

# Defence and the Growing Financial Challenge

by the RUSI Acquisition Focus

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The Gray Report,<sup>1</sup> followed by the latest Major Projects Report from the National Audit Office (NAO),<sup>2</sup> have confirmed that the financial needs of the MoD's Equipment Procurement Plan far outstrip the financial resources likely to be available. As we have argued before in this column, the MoD is in great and growing financial difficulty. The original Smart Procurement guidance was that the Equipment Plan should be built on an assumption of level funding in real terms for the ten-year period involved. However, according to the Gray Report, the MoD has got itself into a situation in which, as a minimum, the equipment budget would need to increase by about 6% a year in cash terms (or 4% in real terms) for a decade to pay for plans in place.

The National Audit Office, reinforcing the over-commitment message, albeit with slightly different numbers, finds that the MoD faces a minimum £6Bn deficit over the coming decade. The NAO's most pessimistic estimate of future funding provision and equipment costs anticipates a ten-year procurement deficit of £36Bn, even higher than the £25Bn which was previously postulated here.

## *The financial needs of the MoD's Equipment Procurement Plan far outstrip the financial resources likely to be available*

Our understanding is that the recent Equipment Examination took £15Bn out of spending in the next four years, but much of that, as with the carriers, took the form of deferrals that **increased** the total bill. The resulting situation is that, over the next ten years, even if the MoD equipment procurement budget is maintained at its current level in real terms, the Ministry will have £11Bn or more in aspirations and commitments for which it lacks funding.

### The Origins of the Problem

How did the Ministry get into this situation? Repeated NAO reports have exposed the significant tendency of project costs to rise above the amounts programmed because of underestimated technical challenges and the 'conspiracy of optimism' which leads to over-ambitious requirements from the government and unrealistically low bids from industry. But the Gray Report, and the latest NAO report, both stress the toxic consequences of deliberately slowing down projects. This reduces the short-term cash needs of procurement, but increases greatly the overall bill.

In contrast to the claim of Defence Equipment Minister, Quentin Davies, that stretching out the carriers made good business sense, the National Audit Office found that "The Ministry of Defence has a multi-billion pound budgetary black hole which it is trying to fix with a 'save now, pay later' approach. This gives a misleading negative picture of how well some major projects within the MoD are managed, represents poor value for money and heightens the risk that the equipment our Armed Forces require may not be available when it is needed or in the quantities promised'.

Additionally we would stress two further considerations that have not helped the Ministry of Defence. The first is that no extra money was made available for defence after 2006 when the decision was taken to replace the *Vanguard*-class submarines that are the platform for the UK Trident deterrent. In 2006 the Government's stance was, as Gray reminded us, that the nuclear project should be 'subject to separate funding arrangements with the Treasury on the basis (announced in the 2006 White Paper) that the cost of the deterrent should not be at the expense of the conventional capabilities required by the Armed Forces'. There are no specific figures on the deterrent provided in Gray, but his diagram shows the Precision Attack and 'DGE' (today specified as Equipment Resources) sections in the Equipment Procurement Plan increasing significantly in the period to 2020, from less than £3Bn a year to approaching £5Bn.<sup>3</sup> Especially in the later years, Trident replacement could account for the great majority of this increase. The



*Bill Kincaid and Hugh Colver examine a document closely during a recent meeting [Adrian Johnson, RUSI]*

deterrent must account for a significant element of the over-commitment in procurement plans.

The second factor is that it is more than a year since the MoD received political direction from the centre of government that there should be no cancellations of projects that would result in bad news, i.e. major job losses. In other words, the MoD has seemingly been prevented from making its own efforts to balance its commitments by cancelling projects. Project cuts were implicitly recommended as long ago as mid-2006 by Tom McKane in his Enabling Acquisition Change report, when he argued that headroom had to be made in the equipment plan. This recommendation, unlike most of his other ideas, was not taken up. It would be reasonable to find that the MoD is in a mess not entirely of its own making.

#### **The Forthcoming Defence Review**

A rational expectation would be that, after the Green Paper laying the ground for a defence review and then a full review after the next election, a less ambitious UK defence policy must be specified. This would mean that the Armed Forces could be designed for more modest missions, less extensive capabilities would be needed, and the equipment procurement programme could be down-sized and re-shaped to fit the new policy. All major programmes,

including FRES, the nuclear deterrent, the carriers and the Joint Strike Fighter, would be shaped to support the new policy or abandoned. We would underline that specifying any new policy will not be easy, since there are effectively only three broad options that can be discerned, and none of them has much obvious political or popular appeal.

One would be to reinforce the line that UK forces will be essentially an appendage to US forces. The UK would continue to have an internationalist/interventionist position but would rely explicitly on the US for more important capabilities and would not expect to undertake any operation without active US support.

An alternative would be to place more emphasis on European cooperation, to argue that, while the UK alone cannot afford comprehensive capabilities for a significant internationalist/interventionist role, much more could be achieved if some major (and smaller) European states pooled more of their efforts. Global communications, surveillance, naval aviation and strategic transport might be cited as candidates for enhanced cooperation. It should be emphasised that this does not imply cooperation with all EU nations, it need embrace only a small number of countries serious about defence and security in an international context.

The third possibility is that the UK would recognise that, with a defence budget of little more than 2% of GDP, it should concentrate on the protection of its own territory, and abandon the internationalist/interventionist position accepted in the 1998 Strategic Defence Review. It would still be possible to maintain some small, modestly equipped forces that could contribute to coalition-based peace-keeping missions and other less demanding tasks.

We will be interested to see if any policy options emerge in addition to these three rather unappealing alternatives, which may be summarised as 'US dependence', 'European cooperation' and 'Little England'. All these lines have significant implications for the commitments in the Defence Industrial Strategy to 'operational autonomy', 'appropriate sovereignty' and a UK capability to sustain and modify its defence equipment. These commitments will need re-examination including the generation of a clearer sense of their costs.

Thus the conduct of a defence review, under the current financial pressures, will be far from straightforward. A foreign policy-led review would be likely to lead to another unaffordable programme, and therefore any review will need to consider both foreign policy objectives and affordability at the same time. One also has to question whether a full review, if conducted in the timescales of previous reviews, is likely to produce effective actions in a timescale that is commensurate with the scale of the current problem. If projects are to be cancelled, a further 12 to 18 months of both spend and commitment will only compound the problem, and stretch outs and delays will result in further damage of the type highlighted by Gray and the NAO.

Regardless of the next election result, as a defence review process unfolds, the disconnect between the available resources and expectations about what UK Armed Forces ought to be able to do may well be so great that the new government backs away from important choices. Major projects could be left in the programme simply because they will not need significant funding until after the 2014/2015 election, a distant horizon for many politicians. This would be to repeat the errors of the 1998 Strategic Defence Review but in worse circumstances. Yet the temptation could well be to fudge the issue, essentially by down-sizing UK forces, without specifying any clear over-arching policy and strategy, i.e. what UK defence is seeking to achieve and the route it will use to success. There are some signs of this already occurring, with press reports of the Navy giving up one aircraft carrier<sup>4</sup> and many rumours of significant cuts to RAF personnel and combat aircraft numbers.

### Urgency and Incoherence

However, the reality is that defence may be significantly reshaped because of financial pressures before a defence review can be completed. Despite the number of project deferrals, the defence budget is under major immediate pressure. The broader financial crisis has meant reduced tax income for government and a major increase in the national

debt and interest payments. The Government has made clear that defence, unlike the police and hospitals, is not an area where spending is to be protected. Consequently, the best that defence can hope for in the next few years is a level cash allocation, which means a real cut of 2% a year. It may even suffer actual cuts in its cash allocation.

In these circumstances, a coherent set of defence changes cannot be anticipated because so much defence money is already committed in medium- and long-term projects. The MoD spends around 58% of its budget on external suppliers,<sup>5</sup> with many having contracts that cannot be changed significantly in the short term. Internally, staffing cuts cannot be made easily or cheaply, given redundancy costs. Thus, as the Ministry is forced to make cuts at short notice, it will have to cut those things that can be cut because they are not on long-term contracts. Research spending is always vulnerable in these circumstances and we know that another £100M is to go from this area in the next financial year. It would be an extraordinary coincidence if the activities that can be cut because the funds are not committed will be the things that should be cut in the light of a changing world and UK policy responses to it.

A further point likely to generate incoherence from imposed short-term economies is that, in the very complicated machine that generates and delivers a wide range of UK capabilities, the MoD's management accounting systems are far from perfect if it is desired to understand the overall costs associated with different capabilities. It is a weakness of the Through Life Capability Management (TLCM) initiative that the MoD's accounting system lacks accurate cost allocations or even rough cost models to link the different Defence Lines of Development (DLoD) to front-line capabilities. To a certain extent, if the MoD makes cuts to different Top Level Budgets, it will do so with an imperfect understanding of what the effects on capability will be.

### Conclusion

If the Government is serious about building and maintaining a coherent set of defence capabilities, while still running a significant campaign in Afghanistan, it will provide sufficient short-term funding for defence to minimise the need for incoherent measures whose essential virtue is that they allow short-term savings. The Government should undertake a defence review that will be of necessity resource-based, a pan-defence parallel to the procurement approach known as Cost as an Independent Variable. The challenge will be to define the most appropriate policy for the money available and, as noted, that policy must be significantly less ambitious than that laid down in 1998. The MoD must be required to live within its means, whatever specified, but it can reasonably ask for time so that it can make required adjustments without losing coherence.

Defence is currently in a perfect storm marked by a demanding, long-term campaign against a non-state but resourceful adversary; a domestic recession that has reduced tax revenue and increased the public debt; over-commitment in the



Professor Trevor Taylor suggests a way forward [Adrian Johnson, RUSI]

equipment programme that can no longer be disregarded; and an inability to launch a full defence review for at least five months. The recently announced cuts will make a contribution to easing the overall problem, but they fall far short of a solution. There is a series of dangers:

- It will prove difficult to devise a defence stance within the framework of the National Security Strategy and a cross-government approach to security including defence.
- Short-term decisions could pre-empt the potential of the review when it occurs.
- Over-riding concern with Afghanistan could distort the sound shaping of UK forces for the longer term.
- Above all, grand projects supported by commercial, regional, political and single-Service interests could stumble on in the absence of a readiness to rethink clearly the UK's affordable foreign and defence policy.

Whatever the composition of the next government, defence poses some very uncomfortable dilemmas which have no easy solutions. Some significant programme cancellations are probably inevitable, and the new government should accept that the funding they can make available for defence will mean a much reduced role for the UK on the international stage. This is not an option that is likely to appeal to a new Prime Minister, but may be unavoidable if anything like a coherent defence stance is to be constructed. ■

## NOTES

- <sup>1</sup> Bernard Gray, Review of Acquisition for the Secretary of State for Defence, London, Ministry of Defence, 15 October 2007, <http://www.mod.uk/DefenceInternet/AboutDefence/CorporatePublications/PolicyStrategyandPlanning/ReviewOfAcquisition.htm>, accessed 29 December 2009
- <sup>2</sup> National Audit Office, Ministry of Defence: Major Projects Report 2009, London, HMSO, 15 December 2009, [http://www.nao.org.uk/publications/0910/mod\\_major\\_projects\\_report\\_2009.aspx](http://www.nao.org.uk/publications/0910/mod_major_projects_report_2009.aspx), accessed 29 December 2009
- <sup>3</sup> Gray, op.cit., page 69
- <sup>4</sup> Michael Smith, 'Navy surrenders one new aircraft carrier in budget battle', *The Sunday Times*, 25 October 2009, <http://www.timesonline.co.uk/tol/news/uk/article6888962.ece>, accessed 27 December 2009
- <sup>5</sup> The Office of Government Commerce, in its 2008 Capability Review of UK Defence Ministry Procurement, reported that the MoD had an annual budget of £31Bn and procured goods and services worth £18Bn. Some £10Bn of the latter was spent with the top 30 suppliers, see [http://www.ogc.gov.uk/documents/MoD\\_PCR\\_Report.pdf](http://www.ogc.gov.uk/documents/MoD_PCR_Report.pdf), accessed 27 December 2009