



National Audit Office

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## **Report**

by the Comptroller  
and Auditor General

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## **Ministry of Defence**

# Major Projects Report 2014 and the Equipment Plan 2014 to 2024

# Summary

## Scope of the report

**1** Since 2012, the Ministry of Defence (the Department) has published an annual Statement on the affordability of its 10-year plan to deliver and support the equipment that the Armed Forces require to meet the objectives set out in the *National Security Strategy*.<sup>1</sup> We report on the robustness of the assumptions underlying the Statement.

**2** Each year the Department also presents to the Committee of Public Accounts a Major Projects Report which provides data on the cost, time and performance of the largest defence projects.<sup>2</sup> We review the information underlying in-year variations to cost time and performance.

**3** The Equipment Plan is the Department's forecast budget to cover the costs of procurement and support of military equipment for the next 10 years. In 2012, the Department adopted a new approach to generate greater stability in its procurement activity by developing a budget for a 'core programme' of key equipment projects, with additional sums set aside for contingency and emerging requirements. It is updated annually. For the period 2014 to 2024, the equipment budget is £163 billion, made up of procurement (£69 billion) and support (£81 billion) budgets, a central contingency reserve (£4.6 billion), and an unallocated budget (£9.2 billion) that the Department has not yet committed to specific programmes. The Plan is funded from the Department's overall budget, and makes up a significant proportion of its planned spend.

**4** For the first time we have combined our review of the Equipment Plan with the Major Projects Report, to enable Parliament to have a more complete view of the Department's management of the procurement and support of the UK's defence capability. We have selected a sample of 17 projects as the basis for reporting project performance and to support our review of the affordability position.<sup>3</sup> This sample of projects has been selected based primarily on value but also to reflect the level of project maturity and type of equipment.

<sup>1</sup> HM Government, *A Strong Britain in an Age of Uncertainty: The National Security Strategy*, Cm 7953, October 2010.

<sup>2</sup> The project summary sheets the Department submits to Parliament are contained in Volume II of this report.

<sup>3</sup> We also looked at the assumptions underlying a small additional sample of support projects.

**5** We do not set out to offer a definitive view on the affordability of the Equipment Plan, as it is, by its nature, based on assumptions about the future that will inevitably change. Rather, we review the assumptions that underpin the forecast costs and funding to assess whether they were reasonable and consistently applied at the time they were made. We explain our approach in Part One of this report, and then look at: the Department's assumptions underpinning the forecast costs of the Equipment Plan (Part Two), including for the first time this year support costs; and the assumptions underpinning available future funding (Part Three), which taken together define whether the plan is affordable. We have also reviewed whether the disclosure in the Department's Statement is sufficient for the reader to fully understand the risks and sensitivities of the affordability position (Part Four). Appendix One contains full details of our audit procedures, and Figures 12 and 13 provide an overview of the projects included in our analysis. Summaries of the projects in our sample are included at Appendix Four. The full set of information for each project is set out in the project summary sheets completed by project teams which are included as Volume II of this report.

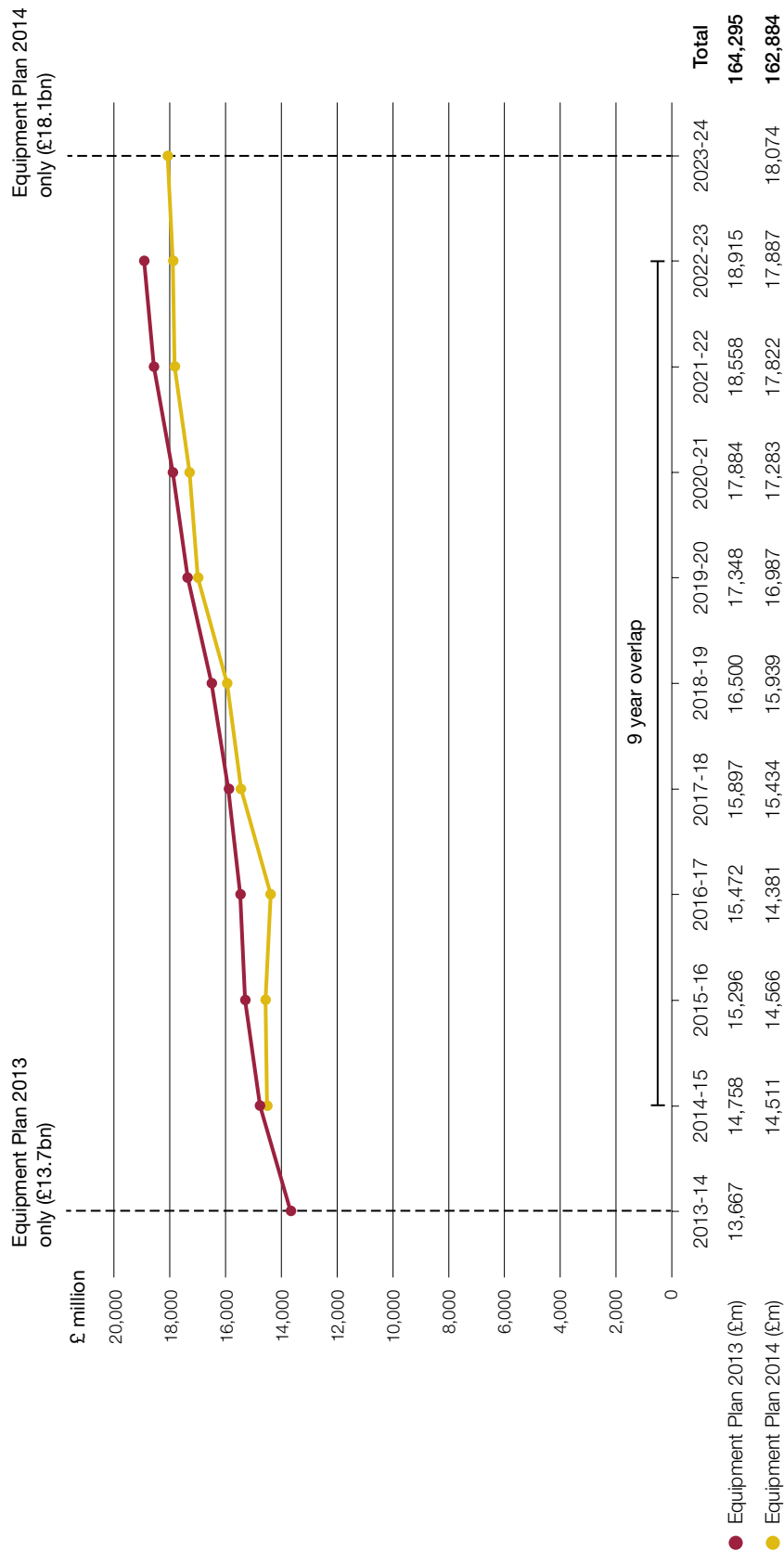
### **Confidence in the continued affordability of the Equipment Plan as a whole**

**6** **The forecast cost of the Equipment Plan 2014 to 2024 is £1.4 billion less than the forecast cost of the 2013 to 2023 Equipment Plan.** The forecast cost of the Plan for 2014 to 2024 is £162.9 billion compared with £164.3 billion for the period 2013 to 2023 (see **Figure 1** overleaf). Since 2012, the Department has emphasised the importance of the affordability of its core equipment programme. For the Department to have confidence that the Equipment Plan is affordable, the combined cost forecasts for its core programme of projects need to be contained within the sums made available by HM Treasury, allowing for the non-equipment commitments of the Department.

**7** **There have been significant movements of funds between procurement and support budgets.** Compared with the 2013 Plan the forecast cost of procurement has increased by £5.4 billion while support costs are expected to be £6.2 billion less over the period. This is due mainly to: a reclassification of costs for one project as procurement rather than support; and anticipated efficiency savings in the support budget more generally. Anticipated efficiency savings are the main cause of a £5.8 billion decrease in the Equipment Plan budget across the 9 years that the 2013 and 2014 Plans have in common (2014 to 2023).

**Figure 1**  
The 10-year forecast cost profiles of the Equipment Plan 2013 and Equipment Plan 2014

This shows changes in the forecast cost of the Plan between 2013 and 2014



**Note**

1 The Equipment Plan covers a forecast 10-year period and is produced annually. Therefore, successive plans share a 9-year period in common with an additional year brought into the scope of the Equipment Plan each year.

Source: National Audit Office analysis of Ministry of Defence data

**8 The Department has removed more than £6 billion from budgets within the Plan in anticipation of achieving significant savings.** The largest element of this is the removal of £4.1 billion of anticipated savings from the support cost budget. The Department has engaged external consultants to assist in identifying savings. They have reviewed 11 major support projects to date, constituting nearly 40% of the value of the equipment support programme. The project teams have provisionally identified potential savings of £2.9 billion over 10 years. Only a limited proportion of these savings have been realised to date. Savings have also been removed from procurement budgets:

- Savings of £1.05 billion expected through the Submarine Enterprise Performance Programme.
- £1.2 billion of savings to be found from the Complex Weapons procurement programme.

If savings are not achieved the Department will need to adjust its budgets, which could mean using money set aside for future projects, or delaying or cancelling existing projects.

**9 Project teams continue to be over-optimistic in their forecasts of both procurement and support costs.** Project teams continue to be over-optimistic in their forecasts of procurement costs. The Department's Cost Assurance and Analysis Service estimates that the forecast cost of procuring equipment is understated by £3.2 billion against project team forecasts, a reduction from £4.3 billion for the 2013 to 2023 period. The Cost Assurance and Analysis Service has also reviewed 28% of the support cost budget to date, and estimate that project team forecasts for those projects are £2 billion understated.

**10 Budgets set using over-optimistic forecast costs could result in overall budgets for procurement and support being significantly understated.** The Equipment Plan budget should be a compilation of the individual budgets that are set based on the estimated forecast cost of each project. In some instances, however, the budget may be set lower than this; for example where the Department is challenging project teams to deliver projects for less. A review of the estimated procurement costs of 29 of the largest projects within the Plan by the Cost Assurance and Analysis Service in January 2014 initially estimated the gap between the allocated budget and the realistic procurement costs of these projects to be some £4.7 billion. In April 2014, the Department adjusted its budget allocations, adding £2.4 billion to the 2014 Equipment Procurement Plan. There is currently no overall estimate of whether, or to what extent, support budgets may be understated.

**11 The Department's contingency may not be enough to mitigate the combined effects of underestimates in project team costs and equipment plan budgets.**

The Department continues to hold a £4.6 billion contingency across the 10-year plan to mitigate potential cost increases within the core equipment programme. Should this contingency be insufficient to mitigate unrealistic forecast costs across procurement and support budgets the Department may need to draw on the £9.2 billion that is set aside to deliver equipment needed for delivery of wider defence capability that currently is not included in the core programme.

**12 The Department's Statement on the Affordability of the Equipment Plan is clearer than the earlier two Statements.** The reader can understand how the Equipment Plan is constructed, managed and challenged. However, the Statement needs to be improved further to explain more clearly the key assumptions and the risks to the affordability of the Equipment Plan. In particular, more information is needed on how to measure the success of initiatives to achieve support cost savings, and how to manage the Equipment Plan if the necessary level of savings is not met.

### **Confidence in the Department's delivery of major projects**

**13 Our review of the forecast cost of 11 major projects where the Department has decided to buy equipment shows that the time, cost and performance of these projects has remained stable in 2013-14.** For the 11 projects within our sample of 17 projects that have passed the main investment decision, the forecast cost of the projects has reduced by £397 million (0.7%). This was largely due to a reduction in the forecast cost for the Lightning and Typhoon fighter jets. There has only been one new significant approval during 2013-14 and no new procurements have been introduced, resulting in a relatively stable portfolio of major projects. We have excluded the £754 million cost increase of the Queen Elizabeth Class Aircraft Carriers, which we reported in our Major Projects Report in February 2014. The Department expects the projects to achieve 99% of their intended capability. There were in-year time variations totalling 14 months for 2 out of 10 projects – for Warrior Capability Sustainment Programme and Core Production Capability; in both cases the Department does not expect any impacts on operational capability from these delays.

### **Confidence in the forecast costs of the largest projects**

**14 Increases in the forecast costs of projects are not due to real cost growth and forecast costs largely remain stable across projects.** Alongside our review of the aggregate cost movement from the prior year, we also undertook a detailed review of 17 of the largest procurement projects to see whether there was cost stability at the project level. We found that the 10-year procurement cost of these projects increased by £2.6 billion compared with the forecast cost for 2013 to 2023. However, these increases mostly came from the Department:

- implementing some projects within the 10-year plan more quickly, thereby bringing costs into the plan earlier; and
- assessing that it would be more appropriate to classify some costs as procurement rather than support.

**15 The Department overspent by £185 million against its original equipment budget in 2013-14 by tasking project teams with a large amount of additional work.** The Department has taken action to manage the risk of underspending against its budget, as in past years. To avoid a significant underspend in 2013-14 the Department included £920 million of additional work in the programme. When the Department became concerned that an underspend would emerge in-year, a further £213 million of additional work was added to the programme. In the event, the Department overspent by £185 million against its original assumptions. In 2012-13, we reported that the Department underspent on equipment by £1.15 billion against the total value of its work programme for the year (original equipment budget plus additional work programmed during the year). For 2013-14, the equivalent figure was £948 million.

**16 A detailed review into the causes of project underspends shows that the largest single cause is accounting adjustments.** Errors and consequent adjustments involve movements of hundreds of millions of pounds within budgets. This can give a misleading picture of spend and forecasts at individual project level. It is clear that the Department needs to improve its in-year financial management. The Department recognises the need to continuously improve its in-year financial management and has established a programme to do so. In addition, external consultants working with the Department to review support costs have found consistent weaknesses in:

- specifying requirements;
- estimating costs; and
- working with suppliers to drive down costs.

**17 Project teams have varying skill levels in cost forecasting and risk management.** Only 9 of our 17 projects forecast a range of potential costs based on the likelihood of different scenarios and risks, in line with good practice. Sometimes project teams rely on industry to model realistic cost estimates for projects. This casts doubt on whether the forecast costs are sufficiently robust for the Department to have confidence that the Equipment Plan is affordable and the Department has sufficient quality of information to manage the risks to the budget.

**18 Project teams need to ensure they are using the most appropriate inflation rate.** The forecast costs of long-term projects can be significantly affected by the projected inflation rate. Unexpected changes in inflation may drive cost increases in projects beyond those that were planned for, so project teams should understand how their projects are affected by inflation. The Department's guidance states that project teams should apply an inflation rate that is suitable to the characteristics of their projects, which is a reasonable approach. However, in 4 projects we found that teams were using rates based on analyses from 2 to 3 years ago or were applying a general rate without evidencing that this was appropriate. We would expect an up-to-date, evidence-based rate to be used to mitigate the effect of unexpected inflation rate movements.

## **Confidence in the funding assumptions of the Equipment Plan**

**19 The Department believes it is making the necessary savings in non-equipment budgets to protect the Equipment Plan, but we have not reviewed these.** Funding for the Equipment Plan is not protected; the Department has to allocate its budget for equipment costs internally, ensuring that there is also enough within the budget to meet non-equipment cost (such as the management of the Defence Estate and costs of Armed Forces personnel). The absence of savings in these budgets could increase the proportion of the defence budget that is needed in those areas and have an impact on the funds available for the Equipment Plan.

**20 The Department believes that the fundamental assumptions underlying the affordability of the Equipment Plan have not changed since last year.**

These assumptions are that a fixed minimum value will be given for the funding of the Equipment Plan for each year in the period covered, based on a 1% real increase above inflation (although this is not guaranteed for the full period of the Equipment Plan). Also, the Department can choose to spend more than that on equipment procurement and support, and the current Equipment Plan budget is significantly in excess of the amount allocated by HM Treasury for equipment procurement.

## **Conclusion**

**21** There are a number of positive features arising from our work on the Equipment Plan, not least the relative stability of forecast project costs and control over in-year variations in approved timings and costs of major projects. The Department has chosen a higher risk approach to managing the affordability of the Equipment Plan by relying on future savings where a significant proportion has not yet been identified. This is within the context of potential continuing over-optimism in the project cost forecasts that make up the Plan. The Department will need to be watchful and quick to react if costs start to grow.