr Bacon:** That was what I thought and that is what I find extraordinary. That was the first part of my question. I just wanted to establish that was what you said because I did not want to misquote you. Then you go on to say, as far as I understand it, that the NAO cannot put a kite mark on this and say it is value for money but you understand them to be saying from something you said earlier they are not saying it is not value for money. What they are saying though is there was a lack of alternative procurement options at the outset, there was a lack of mature fallback plan, the complexity of the project was underestimated, there was very limited competition, you went down to one bidder far too early, there was a series of difficulties in developing a new service model that was quite complex, you did not have visibility of all the costs, you did not have an experienced enough team, there were frequent changes of leadership, a very late appointment of the Senior Responsible Owner to the project, but despite all that you expect us to believe that actually, probably, on balance it was value for money. Sir Bill, that is not credible, is it?

*Sir Bill Jeffrey:* What I am saying is that—

**Q177 Mr Bacon:** Is that credible?

*Sir Bill Jeffrey:* I think it is actually. I do not deny the shortcomings in the management of the project and in particular at the very beginning. If we had decided on the basis of an examination of alternative

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procurement options at the very beginning that the PFI did offer the prospect of producing more beneficial outcomes than alternatives we would have had to go through the process. I do not deny for a moment that that process took longer than it should have done, that there were shortcomings in relation to continuity of staffing and the other shortcomings that this Report reveals. All I am really saying is that at the point when a decision had to be taken we did all we could do in the circumstances, which was to compare the best offer we had been able to extract from the private sector with our estimated cost of providing the same service ourselves having acquired the aircraft ourselves. That suggested that the PFI approach was better value for money. I do not deny that implicitly there must have weighed with us the fact that had we decided that this was not value for money at that stage we would have had to face the prospect of finding the money to pursue the alternative route. I believe we would have done that. If these figures had stacked up differently in figure four and the Public Sector Comparator had convincingly appeared to be more attractive then we would have had no option and as Accounting Officer I would have had no option but to say, "This clearly does not represent value for money and we should not do it".

**Q178 Mr Bacon:** Just on that point about figure four and the Public Sector Comparator. In the NAO Report on the MoD building there was a very helpful chart that went into considerably more detail. It was on page 24 of that NAO Report. I remember because it is tattooed on my eyelids. It broke down the various different risk factors as they were called. I seem to remember the figures were 741, 740, 6.1 million and 746.2. There was a difference of £100,000. By finessing one of the risk factors, of which there were about seven or eight, by half of 1% you could make it swing one way or the other so the Public Sector Comparator appeared to look better or worse. I cannot see, looking at this figure four, apart from the column that says "Delivery Confidence Level", and this is as much a question for the NAO as for the MoD, where I go to do my finessing. Is it possible that you could supply us with a more detailed version of this chart? Presumably the delivery confidence level is comprised of a series of different risk factors, is it?

**Mr Morse:** Yes. We could supply that.

**Q179 Mr Bacon:** That would be very helpful. I think if we could get it to the same level of—to use your word—granularity, the same level of clarity we had with the MoD building PFI we would be able to see where you did your finessing. You know as well as I do, Sir Bill, with a Public Sector Comparator you can make it turn upside down, do a cartwheel. I have done it myself. It is not that difficult when you have got enough risk factors to play with to get the result that you want. Indeed, the NAO said a long time ago if there were a big difference between the Public Sector Comparator and the PFI route there would be something wrong, you would expect them to be

roughly the same over a long period of time. I see the C&AG nodding. Is this not all a load of hogwash basically?

**Sir Bill Jeffrey:** No. First of all I would resist the suggestion that we kind of finessed this to produce the result we wanted and I hope that is not what Mr Bacon is suggesting.

**Q180 Mr Bacon:** It is exactly what I am suggesting.

**Sir Bill Jeffrey:** What I would say is that if you accept the fact, unwelcome as it may be, that our historic performance in delivering projects ourselves is closer to the 90% confidence level cost than the 50% confidence level you are looking here on a 6% discount factor at figures of minus 7% in the right-hand column and minus 15.3%, and on a 3.5% discount factor minus 1.5% and minus 9.7%. These are not trivial figures.

**Q181 Mr Bacon:** You have just made my point. The very fact that you are using the 6% figure when Treasury guidance in the Green Book said "thou shalt use the 3.5% discount figure" and you have got a special exemption not to, it is a figure which in itself enables you to drive a coach and horses through it. I am right in saying, am I not, going with the 50% one, the reason why the 3.8 is more expensive than the 3.6 one, and it is the only one where the AirTanker bid is more expensive, is because you have used the correct, as it were, 3.5% discount? It is only by using the non-correct discount that you get the route that you wanted to go down looking cheaper. This is entirely aside from the column that we have not really seen, the unpacked version of the delivery confidence level column, which has got all other kinds of detail in it that you can fiddle—fiddle is a tendentious word, I accept—or adjust to alter the result. You have to make an enormous number of assumptions in there which are extremely sensitive to very small changes.

**Sir Bill Jeffrey:** As I understand it, although the Report uses the word "exemption", and I slightly wish we had questioned it now, the normal practice of the Treasury when there is a change in discount rates is to expect the departments concerned where they have already initiated a procurement to stick with the previous one.

**Q182 Chair:** We have asked Treasury to look at that issue.

**Mr Gallaher:** That is correct.

**Q183 Eric Joyce:** This is all very exciting, I must say. I have been listening carefully to how you have been phrasing things since the very beginning, Sir Bill, and also noting the fact that a sound evaluation of alternative procurement options does not appear to have been undertaken at the beginning. Given that we had the obvious new government in place in 1997 with a determination to use PFI come hell or high water, is it not simply the case that the MoD was having to put together a case, a bit like training for a regimental boxing match without taking into

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account that your opponent was going to be issued with a cricket bat, that it was going to be a PFI project and that was the way it was?

**Sir Bill Jeffrey:** I tried to make that point at the beginning of the session, Mr Joyce. I do not want to overstate it because I do not want for a moment to appear to be arguing, since I am here to account for the whole of this passage of events, that we were right in not analysing procurement routes way back then. I was around elsewhere way back then and I know the presumption in favour of PFI then was so strong that, to put it no higher, our predecessors would have had a devil of a job persuading the Treasury to make provision in our budgets to acquire this service on-balance sheet. I think in mitigation of our predecessors that does help to explain why they simply set off down the PFI track.

**Q184 Stephen Barclay:** Of all the PFI contracts the MoD has, how many were given an exemption to 3.5%?

**Sir Bill Jeffrey:** I do not know the answer to that question.<sup>21</sup> However, I would make the point I made a moment ago that it is not so much the exemption it is simply that the practice is when the rate changes projects that preceded stick with the previous rate. We may have had some PFI projects that straddled that change in the rate and I will find out whether we had or not.

**Q185 Stephen Barclay:** Will you send us a note, please, on that? Surely that would have been part of the discussion with the Treasury as to how much persuasion they needed in order to—

**Sir Bill Jeffrey:** What I do slightly resist, and I hope the Committee will forgive me, is the suggestion that we were somehow given a free pass by the Treasury to use an advantageous rate that enabled this just to squeak in with a bit of adjustment here and there.<sup>22</sup>

**Chair:** It does feel like that a bit.

**Q186 Mr Bacon:** We are not suggesting it was just a bit of adjustment, Sir, I suspect it required quite a lot of adjustment.

**Mr Gallaher:** Could I intervene here and say there was no exemption given. This would have been the rule for any department entering into projects that had started a long time previously. There was a change in the Green Book rules in 2003 which took the risk factor out of the 6% and the risk factor had to be calculated on each individual project, so it went down to 3.5%, but if a project and the proposals had been worked up for such a long time the Treasury's guidance was "You stick with the 6%".<sup>23</sup>

**Chair:** We are going to get that in writing, thank you. We are also going to get the other assumptions behind figure four and the variations.

**Q187 Mrs McGuire:** Sir Bill, I quite understand you saying that there was pressure in 1997 to go down the PFI route but I am wondering whether or not you can use that as a justification for the fact that the

MoD went into a project, that they did not know what it looked like, would sound like, would turn out like, had no indication of the costs of the subcontractors to the primary contract. Notwithstanding the pressure you were under, do you still think there was an issue about the failure of the process of the project?

**Sir Bill Jeffrey:** For the avoidance of doubt, I am certainly not arguing in favour of the approach that was taken. I believe, as would be our current practice, the right thing to have done, as the NAO says, would have been to examine all alternative procurement routes. That is what we would do now in similar circumstances. All I am doing is trying to offer a little bit of mitigation for that failure by reference to the operating conditions at the time.

**Q188 Chair:** Are you confident that the facilities and expertise will be in place at Brize Norton for when you get this aircraft?

**Sir Bill Jeffrey:** I was there a few weeks ago and the station commander, whom I spoke to, and his staff were confident. They were enthusiastic about the building works that were already going on, including the AirTanker hangar that is being constructed on the edge of airfield. They were confident that they could deliver this.

**Q189 Chair:** So you are confident of that. Are you also confident that everybody who will be in any way engaging with this PFI contract will have sufficient knowledge to know that an instruction they give is within the terms of the contract before they add yet more cost to the taxpayer?

**Sir Bill Jeffrey:** I am determined that they should be. I think the message of the Report in one or two of the passages I have quoted is that in terms of our ability to run this contract we are in a more robust and better position than we might have been in the past.

**Q190 Chair:** Does anybody want to add anything before I draw this to a close? I was going to ask you, if you would, to report back to us once the Defence Review is complete to see whether or not in that context value for money for this contract is still your view. The other thing I was wondering whether you would also come back to us on is this issue of when the TriStar goes and the arrangements that are going to be made, either modifications to this aircraft or by other means, how you are going to make sure you have the transport facilities to go to Afghanistan and also do the refuelling that will be required.<sup>24</sup>

**Sir Bill Jeffrey:** We can and will provide a note.<sup>25</sup> We will also provide a note on some of the more particularly financial issues that emerged earlier in the session where I was conscious that we did not have as many answers as the Committee might have wished.

**Chair:** Can I thank you for your patience in what has been a two-hour session, which I know is very tiring. Many thanks for listening and responding to our questions. Thank you.

<sup>21</sup> Ev 22

<sup>22</sup> Ev 22

<sup>23</sup> Ev 22

<sup>24</sup> The answer is classified.

<sup>25</sup> Ev 22

### Supplementary memorandum from Ministry of Defence

*Questions 45, 48 and 49 (Mr Bacon/Chair): breakdown of costs*

Based on the financial model provided at Financial Close, the approximate breakdown of the £390 million a year cost is as follows. This is based on the £10.4 billion cost spread over the 27 year period of the contract, at the expected usage of 18,000 hours a year:

	<i>Average Annual cost (£m pa)</i>
Capital Costs	100
Finance Costs	132
Operating Costs	158*
Total	390

\* Note: The £80 million operating cost quoted by the NAO represents the annual cost of provision of the FSTA service at the Full Service Delivery (FSD) in 2016. This cost is subject to inflation, and across the 27 years works out as an average cost per year of £158 million.

*Question 80 (Stephen Barclay): staffing of MOD Private Finance Unit*

The MOD Private Finance Unit (PFU) comprises nine staff, supported by two Commercial Assurance and Governance (CAG) staff, and reports to the DG Defence Commercial. The role of the PFU is to provide a central focus for PFI policy and support, and offer corporate assurance to the Department's Investment Approvals Board and to the Treasury. It does not directly manage PFI projects, but instead acts as a source of advice and guidance for the project teams.

*Question 86 (Chair): subcontractor costs*

The point the witness was making was that steps had been taken to address the criticism in the NAO report on the FSTA (paragraph 1.23) that the Department had failed to gain visibility of the subcontractor's costs for designing and modifying the aircraft. But the Department accepts that in many cases it will be unrealistic to obtain visibility of sub-contractors' costs down a more conventional supply chain.

No new PFI projects have commenced procurement since FSTA closed, although the principles of seeking cost transparency have been applied where they can to the two PFIs currently in procurement (ie DTR and SAR-H).

*Questions 131, 132 and 133 (Mr Bacon): approval thresholds*

There are four levels of project categorisation (Category A, B, C and D) and five types of project (Equipment & upgrade, Information Services (IS) enabled business change, Estate, Service/support provision and In Service Support). Approval thresholds are based on a combination of the level of investment and the level of complexity inherent in each type of project.

Approval levels are:

Cat A	Equipment & Upgrade	£400m +
	IS enabled business change	£100m +
	Estate	£100m +
	Service/support provision	£400m +
	In service support	£400m +
Cat B	Equipment & Upgrade	£100m–£400m
	IS enabled business change	£50m–£100m
	Estate	£50m–£100m
	Service/support provision	£200m–£400m
	In service support Equipment	£200m–£400m

*Question 146 (Chris Heaton-Harris): contract hours*

There is no upper limit to the number of hours that FSTA can be utilised under the contract, although sustained high usage, beyond the scope expected over a significant period of time, would require additional support. In those circumstances, there is a mechanism in the contract to renegotiate any additional support costs incurred by the contractor over a prolonged period of time.

*Questions 184 and 185 (Stephen Barclay): discount factor*

As the Treasury confirmed at the hearing, their policy was that, when the discount factor changed, the previous factor could apply to projects which were already under way. In this case, this meant that projects that had already issued the Invitation to Tender continued to assess the VFM case at 6%. There was Treasury advice (which the Department followed) that they should also conduct a sensitivity check at the new 3.5% Discount Factor. Apart from FSTA, three MOD PFI projects were assessed for Value for Money at the 6% discount factor.

*Question 190 (Chair): Defence Review*

We will provide the Committee with a note, following the conclusion of the SDSR, on whether any changes to force structures and planning assumptions are assessed to impact on the Value for Money of the FSTA contract.

August 2010

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**Supplementary memorandum from HM Treasury**

**DELIVERING MULTI-ROLE TANKER AIRCRAFT CAPABILITY**

During its hearing on “Delivering Multi-Role Tanker Aircraft Capability” on Monday 26 July, the Committee of Public Accounts asked HM Treasury to send it further information on three points.

Firstly, HM Treasury was asked whether it considered it acceptable to use PFI as a procurement method for defence projects in general.

There is no reason why PFI should not be considered for defence projects. The Ministry of Defence has assigned 54 PFI projects and of these has a current portfolio of 45 operational PFI projects, the majority of which are operating successfully. Although less widely adopted than in the United Kingdom, several countries (such as The Netherlands, the United States and Australia) have used PFI/PPP as a procurement route for defence infrastructure such as headquarters and accommodation.

In general, there is increased scope for benefits in equipment based PPPs, as the linkages between design and long-term operation, and between build and maintenance, are much greater for equipment-based projects. Although operational and security related issues tend to narrow the potential for PFI in relation to defence equipment projects, these issues are not insurmountable in every case. So, whereas it is correct to suppose that PFI is inappropriate for tanks, attack aircraft and warships which need to be deployed flexibly and are operated and maintained (at least in part) by service personnel, PFI can be appropriate in areas such as training (for example, helicopter simulators), support tasks (for example, the Heavy Equipment Transporter and strategic sealift/roll on-roll off ferries deals) and ancillary services (for example, dockyard tenders). Overseas, France and Greece have delivered defence equipment PPPs for training helicopters and simulators.

The Committee secondly asked whether the Treasury considers that the approximately 10% added to the cost of the project as the premium to be paid for increased risk transfer in PFI is reasonable.

Finance can be considered in the same way as other project inputs; for example, the increased cost of utilising better building materials needs to be considered against the benefits in terms of reduced whole life running costs. The scale of the benefits that are delivered by the risk transfer enabled by private financing depend on the nature of the project. (The aim of the qualitative assessment of value for money prior to launching a PFI project (see attached copy guidance issued by HM Treasury in November 2006)<sup>1</sup> is to ascertain those aspects of a project which could deliver benefits that would outweigh the increased financing costs). Delivering benefits of greater than 10% of the total project costs is considered reasonable.

For example, a review of business cases presented to the Treasury’s Project Review Group for allocation of PFI credits show that local authorities estimate a net value for money position (ie the benefits in terms of reduced whole life costs of the project when offset by the increased cost of financing, discounted at 3.5%) of better than 10% is not uncommon. As mentioned above, there is usually an increased scope for benefits in equipment based PFIs such as the Future Strategic Tanker Aircraft (FSTA).

The Treasury was thirdly asked to clarify whether the Ministry of Defence was given an exemption from the 3.5% discount factor outlined in the updated Green Book rules of 2003, and instead allowed to calculate net present values based on a 6% discount factor.

In 2003, the Green Book guidance on assessing public sector spending and investment was updated. The previous 6% discount rate provided not only the net present value of the options but also included the risk figures for the project. Under the new guidance the risk assessment is separated out into a separate assessment, and the discount rate has been reduced to reflect this. Projects that were started under previous Green Book guidance were allowed to continue using the 6% discount factor as their value for money

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<sup>1</sup> Not printed here.

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benchmark. This was true for *all* departments who had PFI projects that had issued their Invitation to Tender prior to 2003. See paragraph 9 of the attached copy of Treasury guidance letter of 26 April 2003 to all departments.<sup>2</sup>

It was appropriate to use this policy for the FSTA project. The project was started in 1999 when the old guidance was still in place, and the 6% discount factor had been used at the time of formal engagement with industry in the issuance of the Invitation to Tender/the key value for money point for deciding whether or not to pursue PFI as the procurement route. Value for money comparisons were re-conducted later at both the 6% and the 3.5% discount factor rates and the National Audit Office report makes clear that deal was favourable on all but one value for money comparison (of eight).

Alternate Treasury Officer of Accounts  
HM Treasury

3 September 2010

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<sup>2</sup> Not printed here.