



National Audit Office

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## **Report**

by the Comptroller  
and Auditor General

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**Ministry of Defence**

# The Equipment Plan 2017 to 2027

## Key facts

### Affordability gap range

**£179.7bn**

total size of the Ministry of Defence's (the Department's) 10-year equipment and support budget, including contingency

**£4.9bn**

the minimum size of the affordability gap in the Department's Equipment Plan, after contingency

**£15.9bn**

additional affordability gap if all identified financial risks materialise and no assumed savings are achieved

**£20.8bn**

potential affordability gap (£4.9 billion + £15.9 billion)

#### Costs not included in the Plan

**£9.6 billion** excess of the Department's forecast project costs over the 2017 budget, that are not included in the Plan

**£1.3 billion** the Department's forecast cost of buying five Type 31e frigates not included in the Plan

**(£6 billion)** centrally held contingency

**£4.9 billion** **minimum affordability gap**

#### Further risks to affordability

**£3.2 billion** estimated potential understatement of costs in the Plan as calculated by the Department's Cost Assurance and Analysis Service

**£4.6 billion** potential increase in costs if the Department had used the exchange rate prevailing at the start of the Plan period (1 April 2017) to forecast costs

**£8.1 billion** remaining savings assumed within the Plan that the Department must achieve over the next 10 years

**£15.9 billion** **additional affordability gap if all identified financial risks materialise and no assumed savings are achieved**

**£20.8 billion** **potential affordability gap**

# Summary

## Scope of the report

**1** More than 40% of the Ministry of Defence's (the Department's) planned spending over the next 10 years will be on buying new equipment and the support needed to maintain its equipment. Equipment and support budgets cover equipment already in use as well as in development. Forecasting costs and future support needs, particularly where equipment is still being built and tested, can be challenging and requires expert judgement. Despite this, managing the equipment and support budget effectively is critical to maintaining the stability of the wider defence budget and ensuring that the Armed Forces have the equipment they need to meet their objectives.

**2** Since 2012, the Department has published an annual Statement on the affordability of its 10-year Equipment Plan (the Plan). It began to report this after a period of poor financial management, during which a significant gap had developed between its forecast funding and the cost of the defence programme as a whole. This resulted in a cycle of over-committed plans, short-term cuts, and re-profiling expenditure, which led to poor value for money and less funding being available to support front-line military activities.

**3** At the Secretary of State's request, we report on the robustness of the assumptions underlying the Plan and provide commentary to Parliament. When forecasting costs, the Department makes assumptions that will inevitably change. The Department's forecast covers spend for 10 years and is updated annually. For the 10-year period 1 April 2017 to 31 March 2027, the Department has set an equipment budget of £179.7 billion. This is made up of procurement (£84.8 billion) and support (£88.9 billion) budgets, and a central contingency provision (£6 billion).

**4** In this report we look at forecast costs within the Plan (Part Two) and funding for the Plan, including the Department's progress in achieving assumed financial savings (Part Three). We also set out our observations on the affordability of the Plan in the context of the wider defence budget (Part Four). We do not assess the value for money of the various projects mentioned in this report. Appendices One and Two contain full details of our audit procedures. Summaries of the equipment projects we reviewed are included in Appendix Three.

**5** In July 2017, the government announced a review of national security capabilities in support of the ongoing implementation of the National Security Strategy and the Strategic Defence and Security Review 2015. On 25 January 2018, the Secretary of State announced that the high-level findings of that Review has recommended that a programme of further work to modernise defence is undertaken, including a review of defence capabilities. The Department aims to publish the outcome of this programme in summer 2018. The Department's future plans for equipment may be impacted by the outcome of the review.

## **Key findings**

**6 The Equipment Plan is not affordable.** After assuming that the £6 billion of contingency funds set aside in the Plan to supplement budgets will be utilised, the Department is facing a minimum affordability gap of £4.9 billion. There is an additional affordability gap of £15.9 billion if all identified financial risks of cost growth materialise and the Department does not achieve any of the savings assumed in the Plan. Overall, the potential affordability gap is £20.8 billion (paragraphs 4.5 and 4.7).

**7 The Plan does not include £9.6 billion of forecast equipment and support project costs.** For each equipment and support project, the Department estimates the expected cost over the next 10 years. When combining these to form the Equipment Plan, the Department has not accounted for £9.6 billion of forecast costs in the Plan. This variance arose as a result of the Department's 2017 budget setting process not being able to match costs to available budgets (paragraphs 4.2 and 4.3).

**8 The Department has understated forecast costs of equipment and support projects by a further £1.3 billion.** Our review of the Department's approach to forecasting costs found that not all costs are included in the Plan. At least £1.3 billion of planned costs associated with buying five general purpose frigates (Type 31e) are not included in the Equipment Plan (paragraph 2.2).

**9 In addition, there are significant financial risks to the cost of the Equipment Plan:**

- **Exchange rates used to forecast costs do not reflect market rates at the date of the Plan.** The rates the Department has used to forecast costs in the Plan are 24% above the US dollar rate at 1 April 2017, and 2% above the rate for the euro. Using exchange rates at 1 April 2017 (the date the 10-year Plan starts), we estimate that costs in the Plan could be understated by up to £4.6 billion, although exchange rates continue to fluctuate (paragraphs 2.10 and 2.11).
- **Project costings are optimistic and may increase.** Some projects do not yet have a detailed cost forecast. For others, the forecast costs are immature. The Department's Cost Assurance and Analysis Service (CAAS) has completed an independent review of forecast costs. It found that, when compared with its own assessment, the Department's forecast project costs could be understated by £3.2 billion (paragraphs 2.3, 2.4 and 2.6).

**10 Nuclear-related project costs continue to grow and forecast costs are higher than those shown in the Plan.** Nuclear-related projects could destabilise the Plan because of their size and complexity. Our project testing has shown that costs for the Dreadnought and Astute projects have increased by £941 million since the 2016 Plan. The Department is reviewing the reliability of forecast costs for all of its nuclear projects and expects that updated costs as a result of this exercise will be incorporated into the 2018 to 2028 Plan (paragraphs 2.12 to 2.14).

**11 Underlying project forecasts that go into the Plan could change because of weaknesses in cost modelling.** Our review of a sample of equipment projects within the Plan identified areas of weakness in the cost models used to forecast costs. There was insufficient evidence to support some of the assumptions about costs. The costing of project risks was inconsistent. Also, the Department's costing policy means that estimated costs do not take sufficient account of greater uncertainty in complex or new projects (paragraphs 2.5 and 2.7 to 2.9).

**12 To manage affordability of the Plan, the Department has reduced support costs at a time when uncertainty and demand are increasing.** As a consequence of changes introduced by the Strategic Defence and Security Review 2015, forecast costs for supporting new equipment, such as the F-35 Lightning II jets, are inherently immature. In addition, the useful life of existing equipment has been extended, which means that costs are likely to increase but have not been included in the Plan. Our past work has shown that the Navy is increasingly cannibalising parts from ships to maintain capability because of pressure on its budget (paragraphs 2.15 and 2.16).

**13 The affordability gap could widen if the Department's new approach to achieving assumed savings does not work.** The Department reports that it has achieved savings of approximately £7.9 billion against an increased savings target of £16 billion (49%), with approximately £8.1 billion (51%) still to be achieved by 2027. However, in the past, the Department has not managed savings effectively. The full amount of savings included in the Plan is not clear and the Department does not have evidence that shows how it has achieved all the savings it has claimed to have made to date. The Department has started to develop a more rigorous approach to identifying and managing the £8.1 billion of outstanding savings assumed in the Plan. The Department has identified potential savings of approximately £7.6 billion, £0.5 billion below the required savings target. However, the majority of these are at an early stage of development, with implementation plans still to be developed (paragraphs 3.4 to 3.12).

**14 The Department has limited flexibility to use other budgets to address the funding shortfall for equipment and support.** It was unable to agree a balanced defence budget for 2017-18 and is now managing a significant projected overspend in 2017-18. As a result, the Commands have undertaken detailed reviews of their programmes, supplemented by the introduction of stringent controls on non-contractual spending. Our past work has identified an £8.5 billion funding gap for managing the Department's estate. Also, the Department faces challenges in managing its staff budget. It is seeking to increase the number of military personnel which would increase costs, while at the same time, it has made limited progress in reducing civilian workforce costs (paragraphs 4.10 to 4.14).

## **Conclusion**

**15** The Department's Equipment Plan is not affordable. It does not provide a realistic forecast of the costs of buying and supporting the equipment that the Armed Forces will need over the next 10 years. The Department has not included all estimated costs in the Plan and it is facing a considerable affordability gap. There are significant financial risks that this affordability gap will widen because the Department's assumptions about future costs are optimistic. In addition, the Department has also assumed that ambitious savings will be achieved in future years. The Department has a mixed track record of achieving savings and still needs to identify how it will meet its savings targets.

**16** We recognise the significant challenges the Department faces in managing both its equipment and its wider budget and the efforts it is making to respond to them. However, it has not demonstrated that it can afford its plans for equipment and support. The Department risks returning to the situation it was in before the Equipment Plan was first introduced. Unless the Department takes urgent action to close the gap in affordability, it will find that spending on equipment can only be made affordable by reducing the scope of projects, delaying them, or cancelling them altogether. Such an approach risks destabilising the Plan, compromising value for money, and undermining operational capability.

## **Recommendations**

**17** The Department needs to be able to demonstrate, backed by appropriate evidence, the realistic choices open to it in terms of capability and affordability. It needs to be able to support a debate on critical prioritisation choices, both internally and in dialogue with HM Treasury about funding.

**18** The Department must also address the following weaknesses in the current Plan when developing its Plan for 2018 to 2028:

- a** Demonstrate that all equipment and support projects are costed within the Plan, and develop detailed cost estimates for those projects in the Plan that still do not have them.
- b** Complete its current nuclear programme costing exercise to ensure that all affected projects reflect the most up-to-date cost baselines.
- c** Update its assessment of the cost of those projects denominated in foreign currencies by adopting exchange rates that better reflect the current market rate for all 10 years of the Plan.

- d** Ensure greater consistency in how risk and uncertainty are reflected in project costs. The Department must also improve its understanding of the impact of risks across the Equipment Plan portfolio and use this to inform decisions about the size of its contingency budget.
- e** Explore the potential for greater flexibility in how forecast costs are shown in the Plan and set out in the Plan the range of possible costs for projects, rather than the current approach of providing point estimates.
- f** Conclude its work to identify the full extent of savings assumed within the Plan and set out clear accountabilities for delivering these savings. The Department should transparently set out in its Equipment Plan Statement, an assessment of all equipment savings included in the Plan and its progress towards achieving these.
- g** Ensure that any critical prioritisation decisions are supported by a full and transparent evidence base.