THE UNIQUE CHALLENGES OF DEFENCE PROCUREMENT

Securing value for money?

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In UKNDA Commentary No.2 we questioned the military capability that the United Kingdom receives from all the money spent on Defence. As an example, in 2012 France spent some $11bn less than Britain1, was broadly as capable and had a significantly larger front line. How can this be? In this short paper we attempt to show how decisions on Defence expenditure are often taken for reasons other than the military output required and decisions deferred at the political level frequently trigger subsequent cost increases.

The MOD has long had an unenviable reputation for poor financial management in contract letting, prolonged timescales and overspend in its equipment budget. The current aircraft carrier programme is often cited as an example, but other programmes have also attracted heavy criticism from the Public Accounts Committee and the Defence Select Committee. There has been a stream of hand-wringing reports on Defence acquisition since Gibb-Zuckerman in 1961 and most recently by Bernard Gray in 2009, all identifying many of the same problems and offering silver bullets, which then conspicuously fail to do the business. Bernard Gray is only the latest, and the difficulties he is having with finding workable solutions suggest the case is not that simple. Nor are the problems confined to the UK. Gray himself notes that at the same time acquisition reviews were taking place in America, Canada and Australia.

Political pressures

Although the culture of overheated equipment programmes and poor programme management has a long history, the MOD might have highlighted certain mitigating factors and it is surprising that it has failed to make its case better. Let us try to do it for them.

For decades, a combination of high-tech risks, industrial failures and specification changes meant that the day of reckoning when bills were to be paid moved regularly, and often helpfully, to the right. To ensure that available money was not lost, equipment programmes were packed so that when a programme slipped, other programmes could be brought forward using the money already allocated. If they all came in on time, there was insufficient money, but they seldom did. All political parties had a hand in the problem. The Conservatives in 1997 left an overheated programme which included, inter alia, Brimstone, the air-to-ground weapon. They considered cancelling it but were persuaded not to; it has since proved to be a world class weapon with considerable export opportunities. A good decision but a greater bow wave.

Thus the culture of massaging the expenditure “bow wave” was born. Successive ministers were largely happy with this annual juggling act as it allowed them to be flexible in Cabinet when savings had to be made. But deferrals, delays, reductions and cancellations produced severe disruption in programming and forecast costings. Ever more difficult cost cutting rounds required the MOD to offer ever more extreme savings measures, militarily painful, and with economically costly long-term consequences. Given the inevitably very long-term nature of many

1 IISS Military Balance 2012.
programmes, such fiscal short-termism played havoc with sensible programming and contributed to cost over-runs as contracts were regularly re-negotiated. A particular example is the Queen Elizabeth class carrier programme. In 2008, as the economic crisis began to bite, Labour Defence Secretary John Hutton delayed the contract by 2 years, nominally because of F-35 aircraft delays, for a net additional cost to the Defence budget of £674m. Since then ministers have vacillated over whether to field one or two carriers and whether to modify one for “cats and traps”, another false start costing at least a further £74m, before finally reverting to the less capable option requiring vertical landing aircraft, with greater long-term costs.

This is not a one-off. We could mention, amongst others, the delayed production timetable for Astute submarines which, though it removed £131m over the first 4 years, added as much as £539m over the life of the programme. One could go further: to save its annual operating cost, the Government decided in SDSR2010 to cancel the difficult Nimrod MRA-4 programme on which £3.4bn had already been spent. The Government accepted a “capability gap with increased risks” and will re-assess it in the 2015 SDSR. In the likely event that developing threats demand a rethink, we might expect to buy US assets off the shelf at a likely procurement cost of £1-2bn. In each case the effect of this short-termism is to save money now but load future budgets, when it will probably be someone else’s problem.

The MOD is not alone in this. Take the Olympics, which escalated hugely from the initial estimate. Take the Scottish Parliament building, where costs rose tenfold from £40m to over £400m! Neither project could be called ultra hi-tech, in contrast with most MOD programmes. Transport for London has similar problems with the Underground modernisation and faces a £12bn “black hole” in its funding. Too often the programme runs seriously over-budget and is late, with yesterday’s technology and sometimes with the project eventually written off. The NHS and the Border and Immigration Agencies are classic examples. **MOD is certainly not the sole offender when it comes to public sector cost over-runs, yet it is consistently vilified.**

**Some unique and poorly understood difficulties**

Defence procurement is certainly challenging. Consider some of the factors, not generally found in any other business, that make it so, and which greatly complicate the assessment of value. Unlike other government departments, Defence faces violent competition from equally technically advanced opponents. In the West, our preferred *modus operandi* is to fight asymmetrically, using high technology to compensate for reduced personnel numbers, to provide the margin for success and to reduce casualties. For these reasons:

1. Defence equipment tends to be designed at the front edge of technology, since it must match the present and future capability of opponents.
2. Accurate initial estimates are difficult since the technology may require development.
3. Defence equipment has to be robust and capable of operating in the toughest of conditions over a long lifetime so scope for upgrading and updating is essential. Higher upfront investment can reduce total through life costs.
4. The inflation rate in hi-tech projects is three to four times that of the RPI.
5. The issues associated with foreign purchases or collaborative programmes are complicated. Differing requirements and contrasting national bureaucracies are just two reasons.
6. The fact that there is a single customer and often a single supplier distorts the normal competitive market

**Exposure to political expediency**

But the MOD suffers from one further problem which most other departments do not. It has a fundamental role in supporting UK (and sometimes EU) trade and industry. It can provide a fiscal hedge against recession and is

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3 HCDC, *ibid*
4 A proposal to cancel Nimrod in 2002 and buy off the shelf was vigorously opposed by the supplier and eventually rejected on political, not economic or military grounds.
5 [http://www.publications.parliament.uk/pa/cm201213/cmselect/cmdfence/827/82704.htm#a3](http://www.publications.parliament.uk/pa/cm201213/cmselect/cmdfence/827/82704.htm#a3)
6 India’s procurement of 8 P-8i are costing $2.1bn
7 There is an inverse relationship between economic growth and the equipment spend. On the whole, given the choice, contractors find it more profitable to work for the private sector. When the market is in decline they prioritise Government programmes.
frequently required to provide jobs for politically-sensitive regions around the country. If MOD contracts were let in a genuinely free global market it would dramatically reduce the cost of military equipment.

Let us consider a few such examples.

The new aircraft carriers: “On the basis of the evidence we have seen, we cannot conclude on how the Accounting Officer was able to reach a strategic judgement on the value for money of the Carrier Strike decision” (NAO Report Jul 2011). There is certainly a view that they might have been built more cheaply abroad using readily available construction methods. But the future of shipbuilding in this country was and still is at risk.

The selection of Merlin over Chinook in the 1990s cost the nation well over £100m more, but it provided jobs and retained important skills in the UK; the decision was therefore understandable – but why should Defence pick up the extra cost?

Multi-national projects too are costly compared with purchases “off the shelf”. Although some R&D duplication is avoided, costs overall are likely to be as high as 25% above a single-source programme. Of course, despite the additional costs, these projects yield political spin-offs at EU summits and provide EU jobs that would otherwise go elsewhere, most likely to the USA. The A-400M, for example, was not an aircraft the MOD wanted. Although the industrial and political benefits flowing from such a multi-national project have merit, the reality is that this particular aircraft, which has pushed the edges of technology, with consequent cost increases and delays, was not an essential requirement. Other solutions, such as the American C-17, were cheaper. In the event, the A-400 was delayed, then delayed again as costs rose inexorably. The MOD was then forced to lease C-17s, then decided to buy them, and then bought a few more. Once again the MOD budget picked up the tab for a wider benefit.

Achieving value for money

This leads to the much discussed and misunderstood issue of value for money. We need to understand some of the principles which militate against achieving value for money (VFM) in order to discover whether the concept is being applied in a way which helps the defence of the realm.

VFM is not a well understood concept. Although cost is easy to understand, value is not. In the case of equipment with a 30-year life, a higher initial cost to reduce through life costs may represent better VFM. In order to assess value, you must have a clear idea of what it is you are preparing to do, and the broad circumstances in which you might want to do it; all this with sufficient clarity to be able to judge the effectiveness of whatever it is that you seek to acquire. Without this national strategy, a key refrain in our reports, it is very hard to assess the levels of risk you might accept and to judge the value for money. Very rarely, if ever, will it be possible to say that a particular sum of money taken out of the context of national strategy, represents good or poor value. This is a particular challenge in defence where equipment is being procured for a long life, against unknowable eventualities.

Government finds this difficult, to the extent that it often appears that the cost, which can easily be measured, is more important than the value, which is far harder to assess. Defence acquisition is conducted in a timescale which sits uneasily with the very short term pre-occupations of politicians. Because no sensible and agreed output calculus has been developed, there is little likelihood of bipartisan political consensus for this important area. Each government in turn blames its “incompetent” predecessor, and Defence pays the price.

Consider the Olympics again, this time in terms of VFM. This was a project which was first agreed on the basis of a cost estimate of about £2.9 billion – about the same as the initial cost of the two new aircraft carriers. It ultimately cost close to £10 billion, or about twice the revised cost of the carriers. It would be most revealing to know the analysis of value for money which appears to have concluded that one was such a great success whilst the other is an undisciplined and poorly run project. If any such comparative analysis has been done, it is certainly not publicly available.

All of this should at least bring recognition that defence procurement is a complex business and not self-evidently worse managed than other government expenditure. Yet, more than any other department, the MOD is constrained by political shackles in acquiring its equipment.

The post-1997 Labour Government, having inherited a substantial equipment bow wave, conducted its Strategic Defence Review in 1998 and then conspicuously failed to support it financially. Labour then failed to grip the

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8 White Elephants, The Political Economy of Multi-National Defence Projects by Prof Keith Hartley, published by New Direction, Oct 2012.p 29. Typhoon for example is some 20%-60% costlier than the French Rafale. And twice as expensive as Gripen. Development costs are (rule of thumb) increased by the square root of the number of partners.
programme which continued to overheat. In its defence, the UK was engaged in active operations throughout that period; Urgent Operational Requirements (UORs) were the order of the day and cuts to equipment plans might then have been politically damaging. Moreover, levels of slippage declined as smart procurement made some gains and, as the recession loomed, industry upped its game, bringing forward delivery dates.

That a “black hole” of £38bn in the equipment budget was discovered by the incoming Coalition in 2010 was no doubt a shock when added to the then public sector annual net borrowing of over £160bn⁹, but should be compared to the Bank Rescue Package of almost £500bn¹⁰. It should certainly not have been a surprise though, nor in normal circumstances might it have been unmanageable. How much of it should be attributed to the burden of operations in Afghanistan not being fully compensated for is not clear from MOD statistics, which appear at odds with recent statements from officials. The MOD’s own figures¹¹ give a total for the extra costs of Afghanistan alone of £19bn, and for Iraq and Afghanistan together of £35bn up to 2012/13. At its peak, expenditure on these operations was in excess of 10% of the total defence budget. We suspect furthermore that these figures are calculated to be as low as possible. MOD officials are reported to have privately given a figure for Afghanistan alone of £25bn, 30% higher than their own published statistics. It is hardly surprising that countries that have largely dodged operations, have more to spend on other matters.

Thus political calculations inevitably played their part in the £38bn black hole. The MOD could have made some telling points when confronted by the incoming Coalition government. Perhaps it did, but for once this was not leaked. Instead the MOD was vilified and equipment and manpower cut savagely and unwisely. Moreover, whilst operations continued and the black hole was being eradicated, a major reorganisation (under SDSR10) was imposed, never a good arrangement when you want a clear aim, clear costs and clear outputs.

Conclusions

Defence Ministers confront problems of procurement which other departments do not. It is a highly complex process and no government has successfully come to grips with it. Output for money spent is the only way the military can measure value for money; but politicians, and maybe even the nation as a whole, may view it differently if it means jobs in key constituencies.

Of course there have been management failures in MOD as in all government departments but MOD has still managed a very high level of operations whilst suffering a very large budget cut over a long period, and the halving of its share of GDP over the last 20 years. No other major department has managed anything comparable and to “scapegoat” the MOD seems both unreasonable and demotivating. Of course decisions which appear to offer less value for Defence money may be taken for valid political reasons. But where this is done it should be publicly acknowledged and the relevant cost benefit made publicly available. It is not in the public interest that the Defence budget should be expected to pay for benefits in other parts of the public service. Curiously, the Gray Report is silent on this subject.

As we move forward to another Strategic Defence Review in 2015, it is vital for these factors to be recognised and for the MOD to construct a review that avoids the short-termism of the past and offers a strategy that is convincing and enduring. Only then will we truly get value for money, provide adequately for the security of the nation and avoid the waste of both the present and the past.

¹¹ See Table 1.03.06 at http://www.dasa.mod.uk/publications/finance-and-economics/departmental-resources/2013/2013.pdf