



National Audit Office

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## **Report**

by the Comptroller  
and Auditor General

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## **Ministry of Defence**

# The Equipment Plan 2019 to 2029

## Key facts

**The Ministry of Defence's (the Department's) equipment procurement and support budget is large but does not cover its forecast costs over 2019–2029**

The Department's estimates of the funding shortfall over 2019–2029		
<b>£180.7bn</b>	<b>£2.9bn</b>	<b>£13.0bn</b>
the Department's equipment and support budget over 2019–2029	the Department's central estimate of the most likely funding shortfall, based on forecast costs of £183.6 billion over the 10 years	the Department's upper estimate of the funding shortfall should risks it has identified materialise

**The Department has been over-optimistic when making two significant adjustments to the Equipment Plan's forecast costs**

<b>£7.8 billion</b>	additional costs removed from the 2019–2029 Plan as a result of the Department's more optimistic judgements on its ability to deliver the equipment programme and make savings
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**The affordability pressure occurs in the next five years**

	2019-20 to 2023-24	2024-25 to 2028-29
<b>Affordability</b>	£6.0 billion <b>shortfall</b>	£3.1 billion <b>surplus</b>
<b>Contingency in the Equipment Plan budget</b>	£1.5 billion	£3.3 billion

**This year, the Department reduced the Equipment Plan budget to reflect wider funding pressures**

<b>£7.7 billion</b>	shortfall in the overall defence budget between 2020-21 and 2024-25. The Department is restricting spending on the Equipment Plan to offset this funding shortfall
<b>£4.8 billion</b>	Equipment Plan contingency over the next 10 years, down from £5.1 billion last year
<b>£0</b>	department-wide contingency to offset any cost increases across the defence budget over the next 10 years, down from £4.3 billion last year

# Summary

**1** Each year, the Ministry of Defence (the Department) publishes its Equipment Plan report (the Plan), setting out its spending plans for the next 10 years. It assesses whether its equipment and support programmes are affordable and sets out its expected expenditure on projects to equip the Armed Forces. The Plan summarises the Department's investment programme over a 10-year period because of the long-term nature of large, complex defence projects. It includes equipment already in use, such as the Hercules aircraft, and in development, such as the Type 26 global combat ship.

**2** The latest Plan covers the period from 2019 to 2029. During this time the Department has allocated a budget of £181 billion to equipment and support projects, 42% of its entire budget. It needs to manage this expenditure effectively to ensure the Armed Forces can secure and maintain the equipment they need to meet their military objectives. The Department protects some of this budget to ensure it is spent on equipment, but financial pressures across its wider defence budget can reduce the money available for equipment and support projects.

**3** The Department introduced the Equipment Plan in 2012 after a period of weak financial management, which led to a significant gap between funding and forecast costs across the defence programme. As a result, a cycle of over-committed plans, short-term spending cuts and re-profiling of expenditure resulted in poor value for money and reduced funding for front-line military activities. In 2012, the Secretary of State for Defence invited the Comptroller and Auditor General to examine the robustness of the Plan's underlying assumptions. We have since produced a commentary annually when the Department publishes the Plan. The purpose of our report is to assist Parliament in evaluating the Department's assessment of affordability and its response to the financial challenges it faces.

**4** We have reported for the past two years that the Equipment Plan is unaffordable, with the largest funding shortfalls in the early years of the Plans.<sup>1</sup> We concluded that the Department needed to make decisions to develop an affordable long-term Plan, as its focus on short-term financial management was risking longer-term value for money.

<sup>1</sup> Comptroller and Auditor General, *The Equipment Plan 2017 to 2027*, Session 2017–2019, HC 717, National Audit Office, January 2018. Comptroller and Auditor General, *The Equipment Plan 2018 to 2028*, Session 2017–2019, HC 1621, National Audit Office, November 2018.

**5** This report sets out our examination of the Department's approach to assessing the affordability of its Equipment Plan 2019–2029, including our review of the assumptions on which its assessment is based. We completed this review in November 2019. This year, we give greater attention to examining the Department's approach to managing the continued funding shortfalls, and the consequences of its approach. In doing so, we draw on the wider lessons from our assessments of government's financial planning.<sup>2</sup> This report examines:

- the affordability of the Equipment Plan 2019 to 2029 (Part One);
- the Department's approach to producing the Plan (Part Two); and
- the adequacy and consequences of the Department's response to the affordability gap (Part Three).

**6** We do not consider the value for money of the specific projects mentioned in this report. Nor do we comment on the specific prioritisation or operational judgements that the Department needs to make to develop an Equipment Plan that is affordable and meets future defence needs. This report focuses on the scale of affordability challenge that the Department faces, and its response. We are carrying out separate work on the Department's approach to introducing military capabilities.

## **Key findings**

The affordability of the Equipment Plan

**7 The Equipment Plan remains unaffordable, with the Department estimating that costs will be £2.9 billion higher than its budget between 2019 and 2029.**

Its central estimate was that equipment and support costs of £183.6 billion will exceed the budget of £180.7 billion. Although this is less than the £7.0 billion that it reported last year, the apparent reduction is based on the Department's revised approach to assessing the affordability of the Plan rather than the result of actions to address the 10-year funding shortfall. The Department's intention is to provide a more realistic assessment of the funding shortfall, but the changes mean that this year's assessment is not directly comparable to the 2018–2028 Plan. The Department made some substantial management adjustments, such as reducing forecast costs by £5.3 billion more than in 2018 to reflect its revised judgements that some projects will proceed more slowly than previously expected. It also reduced the Plan's budget by £7.7 billion to reflect wider departmental funding pressures, meaning that its assessment of the Plan's affordability is presented on a different basis to last year (paragraphs 1.32 to 1.34).

<sup>2</sup> Comptroller and Auditor General, *Improving government's planning and spending framework*, Session 2017–2019, HC 1679, National Audit Office, November 2018.

**8 The Department's central estimate of the funding shortfall of £2.9 billion is still likely to be understated.** It has assessed the shortfall could be larger, estimating that it could be as high as £13.0 billion if all risks materialise, which is equivalent to 7% of the budget over this period. The Department's Head Office is working with the Top Level Budgets (TLBs) to introduce a more consistent, evidence-based analysis of adjustments to cost forecasts.<sup>3</sup> However, we found that the TLBs are still using inconsistent approaches to making adjustments to cost estimates. We also consider that aspects of the Department's affordability assessment continue to be over-optimistic. In particular:

- it reduced forecast costs by £11.9 billion to reflect revised judgements that it will not deliver its equipment projects as quickly as originally intended or that the risk of cost increases had been over-estimated. However, it has removed these costs from the Plan in their entirety, rather than re-profiling them over a 10-year period. This means that costs in the later years of the Plan are likely to be understated; and
- it reduced forecast costs by £4.7 billion to include potential efficiency savings, but it is less confident of delivering these initiatives. These potential savings are more than double the amount included in last year's cost forecast.

In addition, the 2019–2029 Plan does not reflect all additional costs of developing new military capabilities, which will be based on future decisions about what capabilities are needed. For example, the Department has yet to decide its requirements on the number of F-35 aircraft it needs. It has not, therefore, made provision in the Plan to meet all of the commitments in the 2015 Strategic Defence and Security Review or develop new capabilities to respond to the changing demands of warfare (paragraphs 1.17, 1.18, 1.22, 1.23, 1.28, 1.32, 1.34 and 2.3).

**9 The Department continues to face significant funding shortfalls over the next five years and is locked into a cycle of responding to short-term financial pressures.** It has continued to focus on managing in-year cost pressures to live within its annual budget. This focus, together with additional funding of £1.6 billion over 2018-19 and 2019-20 to help offset the financial pressures, has meant that the Department was able to establish an affordable in-year funding position for equipment and support projects in 2019-20. However, it continues to face the same 10-year profile of funding shortfalls as in previous years, with a shortfall of £6.0 billion in the first five years of the Plan. Continuing to rely on short-term funding decisions means the Department – and the defence industry – do not have a firm basis for future planning, as the Plan was originally designed to encourage (paragraphs 1.3, 1.32, 1.35 and 3.6).

<sup>3</sup> The Head Office oversees the production of the Equipment Plan. The TLBs responsible for managing projects in the Equipment Plan are Navy Command, Army Command, Air Command, Joint Forces Command (now known as Strategic Command), the Defence Nuclear Organisation and Strategic Programmes.

**10 The Department now has less flexibility to respond to short-term financial pressures.** In assessing the funding shortfalls, the Department has assumed that it will achieve efficiency savings of £818 million in 2019-20 and 2020-21, on top of the savings already removed from project costs. It has limited time to design measures to achieve all of these planned savings. At the same time, the Department faces significant pressures in other areas of its budget, most notably its estate, which creates further pressure on its equipment and support budget. Other cost pressures are also likely to emerge. For example, the Department needs to save £460 million between 2019-20 and 2022-23 to fund the Armed Forces pay award announced in July 2019. It also needs to manage the impact of adverse foreign exchange rate movements since the start of the financial year which, at October 2019, had added £1.5 billion to the costs shown in the Plan. It has reduced the amount of contingency ring-fenced for the Equipment Plan by £0.3 billion over the next four years and now has no wider departmental contingency to provide flexibility to address emerging cost pressures (paragraphs 1.10, 1.21, 1.29, 3.14 and 3.15).

**11 The Department is improving its approach to compiling the Plan but has not yet established a consistent approach across the TLBs.** Its Head Office has encouraged TLBs to adopt a more consistent and analytical approach to estimating cost forecasts. It has also addressed the causes of errors that led to the republication of its 2018 report, introducing new data checks. However, Head Office had to make substantive adjustments at the year-end to address inconsistencies in the data provided by TLBs. It undertook more comprehensive quality assurance work to produce the 2019 report but has not yet developed a full understanding of the controls in the end-to-end process for producing the Plan. Its longer-term aim is to improve its financial capabilities, including the accuracy of cost forecasting, but it has not yet recruited enough people with the necessary financial skills (paragraphs 2.2 to 2.11).

The Department's approach to managing the funding shortfalls

**12 The Department has again delayed the difficult decisions to make the Equipment Plan affordable and determine its priorities on future military capabilities.** The Department still does not have an affordable long-term investment programme 28 months after it began reviewing what capabilities were needed and affordable. There have been two missed opportunities to make decisions on an affordable programme. In December 2018, as part of the 'Modernising Defence Programme', the Department introduced changes to modernise the way it operates but did not make any programme-related decisions to make the Plan affordable. In the September 2019 Spending Round, HM Treasury provided additional funding only up to 2020-21 to offset short-term financial pressures. This meant that the Department was unable to address the long-term affordability gap and will have to continue to manage the financial pressures until the next spending review on defence and security. It has now carried out a detailed analysis of investment options on which it can make better informed decisions on the capabilities that should be stopped, deferred or de-scoped to establish an affordable long-term programme to develop future military capabilities (paragraphs 3.2 to 3.6).

**13 The Department's continued short-term focus of living within annual budgets is leading to reduced capabilities and higher overall costs.** We saw increasing evidence of the cumulative impacts of the Department's continued focus on managing in-year costs, with the TLBs making prioritised investment decisions on their programmes to respond to affordability pressures. As a result, existing capabilities will be lost when current funding allocations end, such as the medical facilities provided by the ship *RFA Argus*, or will be reduced, such as the number of Sentry aircraft. The TLBs also had to reduce expenditure on support, such as limiting maintenance activity to legislative minimums. Decisions to defer project expenditure are also leading to poor value for money. For example, the Department now expects the costs of delaying Protector to increase from £160 million to £187 million, with a further £50 million cost of retaining existing, less capable equipment until Protector enters service. As a result, the Department is facing the growing risk that affordability pressures are leaving them with equipment that is in managed decline (paragraphs 3.16 to 3.21).

**14 The Department increased the financial pressure by establishing a transformation fund to develop new capabilities.** In November 2018, the then Secretary of State for Defence decided to spend £500 million over three years on new 'innovative capability enhancements', in addition to existing commitments in the Equipment Plan. The Department funded this by reducing TLB budgets over the next three years, including a reduction of £160 million in 2019-20, which created an additional cost pressure after the TLBs had submitted their annual spending plans. The Secretary of State selected 18 projects, including some capabilities not previously identified as high priorities. The Department will need to provide additional funding to develop useable capabilities from these projects, although it does not yet know the scale of the additional investment required. The Department's most senior board raised questions about TLBs' ability to spend money on these projects at short notice and noted that the impact on existing spending plans was not understood (paragraphs 3.10 to 3.12).

**15 The Department is managing the financial pressures by establishing tighter control of in-year expenditure and future commitments.** Head Office agreed spending profiles with TLBs and allocated their indicative 2019-20 Equipment Plan budgets three months earlier than the previous year, allowing them more time for planning. However, in 2019-20, Head Office approved TLB spending plans which were £269 million higher than budgets (0.7% of the departmental budget) and is monitoring expenditure throughout the year to reduce this variance. This means TLBs may again have to reduce expenditure at short notice, increasing the risk that they will defer projects without fully understanding the cost or operational implications. The Department has also introduced new controls to prevent TLBs from committing to new expenditure in future years but, in doing so, has restricted their ability to enter into multi-year contracts (paragraphs 3.8 to 3.9).

## Conclusion

**16** For the third successive year, the Equipment Plan remains unaffordable. The Department's central estimate of equipment procurement and support costs is lower than last year, but this reflects a restatement of the affordability gap rather than actions to address the funding shortfalls. The Department has still not taken the necessary decisions to establish an affordable long-term investment programme to develop future military capabilities. It has responded to immediate funding pressures by strengthening its management of annual budgets and establishing controls on future expenditure on equipment and support projects. It is also seeking to develop a more realistic assessment of affordability but has not yet addressed inconsistencies in the cost forecasts which support it.

**17** However, the Department has become locked into a cycle of managing its annual budgets to address urgent affordability pressures at the expense of longer-term strategic planning, and is introducing new commitments without fully understanding the impact on the affordability of the Plan. It is not, therefore, using the Equipment Plan as a long-term financial management tool, as it was originally designed to be. The Department's continued short-term decision-making is now leading to higher costs and reduced capabilities. There is evidence that these problems are growing and increasingly affecting the Armed Forces' ability to maintain and enhance their capabilities. As a result, there are increasing risks to value for money from the Department's management of the Equipment Plan.

## Recommendations

**18** The Department has made some improvements to its approach to producing the Equipment Plan but there continue to be inconsistencies between TLBs. The consequences of successive years of focusing on short-term financial management are also having a greater impact on the TLBs' ability to develop the military capabilities they need. The following recommendations are intended to help the Department produce a more realistic assessment of the affordability challenge, which it can use to make informed decisions on current and future priorities.

Improvements to assessing and presenting the affordability assessment in the 2020-2030 Plan

- a The Department should improve consistency of judgements by embedding a common methodology for adjustments to the budget and cost forecasts.** The methodology should be capable of being tailored to individual TLBs but be based on consistent principles and an analytical, evidence-based approach.
- b Head Office should undertake further analysis of the main adjustments to establish how to improve their reliability;** for example, the risk of double-counting or the relationship between different adjustments.
- c The Department should provide a fuller reconciliation of the affordability assessment in its report to compare against the previous year.** This would enable readers to understand the basis of the current assessment and main movements.



### Improvements to the process for producing next year's Plan

- d** **Head Office should strengthen the process for producing the Plan**, given the amount of data needed to compile the Plan, the number of people involved across the TLBs and the need for manual input. It should establish a new financial control framework which clearly sets out the risks, controls and responsibilities.
- e** **The Department should now focus on filling the gaps in key financial positions across TLBs.** Improving financial capabilities across the Department is fundamental to achieving the required improvements to processes and methodology for producing the Plan.

### Addressing the consequences of funding shortfalls in the next strategic review

- f** **The Department should draw on its detailed assessment of options for Spending Round 2019 to maintain a prioritised cross-Department view on future military capabilities.** It should estimate potential development costs of new projects to better inform decisions to delay, defer or de-scope existing projects. It should also ensure TLBs carry out holistic assessments of their priorities for equipment, infrastructure and other areas of spending. It then needs to use the Equipment Plan as it was originally intended – to manage its investment programme over a 10-year period.