National Audit Office

The Equipment Plan 2021 to 2031

Ministry of Defence

REPORT

by the Comptroller and Auditor General

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Key facts

£238bn

the Ministry of Defence's (the Department's) equipment procurement and support budget for the period 2021-2031

£4.3bn

the Department's assessment of the Equipment Plan's (the Plan's) surplus of budget over costs

£22bn

adjustments made to reduce the Equipment Plan (the Plan's) costs (equivalent to 9% of total costs before these adjustments)

£48 billion	increase in the Department's equipment procurement and support budget between 2020–2030 and 2021–2031
£15.8 billion	new investments announced through the Integrated Review reflected in the 2021-31 Plan
£4.1 billion	strategic disinvestments made through the Integrated Review reflected in the 2021-31 Plan
£3.9 billion	savings without delivery plans which the Department assumes will be found in the Equipment Plan between 2021-2031
Third quartile	HM Treasury's 2021 assessment of the Department's relative financial capability, placing it in the lower half of government departments
£1.05 billion	funds set aside to take advantage of promising research and development so that it leads to usable military capabilities (0.4% of the Plan's budget)

Summary

1 The Ministry of Defence (the Department) publishes its Equipment Plan (the Plan) report each year, setting out its spending plans in equipment procurement and support projects over the next 10 years. The Department introduced its first Equipment Plan in 2012 after a period of weak financial management. Its aim was to produce a reliable assessment of the affordability of its equipment programme, and by doing so demonstrate to Parliament that the programme was based on realistic and effective long-term financial decisions. The Secretary of State for Defence invited the Comptroller and Auditor General to examine the robustness of the Equipment Plan's underlying assumptions.

2 Each year since then we have published a report examining the Department's assessment of the Equipment Plan's affordability and its response to the financial challenges it faces. These assessments have shown that the Department has consistently found it difficult to strike the right balance between increasing equipment capability and living within its means. The 2010 Strategic Defence and Security Review took the decision to eliminate a number of capabilities, helping to bring spending in line with the funds available. As a result of the 2015 Strategic Defence and Security Review many of the cuts were reversed. Since then, we have found that the risks to the Equipment Plan's affordability have increased, leading the Department to make short-term deferrals of expenditure which adversely affect equipment capability and value for money.

3 In November 2020, as part of the Spending Review, HM Treasury announced that the Department would receive an additional £16.5 billion above its standard annual increase between 2021-22 and 2024-25. This was followed by the government's publication of the Integrated Review of security, defence, development and foreign policy and the complementary Command Paper on Defence in March 2021, which set out policy intentions for defence over the next decade. The Department announced that the combination of these reviews and the settlement represented a real chance to remedy the affordability problems it had struggled with in its equipment planning over many years, as well as a chance to make a step-change in defence capability.

4 This report examines whether the Department has managed to reduce the risks to affordability in its Plan. It also examines whether the Department is on track to address the wider management and structural weaknesses which have undermined previous Plans. In particular it examines:

- the impact of the increased settlement and Integrated Review on funding for equipment, and the Department's assessment of affordability in its 2021–2031 Plan (Part One);
- how the Department is managing the risks to affordability (Part Two); and
- the extent to which the Department has put in place the building blocks needed for a robust and effective Plan (Part Three).

5 We do not consider the value for money of specific projects mentioned in this report. Nor do we comment on the specific decisions that the Department must take to develop an affordable Equipment Plan to meet future needs, which are policy choices. We have not reviewed the Department's systems to test the accuracy of its data. But we have examined its own quality assurance arrangements for testing the consistency and reliability of data used in the Plan.

Key findings

The impact of the Spending Review and the Integrated Review on the Equipment Plan

6 The government has given a significant increase in funding to defence over the next four years, and the Department is investing more across its activities, including a record increase in equipment. The 2020 Spending Review determined that the Department's overall budget for the period between April 2021 and March 2025 would be £16.5 billion higher than previously assumed. The Department has subsequently set out how it intends to reshape the armed forces to meet future threats. It is spending more on infrastructure and other priorities, such as the National Cyber Force. It expects to spend £11.7 billion more on equipment over the four years covered by the Spending Review. Over 10 years, the Plan has increased in value from £190 billion in the 2020–2030 Plan to £238 billion for 2021–2031, an increase of £48 billion (25%). This is by far the largest increase in the Plan's 10-year history (paragraphs 1.5, 1.6, 1.10 and 1.11).

7 **The Department has invested in new capabilities and cut or deferred some existing programmes, and assesses that the Plan is now affordable**. In addition to re-affirming investment in many existing projects, such as the Type 26 frigate, the Department plans to bring forward spending on other projects, such as the replacement for Astute submarines. It also intends to spend £15.8 billion on new capabilities before March 2031, including £1.3 billion developing a new system to detect and destroy sea mines. It is stopping investments, such as the Warrior armoured vehicles and Hercules transport aircraft, and scaling back others. It also intends to defer some investments to save money in the short term. In some cases, this will lead to higher costs because of the need to re-contract at higher prices (at the time of the Integrated Review, it expected delaying a project to buy new Chinook helicopters by three years would cost an additional £295 million). The Department assesses that the result of these plans, as well as taking account of some unexpected growth in project costs, is that for the first time in four years the Plan is affordable. It currently estimates that the Plan's budget will exceed costs by £4.3 billion to 2031 (paragraphs 1.7 to 1.9, 1.12, Figures 1 and 2).

Managing risks to the Equipment Plan's affordability

8 **Our audits of the Department's Equipment Plans since 2012 have enabled us to identify where we should focus our work to test whether the Plan is affordable over the next 10 years**. In terms of the adequacy of available resources, these include whether the Plan's budget takes sufficient account of the potential impact of other parts of the defence budget (such as infrastructure and workforce) coming under pressure in future years, and that it assumes only those efficiencies and cost reductions which are likely to be achieved. We also look at whether the budget contains all the equipment projects the Department is planning and whether it reflects the ambitions of key policy documents such as the Integrated Review. On the cost side, we examine whether the cost estimates are accurate and based on the best available information, including taking proper account of uncertainty, especially in less mature projects. Focusing on these risk factors, we set out in the rest of this part of the Summary the results of our review of the Plan's forecast budget and costs.

Budget assumptions

9 **The Department's total planned spending across all its areas and activities is higher than the budget it expects to receive from HM Treasury over the next 10 years, effectively reducing the contingency earmarked for the Equipment Plan**. The Department's planned capital spending exceeds its budget in seven out of 10 years, and its resource spending exceeds budget in five out of 10. The Department believes that savings will be made over the years so that budget and costs will eventually align. It has apportioned the current overall budget shortfall against the three different areas of spending (of which the Equipment Plan is one) in proportion to their relative size. As a result, the Equipment Plan budget has been reduced by nearly £1.9 billion over 10 years. This effectively reduces the contingency notionally earmarked for the Plan from £5.9 billion to £4.1 billion (paragraphs 2.4 and 2.5).

Cost estimates

10 **Some project teams have identified a range of costs not currently included in the Plan, which could result in financial risk if the Department does not reassess its priorities**. The Department could address this risk by accepting scope reductions or later delivery of the capability in the related projects. Including these costs would increase the cost of the Plan by £4.2 billion, and both new and existing projects are affected, although none of them have secured full business case approval.[1] The Department has the opportunity to re-visit budgets at that stage. The amount included for one of these projects – the Future Combat Air System – could be considerably less than the funding required over the next 10 years. Its affordability will depend on assumptions about the capability, timetable and contribution from international partners (paragraphs 2.6 to 2.8 and Figure 5).

11 **More widely, project costs could increase by more than the Department has allowed for**. The Department's Cost Assurance and Analysis Service (CAAS) produced an independent assessment of the cost of projects making up 58% of the Plan's costs this year. It concluded that these projects are likely to cost £7.6 billion more than the Plan assumes.[2] It expects that the Dreadnought nuclear submarine, the largest programme in the Plan, will cost an additional £2.6 billion (the Department may be able to ask HM Treasury to increase its budget if Dreadnought costs do increase). Other nuclear projects are also at particular risk of cost growth. This potential cost growth is considerably more than the £4.3 billion total surplus over 10 years, which the Department has assessed it has available. Furthermore, inflation has increased since CAAS's work. While HM Treasury has made available £700 million each year from 2022-23 in part to recognise this change, the extra funding is for day-to-day costs only, while the majority of Equipment Plan costs are capital spending (paragraphs 2.10, 2.12 and 2.14 to 2.15).

1 This includes £409 million of costs associated with the Morpheus programme, which are also included in the Cost Assurance and Analysis Service's assessment that Equipment Plan costs could be £7.6 billion higher (see paragraph 11).

2 CAAS included the under-costing of the Morpheus programme by £409 million in this assessment, but not the other programmes we discuss in Paragraph 11.

Negative cost adjustments

12 **The Plan's budget and projected costs assume that Top Level Budgets (TLBs) will reduce equipment costs by £7 billion over the next 10 years**. They do not yet have plans to achieve £3.9 billion of these 'Planned Cost Reductions', but the Department's worst-case affordability scenario assumes that only £935 million of savings will not be achieved. Navy and Air Commands need to identify many more savings than the other TLBs; Air Command has little flexibility as it is already committed to 62% of its spending over the next 10 years. The TLBs also still need to implement £2.8 billion of efficiency savings (defined as cost reductions which do not affect outputs), which are not well developed, on top of the savings already deducted from projects. Outside the Equipment Plan, the Department requires TLBs to make at least £3.7 billion of savings over and above their headcount reduction targets (paragraphs 2.16 to 2.18).

13 **The Plan also still includes large adjustments to anticipate future delays in the delivery of equipment.** TLBs assume that in future years some equipment will not be introduced as quickly as planned and they adjust spending forecasts accordingly. This year these adjustments are £12 billion, compared with £10 billion in the 2020 Plan, which is a similar proportion of total project cost estimates. We have been critical of the lack of evidence supporting these adjustments and expressed concerns that they were being used to make the Plan seem more affordable. This year we have found some improvement, in particular a more robust methodology used by Navy Command (paragraph 2.21).

The Plan's completeness

14 **It is too early to say if the planned new investments in equipment will mean that the Plan includes all the equipment that the armed forces need**. We reported in our report on the 2020–2030 Plan that filling known and expected equipment capability gaps would cost at least £20 billion. This assessment was based largely on the Department's Defence Capability Assessment Register (DCAR), which assesses the armed forces' effectiveness against a set of scenarios based on the tasks they are expected to prepare for. The Department did not carry out a DCAR assessment this year. Still, a less formal assessment concluded that its Integrated Review investment decisions will reduce the previous capability risk against most of the tasks tested. However, the Plan does not include the procurement and support costs of the new 'National Flagship'. The Department expects to award a fixed-price contract and that the project will cost around £250 million (paragraphs 2.23 and 2.24).

15 **The Department believes its planned spending of £7.4 billion on Research and Development (R&D) between 2020-21 and 2024-25 is an increase from previous periods, but this is difficult to validate as the basis of measuring R&D spending has changed.** In the following six years, current forecasts suggest spending will be significantly lower, although the Department believes projects are under-reporting how much of their spending will qualify as R&D in these years. The Department is setting aside an additional £1.05 billion from 2026-27 to 2030-31 to exploit research to develop usable military capabilities. This is only 0.4% of spending over the 10 years covered by the Plan, although the Department believes the boundary between R&D and exploitation is blurred. Without allocating more funding, there is a risk that some R&D work cannot be exploited. For example, the Department has not funded plans to develop an electronic warfare variant of the SPEAR 3 missile, even though it has judged the armed forces should have the capability (paragraphs 2.26 and 2.27).

Managing pressures from spending in other areas

16 **The Department is aiming to make challenging workforce reductions which, if it fails to achieve them, could reduce the amount it has available to spend on equipment to compensate**. The Army's target strength will be cut from 82,000 to 73,000 by March 2025. Other TLBs must make savings by 2030 equivalent to reducing their military workforce by 6,350, while the cost of the Department's civilian workforce needs to be 10% lower by March 2025. The Department's financial plans also assume further workforce cuts of £2.5 billion by 2030, but it has not yet announced how it intends to deliver these or required the TLBs to reflect them in their plans. The Department struggled to achieve previous top-down headcount reductions and is still working through its detailed plans to achieve these cuts. Retention rates are also higher than usual due to the uncertainty caused by the COVID-19 pandemic, making the challenge harder (paragraphs 2.28 to 2.30).

17 **Other cost pressures from pay growth and infrastructure demands could further reduce the Department's flexibility to provide expenditure for the equipment budget**. The Department's 2021 10-year spending plans set out very limited pay increases in the years up to 2024-25. In October 2021, HM Treasury agreed to provide an additional £700 million to the Department in each year from 2022-23 for day-to-day spending. However, the real value of military and civilian pay is still likely to decrease in every year until 2024-25. Reversing this would be very expensive: for example, an additional 1% pay rise in 2022-23 over the figure already planned would cost approximately £1.4 billion more over the following nine years. In addition, approximately 30% of the Department's built estate is below the acceptable standard. The Department plans to spend an additional £500 million on preventative maintenance by 2025, but this will not be enough to prevent further deterioration in the estate's condition. The Department does have £4.3 billion of contingency (above that ring-fenced for the Equipment Plan), but only £1.3 billion of this is available over the Spending Review period (paragraphs 2.28 and 2.31 to 2.33).

Improving the Plan

18 The weaknesses in cost estimating, over-optimism about budget and cost assumptions and a focus on the short term which we describe above have been consistent findings in our Equipment Plan reports over many years. As we have shown in these reports, together these issues have resulted, in addition to the high affordability risks, in adverse outcomes for equipment capability and value for money. To break the pattern, the Department needs to have in place arrangements and capabilities which have previously been absent or incomplete. This part of the summary examines recent progress and remaining issues and gaps in the key structural and management areas where we think change is needed for the Department to improve the Plan, and make it a reliable guide to affordability and long-term value for money.

The Plan's production

19 The Department's Plan document has improved in recent years, but there are still inconsistencies across years and between TLBs in the treatment of budgets and costs. While the Department has improved the breadth and coverage of its report since 2012, it has not yet settled on a consistent basis of preparation. For example, the shortfall in the overall defence budget has been apportioned between the three areas of defence spending (one of which is the Equipment Plan) in a different way each year. And treatment of some aspects of costs are also inconsistent – for example, the basis of assessing the affordability range between best- and worst- case scenario has also changed. This lack of comparability undermines the Plan's reliability and the strength of some of the Department's assertions about improvement from previous years (paragraphs 3.4 and 3.5).

20 The processes underlying the Plan's production incentivise short-term affordability, which builds up financial pressures over the longer term. The Department's processes to agree budgets and costs typically take many months and result in a combination of TLBs deliberately spending more slowly on projects to keep within their budgets, and re-classifying budget shortfalls as 'Planned Cost Reductions' or efficiencies to be achieved in future years often without any plans on how to do so. These 'negative cost adjustments' make up 9% of the Plan this year (£22 billion) compared with 10% (£20 billion) in 2019. The Department has recognised that participants in the main budgeting process have serious concerns about the way it works including its focus on the current year to the detriment of later years. The Department is planning to make significant reforms by 2024 (paragraphs 3.6 to 3.14 and Figure 8).

Financial skills

21 The Department has improved its financial skills in recent years but they are still short of the level it needs. An effective Equipment Plan needs considerable financial management capacity to deal with the complexity and volume of the projects and programmes involved. The Department acknowledged in 2015 that it needed to improve its financial skills at all levels. It launched the Financial Functional Leadership (FFL) programme in 2018. Progress has been made, for example in building independent scrutiny of business cases and developing a new Department-wide finance operating model. But gaps remain and in 2021 HM Treasury assessed the Department as being in the third quartile of Whitehall departments in terms of financial capability. The Department has pointed to the COVID-19 pandemic, resource challenges and achieving TLB buy-in as key causes of recent delays to progress (paragraphs 3.15 to 3.17).

Wider reform of equipment procurement and support

22 Over the past 10 years, the Department's various attempts to improve the wider programme and project management of its equipment have had limited success, and the enduring weaknesses continue to adversely affect risks to Equipment Plan affordability. In 2011 the Department launched the Defence Reform Programme containing projects to improve the management of equipment procurement and support, which underpin Equipment Plan affordability assessments. Both our audits and Parliamentary scrutiny since then have shown that the Department's reform efforts have rarely met their aims. The Committee of Public Accounts has long been concerned that the Department has a cultural barrier to change. We found that only approximately half of the recommendations we have made in our Equipment Plan reports since 2015 have been fully implemented. The Department's current Defence Transformation Programme is forecasting a £0.7 billion shortfall on its aim to save £4 billion by 2030. Recent internal reviews have reported problems with the programme's governance and coherence (paragraphs 3.18 to 3.22 and Figure 9).

Conclusion on value for money

23 The Department received £16.5 billion additional funding over four years in the 2020 Spending Review both to support the 2021 Integrated Review's ambitious agenda and to cover previous funding shortfalls. The Department has taken difficult decisions to reduce spending in some areas to allow it to spend more on its highest priorities. It will carry out further work to assess what the changes in the Integrated Review mean for equipment in next year's Plan. However, in this year's Plan, risks remain of over-optimistic assumptions about future budgets, costs and the likely achievement of savings targets. There is a real risk that, despite the additional funding it has received, the Department's ambition outstrips the resources available to it.

24 The new multi-year spending settlement gives the Department a rare opportunity to break old habits and set the Plan on course to be affordable. Despite some recent improvements, the Department continues to have to take short-term decisions to balance the books, restricting the delivery of equipment and reducing value for money. Some key arrangements and capabilities which need to be in place for an affordable and cost-effective Plan are still absent. These include: a consistent basis of preparation and reporting, the right incentives in place in the budgeting process for TLBs to focus on long term value for money rather than short term fixes, sufficient financial skills and a long-term approach to efficiencies and savings. To build confidence in the Plan, the Department also needs to deliver promised reform of the management of equipment procurement and support.

Recommendations

25 The Department has not yet fixed its long-standing problems in managing the Plan. It will struggle to do so unless its Head Office, working with the TLBs, makes a fundamental change to the way it builds, and reports on, the Plan. In particular, the Department should:

a ensure all components of the Plan's budgets and costs are prepared on a consistent basis between TLBs and across years, including for example on contingency, apportionment of defence budget shortfalls, and the basis for calculating the range which expresses affordability. This would provide comparability and enable stakeholders to track progress and variability of performance;

b as part of the process of putting the Plan together, clearly set out the respective roles and responsibilities of TLBs and Head Office, including clarifying who is in charge of each part of the process. The objective of this would be to build a shared focus on creating the right incentives for maximising long-term value for money, such as how Head Office takes factors such as quality of cost information, historical delivery of efficiencies or forecasting accuracy into account when allocating budgets and future savings targets to TLBs;

c if total forecast spending exceeds overall control totals in any year, include a section within its Equipment Plan report explaining why the accounting officer is satisfied that this outcome is compliant with Managing Public Money's standards of regularity, propriety and value for money;

d in reporting on future assumed or targeted cost reductions within the Plan, make a clear distinction between those which are supported by a clear plan to achieve them, and those which represent an additional target, and provide supporting evidence;

e in order to give more assurance on the completeness of the Plan, carry out regular audits of capability gaps across TLBs and, subject to national security constraints, publish a high-level summary of the results, such as whether gaps are closing or widening over time; and

f explore the inter-dependencies between the three plans that make up the overall defence plan (the Equipment Plan, Infrastructure Plan, and the plan for operating costs). Using this analysis, it should assess the delivery risks of the Infrastructure and operating costs plans and how these may affect the affordability of the Equipment Plan over the next 10 years and include this in its report on the Equipment Plan.

HM Treasury should:

g define the purpose of the Dreadnought contingency and establish new governance arrangements, including the conditions under which additional funds will be provided to the Department. This work should be undertaken with the aim of incentivising the Department to complete submarine-building on time and in a way that represents value for money.