National Audit Office

Report
by the Comptroller
and Auditor General

Ministry of Defence

The Equipment Plan 2018 to 2028

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Key facts

£186.4bn	£193.3bn	£7.0bn
Ministry of Defence's (the Department's) 10-year equipment and support budget	the Department's 10-year equipment and support forecast costs	most likely variance between budget and costs identified by the Department, after contingency

The Department's budget of £186.4 billion includes:

£5.1 billion	departmental contingency that the Department has allocated to the Equipment Plan
£1.1 billion	nuclear-related contingency that is controlled by the Department and that it has dedicated to nuclear programmes

The Department's forecast costs of £193.3 billion reflects:

£7.3 billion	reduction for efficiency savings for which there are firm plans in place
£2.2 billion	reduction for less certain efficiency savings, which are in outline form and have no detailed cost estimate available
£6.7 billion	reduction for the Department's assumption that, across a portfolio, some projects will be delayed or not progress as envisaged

Risks not reflected in the costs include:

£3 billion	potential understatement of costs in the Plan estimated by the Department's Cost Assurance and Analysis Service

Note

1 Figures do not sum due to rounding.

Summary

1 The Ministry of Defence's (the Department's) Equipment Plan 2018 to 2028 (the Plan) sets out its equipment and support budget for the period 2018 to 2028. The Plan includes equipment already in use, such as the Typhoon combat aircraft, as well as equipment in development, such as four new nuclear-armed submarines. For the next 10 years, the Department will allocate more than 40% of its total budget to its equipment and support programmes. Consequently, it needs to manage the Plan effectively in order to maintain the stability of the wider defence budget and to ensure that the Armed Forces have the equipment they need to meet their objectives.

2 The Department introduced the Plan in 2012 following a period of poor financial management, during which a significant gap developed between forecast funding and costs across the defence programme. This led to a cycle of over-committed plans, short-term cuts, and the re-profiling of expenditure, which resulted in poor value for money and reduced funding for front-line military activities. At the request of the then Secretary of State, we provide Parliament with a commentary on the Plan when it is published each year, and assess the robustness of its underlying assumptions.

3 In January 2018, we reported that the Equipment Plan 2017 to 2027 was not affordable. Around that time, the government announced the Modernising Defence Programme (MDP). Among other things, the Department expects that this will address the affordability challenge, including by taking actions to delay, defer or de-scope some projects. Work on the MDP has not yet concluded and so does not feed into the Equipment Plan 2018 to 2028. In this report, we summarise our assessment of the robustness of the Department's financial data and assumptions for its Equipment Plan 2018 to 2028. In particular, we review how the Department:

- sets its Equipment Plan 2018 to 2028 budget (Part One);
- forecasts the cost of the Plan and associated risks (Part Two); and
- assesses and addresses the risks to affordability (Part Three).

We do not consider the value for money of the various projects mentioned in this report or comment on the extent to which the Department can make the programme affordable. We intend to examine and report on affordability further once the MDP review has concluded. Appendices One and Two summarise our audit approach.

Key findings

4 **The Department has made some improvements to the way it compiles its Plan, and the 2018 Plan is more transparent than in previous years.** Our report on the Department's 2017 Plan identified that it did not include sufficient information on its affordability challenges. This year, for the first time, the Department sets out and quantifies the gap between forecast costs and budget. It also provides a narrative on the risks to the costs included in the Plan, and quantifies the effect of these. While developing the Plan, the Department sought to improve communication with Top Level Budgets (TLBs) and better understand the risks within the Plan (paragraphs 1.8 and 1.9, 1.13, 3.4 and Figure 5).[1]

5 **The Plan remains unaffordable, with the Department reporting a £7.0 billion difference between expected costs and budget for 2018 to 2028, 84% of which falls in the first four years.** The Department's expected equipment and support costs of £193.3 billion, after applying assumptions and adjustments, exceed its budget of £186.4 billion, which includes a £6.2 billion contingency. This difference incorporates the Department's assumptions on project costs, risk and foreign exchange rates as well as assumed efficiencies. There are significant pressures in the budget over the next four years. This means the Department needs to make immediate savings decisions rather than relying on longer-term cuts or efficiencies (paragraphs 1.10, 2.8, 3.2 and 3.3 and Figures 10 and 11).

6 **The Department aims for the MDP to resolve its affordability challenges.** As part of the MDP, announced in January 2018, the Department will consider its future equipment and support projects, including whether to delay, defer or de-scope some of its future defence requirements. Starting the MDP half-way through the budgetary process meant the Department had to revisit its aims for the 2018 Plan. Instead of tackling the increased financial risks and establishing a basis for long-term affordability, the Department focused on making just the first year of its 10-year Plan affordable. In March 2018, the Department committed to sharing emerging MDP findings with Parliament in July, but instead provided an overview of the broad strategic context, indicating the Department's direction of travel. At the time of our report, the Department had not yet concluded the MDP. Decisions are now unlikely to be reflected in the 2019 Plan (paragraphs 1.7, 3.7 to 3.9, 3.13 and Figure 13).

7 **In developing its 2018 Plan, the Department has adopted a more realistic approach than in previous years, although forecast costs are still likely to be understated.** This year, for example, forecast project costs in the 2018 Plan incorporate a more detailed bottom-up review of nuclear project costs; better reflect US dollar exchange rates; and capture, as the Department considers, all expected projects. These include forecast costs of £1.5 billion for the Type 31e frigates, which were missing last year. However, the Department's independent Cost Assurance and Analysis Service (CAAS) has assessed that project costs are potentially underestimated by £3 billion, which could make the Department's task of making the Plan balance harder (paragraphs 2.4 to 2.12 and Figure 6).

1 The Department delegates fiscal responsibility for the Plan to Top Level Budgets (TLBs), which specify equipment requirements and manage associated budgets. They include the four front-line military commands of Air, Army, Navy and Joint Forces, alongside the Defence Nuclear Organisation and Strategic Programmes Directorate within the Department.

8 **The Department estimates that, should all identified risks materialise, the budget and cost difference for the Plan would widen to £14.8 billion, although we consider this could still be optimistic.** In its 2018 Equipment Plan, the Department outlines for the first time the affordability risks it faces and the underlying assumptions. Despite these improvements, its assessment is optimistic, meaning the affordability challenge could increase over the next 10 years. For example, the Department's assessment does not reflect CAAS's worst-case scenario that forecast costs are underestimated by £13.9 billion. In its most likely variance the Department assumes it will realise £2.2 billion of the £4.1 billion potential efficiencies it is not yet confident in. We could not provide assurance over this figure, and the Department found it difficult to provide a clear and comprehensive view of progress towards efficiency targets, with figures changing late in our audit. It plans to improve cost forecasting and its cost and financial risk management gradually over the next few years (paragraphs 1.13, 2.14 to 2.18, 3.2, 3.4 and 3.5 and Figures 10 and 12).

9 **The Department's approach of setting a 10-year budget lower than the Plan's forecast costs for 2018 to 2028 risks repeating practices which led to the Equipment Plan's original introduction.** In 2012, the Department announced its intention to make the Plan balance, with forecast costs fully funded from the start of the year. Since the Spending Review 2015 the Department has not fully funded its costs from the outset. It has relied on reducing costs to within budget during the year, through making individual programme decisions and not incurring planned spending. A reliance on in-year decisions creates greater uncertainty over costs and increases the likelihood of decisions focusing on short-term affordability rather than longer-term value for money. Our recent work, for example, on supporting naval equipment, has shown this can lead to increased costs. To make 2018-19 affordable, the Department has delayed work programmes, such as replacing Astute-class submarines and introducing remotely controlled aircraft (Protector), which could increase future costs (paragraphs 3.15 to 3.18 and Figure 16).

10 **In 2018-19, the first year of the Plan, the Department has a variance of £1.3 billion which it needs to manage in-year.** The Department told us it sought to set each TLB a tight but realistic budget to incentivise better cost control and better reflect historical spending trends. It based this budget on its own judgement of past TLB performance, and after having taken decisions to reduce or re-profile £59 million of specific programme costs. It remains confident it can reduce the remaining variance by spending £1.3 billion less than it forecast at the start of the year. Although the Department managed a similar variance in 2017-18, we consider this a high-risk approach given the assumptions already built into the 2018 Plan (paragraphs 3.13 and 3.14, 3.16, 3.18 and Figures 15 and 16).

11 **The Department has limited flexibility to redirect other budgets to address the funding shortfalls it faces in relation to equipment and support.** The Plan accounts for more than 40% of the Department's spending, and this is set to rise to 49% in 2021-22. For 2018-19, the Department has agreed with HM Treasury a departmental budget £1.2 billion in excess of the funds voted by Parliament. This covers both the Equipment Plan and all other departmental spend. The Department has allocated this larger budget, agreeing with HM Treasury that it will manage it in-year. Given the financial constraints elsewhere in the Department, it has limited flexibility to redirect other budgets, such as for estates and personnel, to address the funding shortfall for equipment and support. The Department has managed similar budget variances in previous years (paragraphs 3.10 to 3.12, 3.16 and 3.17 and Figures 14 and 16).

Conclusion

12 The Department's Equipment Plan remains unaffordable, with forecast costs exceeding budgets by £7.0 billion over the next 10 years. This variance could increase or decrease depending on different circumstances, with the Department estimating a worst-case scenario of costs increasing by £14.8 billion should all the identified risks materialise. However, some of its analysis remains optimistic and costs could increase further. The Department is improving its understanding of affordability risks, but we are not yet fully confident in the robustness of some of its underlying assumptions, particularly around efficiencies.

13 The Department recognises that continued unaffordability of the Plan is not sustainable and has presented the nature and scale of the challenges it faces more clearly in its latest Plan. However, as we have previously recommended, it still needs to undertake the necessary analysis and make the decisions needed for the Plan to be affordable. In January 2018, it established the MDP to take the action needed to close the affordability gap, but this work has not yet concluded. Given that 84% of the identified affordability challenge falls in the next four years, the Department must make decisions now. During the current period of uncertainty, the Department has resorted to short-term decision-making, increasing the longer-term risks to value for money and the likelihood of returning to past poor practices.

Recommendations

14 In developing its Plan for 2018 to 2028, the Department has addressed some of our previous recommendations (Appendix Three). However, it is still to make the decisions necessary to bring the Plan back into balance. To achieve this, the Department must:

a make the decisions required to defer, de-scope or delete programmes as soon as possible so as to address the affordability challenge;

b ensure decisions are supported by a full and transparent evidence base to demonstrate longer-term value for money; and

c outline its decisions, including the financial and broader implications, to Parliament.

15 In setting its Plan for 2019 to 2029, the Department must:

d continue its current plans to improve cost forecasting and consider, as part of this, what can be learnt from the work of the Cost Assurance and Analysis Service;

e ensure greater consistency across TLBs and delivery organisations in how risk and uncertainty are reflected in project costs, for example, through further challenge of TLBs, in line with our recommendation last year;

f continue, for example through delivering its current plans to improve financial leadership, to improve its understanding of affordability risks, and their impact, across the Equipment Plan portfolio. This includes using this insight to inform the size of its contingency budget; and

g improve central oversight of efficiency savings by ensuring that there is a single point of accountability, a central view of efficiencies included in the Plan, and a clear and accessible audit trail for all the efficiencies included in the Plan.