Public Accounts Committee

Oral evidence: Ministry of Defence Equipment Plan and Major Projects Report 2013, HC 1060

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Members present: Margaret Hodge (Chair); Mr Richard Bacon; Jackie Doyle-Price, Chris Heaton-Harris, Austin Mitchell, Justin Tomlinson.

Amyas Morse, Comptroller and Auditor General, National Audit Office, Gabrielle Cohen, Assistant Auditor General, NAO, Lee Summerfield, Director, NAO, and Marius Gallaher, Alternate Treasury Officer of Accounts, were in attendance.

Witnesses: Jon Thompson, Permanent Secretary, David Williams, Finance Director, Bernard Gray, Chief of Defence Materiel, and Air Marshal Sir Stephen Hillier, Deputy Chief of Defence Staff, Ministry of Defence, gave evidence

Q1 Chair: Welcome. This is year two of your new regime at the Ministry of Defence. Some of the top figures look better, but we want to explore underneath them a little bit, at where we see some problems possibly still existing, looking to the future.

It is difficult to know where to start. I have done a little section for myself that I've called "Savings; Illusion or Reality?", so it might be worth dealing with those first. If you look at page 13, paragraph 19, of the Report, those are some of the ways in which you have sought to find cash to use elsewhere. I am just wondering how real they are. One, for example, is an accounting adjustment on the A400M, which is half a billion pounds. One is about bringing the cost down simply because you are buying less gear, which of course is a way of bringing down the budget. We welcome that realism, but nevertheless that gives it to you. Then there is another little lot of savings, which are ones that at project level they don't think exist, but you have pulled them out at departmental level with this Cost Assurance and Analysis Service, which makes me a bit suspicious that they are more figures than reality. It's a case of "It does feel more in control, but" and the first but is: how real are some of those savings? I have given you those as examples.

Jon Thompson: Okay. I think it's best if we just pick them up one at a time, if you don't mind. On the accounting adjustment on the A400M, it's best to start with David, I think.

David Williams: The A400M example is simply a profiling change as a result of the way in which we treat it in our accounts, but the up-front pressure went through our accounts in 2011-12. It means our forward programme then has less cost pressure in it as a result of us recognising—

Q2 Chair: Okay. Can I pause you there? Thank you. I thought that was what it was. Then of course what you get into, which I think will be a feature of our discussion this afternoon, is that if you put it off, inflation is likely to come in or industry costs could well come in and that £400 million figure could quite readily rise. But a reprofiling is not to me a cost saving. I can see it helps you to balance the books in year 1. It is not a cost saving. You would agree with that, wouldn't you?

David Williams: I would, although in this case we have already taken the cost pressure through our books, so the £400 million has been recognised in our accounts already as a prepayment. The cash payments that relate to that will still go out on the same profile, but they will not hit our budget as—

Q3 Chair: What do you mean? You have taken it up, put it in the bank and saved it or something, have you? In simple terms.

David Williams: We took the full £400 million as a charge in 2011-12. Then, as we pay cash out to the Airbus consortium, we reduce the prepayment that we are holding on our balance sheet, so it is not a deferral or reprofiling in the more traditional way that you have set out.

Q4 Mr Bacon: When you say you recuse the prepayment on the balance sheet, you mean that having made the prepayment, having, as it were, dented or damaged your balance sheet, you are building it up again bit by bit. Is that what you mean?

David Williams: We reflected the charge on our balance sheet—

Mr Bacon: In 2011-12?

David Williams: As a cost to our programme in '11-12 that we had to accommodate.

Q5 Mr Bacon: I'm just asking you to speak in normal English. You say, "We will recuse the prepayment". Recusing is something that most people are used to witnesses doing when there is a conflict of interest, but you are talking about recusing prepayments. I am just asking you to translate that into English and, by the bye, I was asking you whether, the dent, the cost and the impact having been recognised, the recusing of the prepayment is the building it back up again—the repairing of the balance sheet? Is that what it means?

David Williams: I'll just say yes—

Mr Bacon: Well, only if yes is the right answer.

David Williams: It is the right answer.

Chair: Well, you understand it, Richard; I still don't.

Mr Bacon: Well, I'm not an accountant. I worked in a bank, but I just want to be clear.

Q6 Chair: Well, I still don't understand. You paid the £400 million up front, but you are actually spending it in years 2 and 3. Is that what you are telling me, or is it that you have actually spent it but you are going to pay for it in years 2 and 3? It's very simple.

David Williams: We are paying the cash out over the next few years, but it has been reflected as a charge in our budgets by the balance sheet adjustment in 2011-12. The cash payments then—

Q7 Mr Bacon: Again, in English, you have said that you have spent it although you haven't actually spent it?

Bernard Gray: We have accrued the expenditure in the balance sheet and the cash flow will flow out in an unchanged manner over the next three years.

Q8 Mr Bacon: In other words, I was right the first time—you have said that you have spent it but you haven't actually spent it. Your answer was, "We've committed to spending it." I could commit to buying a Datsun—well, they don't make Datsuns any more—or a Toyota in three years' time, but I haven't actually bought it or spent the money. You are saying that you have said that you have spent it, but you haven't actually spent it, and you are going to spend it. That is what it means, isn't it?

David Williams: Yes.

Bernard Gray: We've ring-fenced the money. That's the point. In your car example, we would have set aside the money to buy the car and then the payments for the car follow in the following years.

Q9 Chair: Let me just make a point about that. You have spent it this year. You didn't want to pay for it this year because you didn't have it in your budget—although we will come back to the underspend—so you decided that you are going to pay for it in years 2, 3 and 4. But that is pre-empting your resources in years 2, 3 and 4. Why don't you pay for it as you actually spend it? What is the reason not to pay for it in the year when you have spent it?

Jon Thompson: Well, because managing public money and international financial reporting standards allow you to decouple cash flow—

Chair: Don't accountancy me. Don't do it in accountancy terms.

Jon Thompson: I'm sorry. The Comptroller and Auditor General was agreeing with me.

Q10 Chair: No. Mr Thompson, answer the question. If you are buying something in year one, why is it that you are then choosing to pay for it in years 2, 3 and 4?

Jon Thompson: In this particular case, the accounting standards allow us to do something that is disconnected from the cash flow. That is all through the 2011-12 accounts, which were signed off.

Q11 Chair: But why do it, Mr Thompson?

Jon Thompson: I couldn't actually answer that particular question.

David Williams: We were able to accommodate the budget hit in 2011-12 within our control data rules as set by the Treasury and the Department. Recognising it early creates financial headroom for us this year and the next couple of years.

Q12 Chair: Quite. So I am right when I said—and you shook your head—that it gave you greater flexibility in the year 2011-12, but has committed you and pre-empted your resources in the future years. You have already spent the money, so you are going to have to pay it. You are going to have to give your suppliers cash.

Bernard Gray: It's the other way around.

Chair: It's the other way around?

David Williams: It reduced our flexibility in 2011-12 but buys us flexibility back in the future.

Q13 Chair: Okay. Do the next one for me.

Jon Thompson: Sorry—did you say you wanted to talk about the cost assurance service?

Chair: I want you to deal with all three issues I raised.

Jon Thompson: I am sorry. What was the middle one?

Chair: It was connected to paragraph 24 on page 14.

Jon Thompson: Well, paragraph 24 on page 14 is the question of the Cost Assurance and Analysis Service.

Chair: Yes. It must be that. Go on.

Jon Thompson: Bernard, do you want to lead on that?

Bernard Gray: The difference between the previous year and the current year's estimate of the provision that will be required by the cost analysis service relates to three items that you see there, the largest of which is the fact that we made a decision in PR12—so just under two years ago—to exclude some potential programmes from the mainstream equipment plan and to fund and recognise only those programmes that were affordable. Five billion pounds of the potential deficit that is described there related to programmes that we have excluded from the plan. Therefore, they are not relevant, because we have not funded them; any cost increase in them is not relevant because we are not doing them—at least, not at the moment. They would only become relevant if we decided to do them. Sorry—that is the £4.1 billion.

Q14 Chair: So it is a saving to the extent that you are not buying certain equipment full stop.

Bernard Gray: Yes. In a reconciliation between the two things, we had previously said that we would need £4 billion to cover off that component. We do not need to cover it off unless we choose to buy it. When we choose to buy it we have to come forward with a realistic cost for it if we choose to proceed.

There is £1 billion because, as we roll forward one year in the plan, inflation over the whole 10-year period means that the total size of our budget increases by about £1 billion. If you think about it, we have a 10-year plan that was from 2012-13 to 2021-22 but is now from 2013-14 to 2022-23. Inflation takes the total amount available up by about £1 billion over that period. Five billion pounds is where the teams and the cost assurance service have been able to work together over the intervening 12 months to narrow the gap on what they think a realistic number is. Those are the sources of reduction in the proposals.

Q15 Chair: Explain to me why the assurance team has a different view from that of the project level. Give me an example of what that means.

Bernard Gray: To give you a relevant example, which we will doubtless come to later, three years ago the assurance team that was looking at the cost of the aircraft carriers believed that they were going to cost more than the team said. The teams, as we have commented here and elsewhere before, are subject to a systematic bias. They tend to be over-optimistic and not to see all the costs arising, and to be enthusiasts for their subject, whereas the cost assurance service is not subject to any bias in that sense; it is just there to tell us what the score is. There was a gap of about £600 million or so between what the cost assurance service said the carriers were going to cost and what the programme team said the carriers were going to cost. That is why in the middle of 2011 we put aside another £600 million to agree with the CAAS team about what the carriers would cost, which has played out in the negotiations in the intervening period.

Q16 Chair: So on the whole the central team tends to put the costs up, not down.

Bernard Gray: If by "the central team" you mean the CAAS team.

Chair: The cost assurance analysis service, or whatever it is, which I assume is the central team.

Bernard Gray: The only quibble I have is over the language. They don't put it up; they tell us what they think it will cost.

Chair: On the whole, costs go up.

Bernard Gray: No. Typically, they think it will cost more than the teams think it will cost.

Q17 Chair: Yes, so the costs go up. Okay. Can I ask you something else on the actual costs? You are assuming a saving of £1 billion on Astute—is that right?

Bernard Gray: No.

Q18 Chair: How much are you assuming?

Bernard Gray: It is a relatively small sum.

David Williams: There is SEPP.

Bernard Gray: On the total—

Chair: Astute and Successor.

Bernard Gray: Across the total submarine enterprise, in the defence review in 2010 we assumed a cost saving of not quite £1 billion—£920 million, if I remember.

Q19 Chair: Okay. Let me test that assumption a little. The Report is not entirely clear about this, but the figure in the Major Projects Report on page 6, in paragraph 9 says that you saved £26 million in the year that we are talking about. Then there is another figure that talks about yet another of these weird accounting adjustments—I am always suspicious about whether they are real savings or reprofiling. If you look at figure 3 on page 20 of the Major Projects Report, it actually shows an increase in the costs of Astute. You are looking for a saving, but there is a muddled story. There is a bit of money that you have got out—£26 million, on page 6 in paragraph 9—then there is a bit more money that you have got out with an accounting adjustment, which is £72 million, but I wonder whether that is re-profiling.

Then the main figure in figure 3 on page 20 of the Major Projects Report shows an increase in the cost.

Bernard Gray: Okay, so to take the last one first, figure 3 on page 20 refers to the historic cost of the first three Astute submarines, which were built between 1996 and about now. That is how much the price of those has changed. The price here reflects the re-baselining of the programme in 2003, if I remember correctly. That is a historic trend of the programme. The SEPP saving that you are talking about in relation to the total submarine enterprise—not just the building of new submarines, but the manufacturing of cores and the refitting of submarines once they are in service and all the associated basing—is assumed to drive out a saving of something over £900 million over the next 10 years. Figure 3 looks backwards over the past 15 years, and the SEPP saving that is assumed looks forward over the next 10. Finally, the smaller amount—about £25 million or £26 million—associates with the change in the cost of the Astute programme itself within the past financial year.

Q20 Chair: I understand that. I suppose the question is, how realistic is it that you are going to be able to get £1 billion out of it? Is the only way that you are going to be able to get £1 billion out by having fewer Astute submarines?

Bernard Gray: No, we are working on it significantly by changing the way that we contract with the companies. So far we have driven out about half of that cost. So something over £400 million of the £900 million is what we have achieved—

Q21 Chair: Why is that not reflected here?

Bernard Gray: Many of those happened after the end of the last financial year, so they will turn up in the next financial year. Some of it is in there, because if you look at the core production capability issues, that relates to putting in place new submarine core manufacturing in Derby, which we signed off, and that CPC saving is in this Report as an example of that.

But the in-principle issue is that we are continuing to work with the three companies involved, Rolls-Royce, BAE Systems and Babcock, to get them to work together to share facilities to drive down the total cost of running the submarine enterprise. That has significant costs in addition to just the manufacturing of the individual submarines; there is a lot of infrastructure there.

Q22 Chris Heaton-Harris: I just want to skip back a bit to the cost assurance teams. We were talking about the equipment plan—it was paragraph 25, wasn't it?

Bernard Gray: 24, I think.

Chris Heaton-Harris: Yes. I am more interested in paragraph 25, which says, "Although the cost estimates have converged, there remains a significant risk that the Equipment Plan has been under-costed". You mentioned the difference between your cost assurance teams and the other teams, and I wondered whether a healthy tension exists between those two teams. Is that something that you build in? Does that build in an over-optimistic costing on projects in the initial team?

Bernard Gray: As far as the first sentence of paragraph 25 is concerned, I think it is somewhat tautological in the sense that it says that if they have been over-optimistic, then the plan is under-costed. So I have some difficulty with that sentence.

As to your main point, I think it is a healthy tension, and in fact the 2009 Report and the actions taken by Mr Thompson when he was finance director to increase the capability of the Cost Assurance and Analysis Service—we have invested significantly in that area—have substantially improved its ability to tell truth to power, if you like, in statistical bases as well as saving us significant money in its work on the aircraft carrier programme, which we will probably come to later.

I think it is fair to say that there has been an adjustment between the teams, who are sometimes not keen for the full light of day to come on to assumptions they have made, with that full light of day being brought to bear by CAAS. We have all encouraged and tasked CAAS to try to do that. I think that having that robust challenge to the teams is a very healthy thing.

Jon Thompson: There was a review by the National Audit Office in December 2012 on our approval of new projects and the fact that we stopped delaying projects in April 2011—I have previously said this to this Committee. That review did indeed say that that was a more robust approach and that it had the kind of expertise we wanted. We think that having some independent challenge is a good thing for decision makers and also for the setting of the corporate provision, because this question goes to the heart of whether we should have some sort of corporate financial risk provision above the projects. That is also incredibly helpful.

Q23 Chair: Chris, I will come in on the same point. It is good to have the corporate central challenge. I do not know how big this team is, but, if you look at paragraph 30, you are really, really weak at the project level. These are just the projects that the NAO looked at—20 procurement cost lines, of which they could not do a couple because you have not decided whether to go ahead. Am I right in that? How many are we talking about?

Lee Summerfield: It is out of 20.

Chair: But the Report says, "In 11 cases, teams were unable to produce the range of costs for their projects, either due to lack of expertise within the team or because the costing techniques were not kept up to date. In 10 cases, teams could not adequately link the risks they had identified to the forecast costs". Then it says, "We obtained reliable values for these 'risks outside costing' in only 13 cases". And finally, it says, "For our sample, we attempted to find out the total value of these risks and to review why they had been excluded, but only around a quarter of project teams could provide a value supported by a list of risks." You are sitting here telling us that it is all much tougher and better, yet the evidence suggests that there is one heck of a lot of room for improvement.

Bernard Gray: There are two separate questions. One is: is an independent challenge a useful thing?

Chair: Nobody is arguing with that, Mr Gray.

Bernard Gray: I was asked the question. The second question is: is there room for improvement in the teams? I do not think I would support your statement that it was really, really, really weak. I would say that there is absolutely room for significant improvement. That is the purpose behind my drive to improve the capability of DE&S. I absolutely agree with you about that.

Q24 Chair: You are in year three now?

Bernard Gray: Yes.

Chair: How many years have you been there? Is it your third year?

Bernard Gray: Three years, yes.

Chair: So you have done three years and you are entering your fourth year.

Bernard Gray: Yes, and I think we can see significant improvement.

Chair: You are looking at Mr Heaton-Harris—you can look at me when you say that, as well.

Chris Heaton-Harris: Margaret has got nice new lipstick on. I haven't.

Bernard Gray: Is there a history here?

Q25 Chris Heaton-Harris: Don't go there.

I have a couple of points I would like to take up. Paragraph 30 talks about the 11 cases where teams were unable to produce. It also talks about the lack of expertise in the team because costing techniques were not kept up to date. They were the two bits of the sentence that concerned me. Because you have been going at this for a reasonable period of time, I would imagine that you would have identified the weaknesses in those teams probably before your backside hit your seat when you took the role. I wonder why it is still taking so much time to percolate this through the system.

Bernard Gray: Because we need the ability to hire better people than we have the capacity to do today. We need to be able to hire more highly paid people. If you look at where our skills are weak, the more senior people are and the more specialist they are, the more weakness and fragility we have in the system. Our best people get bid away to do the same kind of work, either in the defence industry or the aerospace industry or somewhere else.

We are absolutely concerned to ensure that we have the flexibility to recruit the people we need, which is the purpose of the matériel strategy work and the discussions that we are now having with the Treasury to get the freedom we need to recruit the people we want.

The problem I have had is that I have had to pay civil service rates that are not fundamentally attractive. To give you a specific example, I have been trying to recruit about 900 people over the past 12 months. Of those general administrative tasks that we have had, we have filled about 90% of the roles; of those needing specific commercial, engineering and project management skills, we have filled about 10% of the roles, fundamentally because our pay is not competitive.

Q26 Mr Bacon: What would be establishment, and how many roles are unfilled?

Bernard Gray: Establishment is about 17,000, of which about 800 or so are unfilled.

Mr Bacon: You are talking about within the area you were just describing.

Bernard Gray: The whole of DE&S.

Q27 Chair: So you become ever more dependent on your central capacity.

Bernard Gray: No. We have not only had a recruitment campaign running, we are working with colleagues in the Ministry of Defence and in the centre to get us the flexibility to hire the people we need.

Q28 Mr Bacon: Can I be clear? I think you said only 10% were filled at one point.

Bernard Gray: Of the vacancies that we had in the three specialisms of engineering, commercial and programme management, such as those needing contract management and supply chain management skills. I can look up, but I have not brought with me, the exact number of vacancies. I can certainly let you have that. That is probably between 300 and 400, taking those three specialisms together. We have filled only about 10% of those vacancies. The principal reason given to us by potential candidates is uncompetitive salary.

Q29 Mr Bacon: So there are, as it were, 390—or 370 to 420, or whatever it is—unfilled.

Bernard Gray: That is correct.

Q30 Chair: How much have you spent on consultants over the past year or so? Has that bill gone up to fill that gap?

Bernard Gray: If you are talking about the totality of FATS, which is the framework agreement we have, plus other moneys, I think it is about flat. However, the fact that we are spending that much on it is a reflection of the fact that we can’t recruit the skills that we need in-house.

Q31 Chair: So you haven't gone up; you have stayed flat.

Bernard Gray: I honestly can't remember the number. I would have to come back to you.

Q32 Mr Bacon: But if I am a programme manager or a commercial person or engineer and look at the job ads, and I don't fancy it because the money is not good enough, I go and work for Babcock or BAE Systems or somewhere like that. Babcock or BAE then have to get the money from somewhere with which to pay the higher salary for that individual, don't they? They get it from the MOD, don't they?

Bernard Gray: I agree—it is mad. One of the many reasons I have argued that we need to be able to pay people properly is so that we can manage public money better. I absolutely want to improve the quality of the organisation, and I need to be market-competitive to get hold of these people to work for us instead of the companies.

Q33 Mr Bacon: You said that you have discussions ongoing with the Treasury on this.

Jon Thompson: Yes.

Mr Bacon: How far advanced are those discussions, and when do you expect them to conclude?

Jon Thompson: We gave evidence to the Defence Committee last week on this issue. We are currently negotiating to put the salary pay bill and the consultants' pay bill together in one financial envelope and to be given people freedoms in that financial envelope. We are at the point where the two principals—the Chief Secretary to the Treasury and the Secretary of State—need to sit down and discuss what we think is a deal that can be done which would protect public money overall, because you can cap the financial—

Q34 Mr Bacon: Yes. I was about to say: you are not asking for more money; you are asking for greater freedom within the envelope.

Jon Thompson: Correct, and we are prepared to commit to an envelope that decreases in real terms.

Q35 Mr Bacon: Despite that—I do not want to mischaracterise your discussions with the Treasury—*[Interruption.]*

Jon Thompson: I will go a reasonable way in this conversation, but—

Mr Bacon: Your proposition that you do not want more money and you are prepared to agree to a real-terms cut, but that you want freedom within it, is one that I would have thought would be hard for a sensible Treasury to disagree with.

Jon Thompson: Obviously we agree with that.

Q36 Chair: Is that right? Can we ask the Treasury?

Marius Gallaher: I am aware that there are discussions going on, but I am not sure where we have got on it

Chair: A non-answer.

Marius Gallaher: We would look at all cost-effective mechanisms.

Q37 Chair: Mr Thompson, how much are you spending on consultants in the year we are looking at compared with the previous year?

Jon Thompson: On technical support we spent around £400 million.

Q38 Chair: And how much did you spend in the previous year?

Jon Thompson: Around £400 million.

Q39 Chair: What does technical support exclude?

Jon Thompson: Technical support includes engineering skills and commercial skills. It is not what I would call consultancy, which is about asking someone to give a second opinion and sticking it on the shelf, which I understand is called shelf wear in the trade. It is about getting people with engineering skills or particular commercial skills who can do a job.

To give a view of the numbers, the salary payments were around £900 million, with £400 million on technical support, and we are saying that those two should be put together and capped, and that the freedom should be given to us within that financial envelope. It is breaking new ground.

Q40 Chris Heaton-Harris: On this point, I can see that the one risk for the Treasury is that you are then entering a bidding war for particularly good individuals that could escalate to an unbelievable extent.

Bernard Gray: Clearly, the Treasury will be concerned about the containment of overall pay within the public sector. I get that. The issue for us is that certainly disproportionately to other Departments, and sometimes completely unlike other Departments, we have people in these areas of engineering and programme management who are in high demand in the private sector as opposed to Whitehall policy folk who tend to be competing with universities for jobs.

Q41 Chair: Actually, to be fair, Mr Gray, the same could be said of DECC, the Department for Transport and the Treasury.

Bernard Gray: To a degree, but a significant minority of public servants are in that space. An issue for us is how best to spend money to control the programme. We are acknowledging that we need more skill in this area. To take up an aside from the Comptroller earlier, when we pay these firms for technical support, we pay significant premiums for the cost of hiring the individual. We are talking about something of the order of a 100% mark-up on someone's time for going out and having them off our books, as it were, but supplying us with services as opposed to having them on the books.

Q42 Mr Bacon: To take an example, let's imagine an engineer with specialist skills in maintaining an aircraft, whether an existing one or a new one that is coming. What salary might be suitable to retain such a person that you cannot offer? I know this is just picking one example, and there is an enormous range, but paint us a picture, with an example, of a person whom you might like to hire, and what it would cost, and the difference between that and what you are allowed to pay them and what they can go and get by being employed elsewhere—and then presumably we double that to get the mark-up that you were referring to.

Bernard Gray: Okay. This is not me trying to be picky, but the person who does the work on the aeroplane is typically a fitter, and the engineer will be the person running the programme. I will give you one specific example that I hope will make the point, and I hope the individual, whom I will not name, will forgive me. We had somebody running our nuclear weapons programme, until about a year ago, who has now gone to work in the private sector, and—I need to be careful, to protect the individual—he went to work for a 50% premium in the private sector, and we would probably, if we were hiring that person in on a day rate, pay a 100% premium on his money. So, therefore, for argument's sake, that then takes you to three times what we were actually paying that person, and it was a highly skilled person, and we lost them.

Amyas Morse: I can understand the sense in paying a mark-up for renting people; of course skills are maintained and things like that. I just want to ask, if you had access to the skills you need, would that mean you could descale the headcount you need in some of these teams?

Bernard Gray: My first port of call would be to replace the technical services; so in sweating down that—and actually headcount might rise, within our vote, for the reasons that we have just discussed—there is a separate question around the amount of, I am trying to find a better word, but it will have to be bureaucracy, associated with all of the processes that we have to go through around Whitehall. That is significantly time-consuming, and therefore, to a degree, non-value adding in the production of the programmes. I do not know the degree to which we will be able to streamline that, because it is dependent on other people, including the Cabinet Office, whether we will be able to do that. Compared to a company, we certainly experience a significant amount more frictional bureaucracy that we would otherwise, and cutting down on that core is not really about the task, it is about the administration that goes with the task; so I think about it in two parts.

Q43 Chris Heaton-Harris: I can understand the point you are making about the point in the Report about it being "due to a lack of expertise", and you have answered that point completely fairly; but another part of this paragraph is "because the costing techniques were not kept up to date", and that strikes me as something that you do not need to re-employ a consultant to fix, on three times the salary that you would employ them for. Equally, the point beneath says, "In ten cases, teams could not adequately link the risks they had identified to the forecast costs of their projects." That does not strike me as something that expertise brings. That strikes me as a bit of a lack of joined-up thinking within the team, more than anything else.

Bernard Gray: I think the way I would characterise it is that things historically have not been done to the level of due diligence that I would expect in a commercial organisation—people are not expected to do tasks to that level, although I personally feel that they should—and that we are on a journey in importing good practice into the team. To a degree people have not in some cases understood, or in some cases agreed with, the need for it. I am not taking their part in that. I am just saying that actually, getting people to understand that it is possible to get to a higher level of assurance about these things, and that it is worth doing because it releases more money for defence and creates more certainty, has been a significant journey, and I do not think we are all the way there yet. In the quarterly budget challenges that people are going through, we still get people coming into those with propositions that they are not able adequately to support. The situation is improving, but I think there is still further to go.

Q44 Mr Bacon: To what extent, if that is a phenomenon—the one you have just described, where people are coming into these quarterly reviews, or three-times-a-year reviews, whatever they are, without an adequate ability to defend what they are proposing and what it would cost—are you trying to feed that back collectively to everyone in this community, and saying, "Did you know, we had somebody who came in last week, who couldn't begin to defend this, this, or this?" You sound like you have got a significant cultural challenge in persuading these people that it matters. What are you doing internally, rather than just in a case-by-case meeting slapping them down and saying, "This is not good enough" and sending them back to the drawing board, so to speak? To what extent are you taking a more holistic approach about trying to educate them all that this is required?

Bernard Gray: I do not personally think that public hangings are a particularly effective instructional tool for these purposes—

Q45 Mr Bacon: You would not necessarily have to use a named example in order to make the point, would you?

Bernard Gray: No, but your proposition, albeit illustrative, was that I might. I am just saying that that is not the approach we have taken. We do have meetings of the most senior 30 or so individuals inside the business once a month, where we take a whole day at the

Shrivenham defence college and we go through cases of how we have reformulated programmes, how we are working to sweat out the costs in the equipment support plan and a bunch of other initiatives. We have definitely, over the course of the past 12 months, got people to a space where they are comfortable discussing the problem that they had within their area and how they resolved it, and trying to share that good practice in that kind of way. That is the carrot, which says, "We can support you if you are prepared to get on board with doing it in this way." Then we have the stick, or the back-stop in the quarterly process, which says, "If people come in trying to arm-wave through some cost increase, they run into the finance director and the board."

Q46 Chris Heaton-Harris: So obviously this Report is going to be quite helpful in that, because we are having a public discussion about the sorts of things you are trying to do in cultural change.

Bernard Gray: Sure, and you do not find us resisting that discussion.

Q47 Chair: Can I get back to the Astute, because we did not have an answer to that? Can you tell the Committee this afternoon that you are confident that you will be able to sweat out the £1 billion without reducing the number of submarines that you will have to buy?

Bernard Gray: To be clear, it is more than just the Astute; it is the total submarine programme, against which we have the £900 million and change cost target. As I said, we have already got to half of that. The principal area that I am looking to drive on now is in the BAE manufacturing facilities in Barrow. Again, I would say that that was a work in progress. I have been in fairly intense discussions with them since I started, and it is fair to say that I think we are making some headway, but it is still not where I would like it to be.

Q48 Chair: Are you telling me that it is too early to express confidence either way? Is that what you are telling me?

Bernard Gray: I am saying that I have got part way to the target and I am continuing to work it. I do not know whether I will get there, and I will not declare victory on that until I have. I am continuing to work the problem. Part of the problem lies outside my control, but I am continuing to work on forcing efficiency into the company, sometimes against their natural tendencies.

Q49 Chair: Okay. Can I just ask a more general question? We want to talk about the underspend a little bit. You have got a £1.2 billion underspend, which is despite an over-programming of about £1 billion. In effect, you added things in to try to deal with that underspend. Again, if we look at the way in which you are bringing costs under control, £2 billion-plus on an annual acquisition programme of £14 billion, or whatever it is, is quite a lot. That is the first thing—what does that say about your ability to control expenditure and costs? The second one, which we are all disturbed about, is the assertion in the Report that you do not really understand where the underspend comes from.

Jon Thompson: We ought to clear up that we did not underspend by—you cannot add those two numbers together to get £2 billion. We over-programmed over the amount of money that we had, and then you fall short of that, so you net the two together. It is correct to say that it is £1.2 billion, but you cannot add the other billion of over-programming on.

Bernard Gray: We then spent a billion of that on other things, so it is a net £200 million.

Jon Thompson: To come back to your question, one of the issues here is exactly the question that you are asking about: what exactly is changing in a project. Is it that you have created a genuine efficiency or a cost saving, or has the risk changed? Risks do not necessarily accrue in easy ways in particular financial years, so what exactly has led us to this particular point requires further significant diagnosis. We have some initial diagnosis—again, through the cost assurance and analysis service in KPMG—but that does not give us a satisfactory answer as far as we are concerned, and it requires more work so that we understand whether, if it is a cost that has just slipped, it is going to come up somewhere else in the programme later on. We have some assurance that the overall cost of the programme has not risen on a 10-year basis; nevertheless, it could be that that risk will accrue at the end of a programme in 12, 15 or 20 years' time. Quite a complicated diagnosis needs to be made. It is one of three reasons that there could be an underspend, as set out in the Report, but we need a clearer diagnosis of what is really happening.

Q50 Mr Bacon: You said we have "some assurance", but surely the whole point is that if you do not, as the Report says in paragraph 26, have a clear view of why the underspend occurred, how can you have assurance about the future?

Jon Thompson: There is a difference between knowing nothing and having a full answer to your question. I am saying that we are somewhere between the two. We had some initial diagnosis, but that does not provide us with a satisfactory answer to answer your question. It could be one of three reasons, and they are set out in the Report. We need to do further work on which of the three it is.

Q51 Mr Bacon: But it is rather surprising to a layperson. You have proposals to spend money in a variety of different areas, on a variety of different programmes, and plainly these programmes are complex. For whatever reason—the three reasons set out in the Report are that the Department believes that "it was the result of a combination of factors, including: better than expected outcomes from contract negotiations; budget being allocated for risks that did not materialise; and the impact of programme slippage." So, better than expected outcomes, risks that did not materialise and slippage—it will be one of those three things. It is just odd—intuitively odd to the layperson—that you have this proposal to spend money, you do not end up spending it and it is not really startlingly obvious, straight away, why you did not. For most people, in business and in their private lives, if they did not spend money, they would know why not, and here are you saying that you have more work to do to understand why you did not spend it. It is a really big concern.

Jon Thompson: We share your concern, but in answer to the previous questions about the accuracy of project costing, when those costs will land in any financial year and what the financial risks are in those projects, there is still further work to do. There is clearly work to do; we are telling you that that is correct. If in any one financial year you have an underspend, your original data is not exactly in the way that you suggest, and therefore it can be for one of those three reasons. The reason why we are hedging around the question is that I cannot sit here and say to you, "We underspent by £1.2 billion. That is £900 million of slippage, £300 million of risk, and there is no genuine underspend". I cannot—

Mr Bacon: And that is exactly what I would expect you to be able to say.

Jon Thompson: I can't.

Q52 Mr Bacon: For example, for contract negotiations, if a contract negotiation goes better than expected, and you were expecting to spend £100 and you only ended up spending £91, I would expect you to bank or park that £9 on the right in your spreadsheet and do that for each of the programmes. Of course, some of those contract negotiations might have gone less well than expected, but you would add them all up and have a number, so you ought to be able to say to us, "Of the £1.2 billion, £326 million is accounted for by better than expected contract negotiations."

Bernard Gray: That's not what we are talking about. Typically, what is happening here is that you have a contract let some time ago that you are part-way through, and in any given year, how much progress does the contractor make on manufacturing a submarine, an aircraft or whatever it may be?

To challenge you slightly, there are three problems that we are dealing with here. One is: what is the total cost of a system, summed up for the programme? The second is: how long is it going to take? The third one, in the jargon, is: what is the phasing? When does that cost arise? The third one has not been a focus of the Ministry of Defence for a long time, because it was so badly over-programmed. Everybody was trying to slow down cash flow, so nobody really understood what industry could or could not achieve by the rate of progress in a year, because we kept applying the brake and telling industry to slow down. When we got into this year, we were not telling industry to slow down on projects, and the project teams did not have accurate phasing of their expenditure. So we think that all three of those issues are pertinent, and we are trying to determine the proportion between them.

We have to get back into this. Submarines are a classic. "Okay, we spent £100 million in cash less in submarines in-year than we expected to." Why did that happen? "Well, BAE did £100 million-worth less work than we expected." Is that because the work that they had completed on that task was under budget, and therefore we had a genuine gain? Is it because they made progress more slowly than expected, and therefore that cost is just deferred and will arise later? Or have we provisioned against a risk of something going wrong, which did not happen in that year, but might or might not in some subsequent year? We have to go through project by project to figure out what industry is actually doing. It is not in the contract negotiation, but in the progress on the work.

Q53 Mr Bacon: That is exactly the sort of thing that I expect programme managers and project mangers would be doing. You mentioned phasing. I accept what you say that hitherto what we have been used to is only one direction—it gets shoved to the right, so that the costs go up, because facilities are not used. The classic example is the carrier: £1.56 billion just in the last Parliament, and there has been more since. I think the same happened on the Astute.

Even that, however—even the fact that you can nail it at £1.56 billion—presupposes that you understand the exact cost of that delay, the exact cost of that bit of change to the phasing, as it were. You are saying now that it is more complicated, because we are not telling them to put the brakes on; we might even need to tell them to speed up. To have any underlying understanding of what the implications are, you must have—your programme managers must have—an understanding of what the costs of all this activity are.

Bernard Gray: We have an understanding in aggregate of the amount of work that has to be done. The question is, if they do less work in any one year, are they capable of catching up, or is the work unnecessary? There is a technique called earned value management, which we are going to introduce as part of the reforms. It tracks how much activity has happened versus how much of the budget has been consumed. That has not been standard operating practice in the Ministry of Defence hitherto and it is the kind of tool that will allow us to track in the kind of way that you are describing.

Q54 Mr Bacon: I carefully said what the costs are, not what the activity is. One hopes that you would be able to do both and to align one with the other. It is deeply concerning, because underlying all this—at the very deep level or, if you like, at the very top level—the narrative underneath sounds as if you do not have as deep an understanding of all this as you need to, although I accept that there has been some improvement and that things have been brought into balance, which is a very good start. You are still some way off that deep understanding.

Chris Heaton-Harris: I have an extra concern—

Bernard Gray: If I may answer that point, we agree that—it is like peeling the layers of the onion—first, we need to get control over the total entity; then we start drilling into, "Okay, what is happening on a year-to-year basis?" and whether we are accumulating any risk later. Until we stabilise the programme, however, it is really impossible to get to that second level of accuracy. We need more skills to be able to do it, which is why we are making the progressive changes that we are making.

Q55 Chris Heaton-Harris: I do not have many concerns about being unable to identify where the costs come, because I can kind of understand the pitch you are going to make. My concern is with Mr Gray saying that you have spent £1 billion of the cost savings, while I know that you do not know where they have come from—*[Interruption.]* Just then, because you said that therefore we have only £200 million—

Bernard Gray: We have bought other things.

Q56 Chris Heaton-Harris: You have bought other things, yes, but because you do not know what form this £1.2 billion takes, you do not know—or you cannot tell me—that part of the £1 billion will be needed because the profile of payments will follow later in whatever project it might have been.

Bernard Gray: That is correct, but we manage under an annual cash-flow target from the Treasury, so we could bring forward other requirements that Steve has and buy them earlier, because they are off the shelf and we can make use of that money in that time. What we are effectively doing is reprofiling the order of delivery of the equipment programme.

Jon Thompson: This is also significantly more complicated because in some financial years we have money that is not allocated to some projects in the form of a contingency or a departmental unallocated provision. We also have unprecedented flexibility with the Treasury to have roll-overs between years in terms of EYF, some of which is top-sliced and some of which is not. It gets incredibly complicated, but the heart of the issue here, I think, is that there is a risk for us that unless we fully understand why we are underspending, we do not have full assurance about the cost of the programme going forward. We accept that.

Q57 Austin Mitchell: Margaret said that things seem to be under better control, which of course you would expect because you are ordering less and we are now entering a year when, we hope, we are not fighting a war anywhere. It all looks fairly vague and seat-of-the-pants stuff to me, uninitiated into defence spending. Support costs: you have not supplied the independent review that was promised at the session last year. That is over half the spending, so we do not know that the £4.7 billion contingency is going to be adequate. That is a bit seat of the pants. You don't know, as Richard elicited, why there was an underspend in the year we are dealing with, but you have compensated for that underspend by over-ordering and over-programming, which is a fairly risky business because the costs could escalate and come home to hit you. The Report then says, to add to those two factors, at paragraph 40 that there is a "significant risk that the Equipment Plan has been under-costed", and that that suggests "over-optimism at project level." All that is very vague indeed, when we need much tighter costing of what you are doing.

Jon Thompson: We accept that we need to improve project costing, but there are overall controls and flexibility that we built in, so we are not sitting on £38 billion over-programming. We are sitting on just short of £5 billion-worth of contingency and we have not allocated the entire funding available to us, which is to the tune of £8 billion. There is still some flexibility. If there were to be some horrendous situation that blew out of all control, we have some financial flexibility to move.

On the question of the equipment support plan—both the Air Marshal and Bernard may want to add something—it does not have the same financial risks as the equipment procurement plan. It has a much more stable financial base. More than 91% of the cost is on contract for something already in service. Over the next few years, that percentage decreases very slowly—it goes 91%, 89%, 85%, 82%—so significant elements of that, if you are already on contract, are stable. Year-on-year, the equipment support provided has only moved by 0.1%.

Austin Mitchell: Why didn't you provide the NAO with the data from your independent review of support costs?

Q58 Chair: There is a phrase in the Report, Mr Thompson, which says—page 18, paragraph 36—that the "support costs consist of a complex and highly variable set of cost lines that the Department understands less well". I can understand that the variations may be less than they are likely to be in the capital acquisition programme, but the truth is that this is more than half your programme. According to the Report—unless you are going to quarrel with that sentence—you do not really know where your money is going.

Jon Thompson: I dispute that we do not know where our money is going.

Chair: They "consist of a complex and highly variable set of cost lines that the Department understands less well".

Jon Thompson: Correct, but that is not what you said. I am sorry, but you said that we did not know where it was going. I dispute that.

Chair: The "understands less well" means that you do not know where it is going.

Jon Thompson: I dispute that. We do know where it is going: 91% of it is on contract, and if you want to go for all that, that is not the point that Mr Summerfield made.

Chair: It might be in a contract, but that does not mean you know where it is going.

Lee Summerfield: May I intervene very briefly? At the NAO, we have seen nothing in terms of the support costs and the work that CAAS has been doing over the past six months or so in relation to the support costs. We were hoping to have that in this Report. We have not had it. We have been promised it for our next engagement, so we should be able to report on it. I think we are probably talking from slightly different perspectives here. We have not seen the support cost element of the work, but I think colleagues here have.

Air Marshal Sir Stephen Hillier: From my perspective, we understand where the money is going, but we think that money could work better for us than it is at the moment. It is about getting more efficient equipment support. The initial work that we have done so far—and we have been at this for the best part of a year to 18 months now—confirms that we can take a significant amount of money, which we can either then use to reinvest or to deal with wider departmental financial challenges. We know where it goes; we just think we can make it work better for us than it does.

Bernard Gray: If I can add, the reason that we can see it is more stable is that the cost of flying a Typhoon this year is very similar to the cost of flying one last year and so on for Type 45s or Challenger tanks or anything else. It is a much more stable thing. You don't have the same financial risks as you have in the new equipment programme that could treble in cost. We have tackled the problems from the most volatile and most threatening to the defence budget first.

Having made significant inroads, with further to go, on the new equipment procurement plan, we turned our attention about 12 months ago to trying to improve performance in the equipment support plan. It is basically stable and therefore it does not present a financial risk. One of the reasons that we are less concerned about it than this Report implies is that we do not think that there is a major risk of some dramatic excursion that could make the programme unaffordable.

However, as Steve says, we are trying to ensure that, having got a better grip on the new equipment plan, we drive better value out of the equipment support maintenance area. There are two strands of activity associated with that. The first, which Steve and I started about 12 months ago, is driving down the cost of some of our highest profile programmes, which we will report on in the course of the next Report. The second is the work that CAAS have been doing on the ESP. That work is a first for them. In their near-100-year history they have always focused on new equipment purchase and they have not focused on equipment support. We directed them to do that about 18 months ago, but we suspended the work part way through last year in order to focus their effort on delivering the aircraft carrier renegotiation. We needed those people to do the detailed work. So we paused that work in order to conclude the aircraft carrier project, which is why it is late, and we have then put them back on it. We have not seen, any more than Mr Summerfield has, the results of that work.

Amyas Morse: Before we leave, I would quickly like to mention two things. One is to say that it worth noting—I think I am right in saying this to the defence team—that it should be put on the record that it is likely that next year you will also have an underspend and a plan-over programme to compensate. Is that about right? So that we do not have this next year and when we come along next we are going to have the same situation?

Q59 Chair: Will you understand it next year?

Jon Thompson: We have taken on board in this hearing that there is still plenty to do in this area to improve, and that is one of them.

Amyas Morse: I am not trying to be critical. I am just trying to say something. This year we have had a discussion about underspend and using the money for other things. It is quite likely that we will have a similar discussion next year. Is that right?

Jon Thompson: Sure.

Bernard Gray: A smaller number.

Amyas Morse: Right. Okay, good. May I ask one question about support costs? Support costs are linked to equipment activity, aren't they? In other words, one of the ways that you can control support costs is by flying fewer sorties or by not going to sea as much. Are you concerned that that sort of thing has been happening? Are you getting consistent use of it? It is only all stable if you are using the equipment on a stable basis and not using reduced sortie time as a way of economising on support costs.

Air Marshal Sir Stephen Hillier: We are not seeing that at the moment. It would be the biggest concern of the front-line commands if that were happening. That, for me, puts an extra premium on getting this equipment support review done properly, so that we take the money out in a way that allows the front-line commands to continue doing what they need to do, just doing them in a more efficient way.

Bernard Gray: One observation I would make about that is that we get a demand signal from the front-line commands that says how much activity they want to do. They usually do not conduct that amount of activity, which is mostly training, as you say. Therefore we have to try to manage—it shows up classically in ammunition—how much ammunition we provide, for example, because quite a lot of it gets returned unused. One of the things we are trying to improve in the new delegated model is to make sure that commands are accurately forecasting how much activity they want to do. Typically, it is not us cutting back; it is commands conducting less activity than they predicted before the start of the financial year.

Q60 Jackie Doyle-Price: I want to come back to the discussion that you were having with Chris earlier about your ability to purchase and reward appropriate skills within the Department. It seems to me that unless we get this injection of the right skills, we will continue to have this problem; and I would say you are preaching to the converted in that regard. It is certainly my view, having been on this Committee for the number of years that I have, that we are drifting towards a model that is increasingly engaging with the private sector to buy services, but we still have a culture that is rewarding policy rather than those skills.

Having said that, I really want to satisfy myself that what you are saying is for real and not just an excuse. I just want to ask a few questions about the internal behaviours in the Department. For your civil servants, do you still have annual increments that are automatic?

Jon Thompson: No, we withdrew that some years ago.

Q61 Jackie Doyle-Price: Right. Do you have the ability to reward performance within those envelopes?

Jon Thompson: We do. We significantly changed our performance management system, so that in 2011-12, 98.4% of the staff got a bonus, if you like, which seems an incredibly large amount to me. We changed the policy, so that figure is now 25%. We kept the amount of money broadly the same, so you can get a bonus of approaching 10% for performance.

Q62 Jackie Doyle-Price: So you have used what flexibility you have within the system to encourage good performance.

Jon Thompson: Yes.

Q63 Jackie Doyle-Price: I have to say that 98.4% is the kind of figure that headline writers out there would get very excited about, but actually it is about rewarding the right behaviours.

Of course, there is another element to reward, which is pensions, and it remains the case that public sector pensions are extremely generous compared with their private sector counterparts. In the example that you mentioned, Mr Gray, you said that the private sector employer would have had to inflate pay by 50%. To what extent was that a recruitment figure, and to what extent would that factor in buying out that pension provision?

Bernard Gray: I obviously cannot speak to the motivations in the individual concern, but what I can say is that some of the areas where we are short, which we have been trying to recruit in, are things like airworthiness engineers, nuclear engineers and negotiators for our contracts. Notwithstanding the fact that we want additional freedom, we have been trying very hard to recruit these people and put a significant amount of effort in. We have played up, as much as we can, the advantages of working for us, which have included not only the pension point but relative employment security compared with the private sector. All I can tell you is that most people are not buyers of that proposition. Statistically, we are not recruiting the people in the key skill areas. I can get general administrators, but I cannot get airworthiness engineers.

Jon Thompson: I think the comparison Mr Gray has given you is one of salary as opposed to the whole cost of employment. Clearly if we were to show the whole cost of employment of somebody, the employer's contribution at 35% or whatever for the civil service pension would add significantly to the cost. It is a salary-to-salary comparison, but there are other factors. The NAO produced a Report on reward in the senior civil service not so long ago, and I suppose what we are doing here is bringing that report to life with some very specific examples.

Q64 Jackie Doyle-Price: Do you have the flexibility to recruit people on fixed-term contracts that can then be inflated?

Jon Thompson: We currently have the ability to recruit people on fixed-term contracts.

Q65 Jackie Doyle-Price: But is that still within the civil service pay bands, or can you add a premium to that?

Jon Thompson: We have—off the top of my head, the last time I checked—five members of the senior civil service who are on fixed-term appointments with salaries that were pushing right at the boundaries of the civil service pay grades, so right at the top, not at the bottom.

Chair: Five out of?

Jon Thompson: Senior civil service—approaching 300.

Q66 Jackie Doyle-Price: So when they come to the end of their contracts, basically there is nowhere for them to go within the organisation, because of the limits to the—

Bernard Gray: They are hired for a job, really.

Q67 Jackie Doyle-Price: You mentioned that you are having discussions with the Treasury about this, but what discussions have you had with the Cabinet Office? This really goes to the heart of what we need to do to make Whitehall work in the future.

Jon Thompson: It is a three-way conversation. Clearly, the civil service human resources policy is largely driven from the Cabinet Office, but pay policy is with the Treasury, so you have to have a three-party conversation. Some of the controls are about not just pay, but process and so on, so you have to get into a conversation with the Cabinet Office. We have been transparent with both the Cabinet Office and the Treasury about the negotiations.

Q68Jackie Doyle-Price: Some of the skills that you have referred to are peculiar to the MOD and the industry, but there is a skills deficit across Whitehall for the wider commercial ones, such as project management. Is there any thought about what more can be done to home-grow those skills within the civil service?

Jon Thompson: We are doing that. We have a significant graduate intake and apprentice intake for the 18-plus level. At that age, we are a reasonably competitive employer. Our problem comes with people in their 30s. Civil service pay has been frozen, so there is no annual increment. If people are promoted within a job, they are then stuck on the entry-level grade for that job. There is relatively little inflation uplift, and there is no annual increment, so people in the senior civil service, broadly speaking, have been stuck on the same salary for the past five years.

A particular problem is with people on the first rung of the senior civil service—the deputy director level. They cannot get any more money—the person I talked about earlier was at that level—and they have no realistic prospect of a significant increase, but they are in their mid-to-late 30s, they have families and the cost of living is going up for them. In the end, they cannot afford to work for us any more.

Q69Jackie Doyle-Price: And it is basically the generation between 35 and 50 that you are losing. Once you get to 50, it is going to be too expensive for you to give up your pension.

Bernard Gray: Yes. Historically, we hire people as they come out of university or school and keep them for life, but we are getting leeched out in the intervening period—particularly people in their 30s and 40s, as you say. The problem is that those people are the potential future leaders of the organisation. I can home-grow people, but I am probably training people for somebody else unless I can do more to keep people mid-career.

Jon Thompson: There are two excellent Cabinet Office initiatives in this space. One is the so-called pivotal role allowance. We are limited to five people who we can say hold roles that are so pivotal to the organisation that we can reward them with an additional sum of up to £20,000 a year, tied to specific deliverables. That has to be agreed by the Cabinet Office. The other is the Major Projects Leadership Academy. We have had at least four people through each of the six cohorts so far. We have gone a long way in terms of the Cabinet Office's initiatives, and we have done as much as we can, but we still think that is not enough for a systemic solution.

Q70 Mr Bacon: Under the rules, you are allowed to pay them more when they have been through the MPLA and come out the other side.

Jon Thompson: No, not necessarily. I am just saying that that increases your ability and your skill to do the job.

Q71 Chair: Mr Thompson, are you working with DECC, the Department for Transport and the Treasury, which face similar problems to you?

Jon Thompson: Yes, we are. There was a meeting of the Department for Transport board and those of us who are involved in this area to talk about these problems.

Q72 Chair: Are we looking forward to a Government-wide initiative, rather than an MOD initiative?

Jon Thompson: I cannot speak for the Government; all I can say is that we are trying to do the best we can for the Ministry of Defence.

Q73 Austin Mitchell: Just to come back to my "flying by the seat of your capacious pants" argument, I am concerned about paragraph 30, on the equipment plan. I want to know how you are going to stop over-optimistic costing and make good practice consistent among the project team. Paragraph 30 says: "In 11 cases, teams were unable to produce the possible range of costs for their projects…In ten cases, teams could not adequately link the risks they had identified to the forecast costs…Costs"—this is point 3—"that lie above the 50th percentile within a cost model are not built into projects". Finally, it says: "Risks are also excluded from costs if a project team cannot directly control that risk…from cost modelling". This will surely lead to over-optimistic predictions, which need to be much more tightly controlled and consistently made.

Bernard Gray: That is definitely the risk; and that is all the work we are doing to try to drill into teams a better understanding of the implications of under-costing the programme. I have had probably four rounds in the last three years of going through programmes, insisting on getting to the bottom of it. We also have the quarterly budget process that the finance director runs in order to track progress on all of that, and we have initiatives such as the one we are talking about on earned value management and getting more skills into the organisation to try to address it, but that is a systematic weakness that we are trying to improve, and it is a work in progress.

Q74 Chair: Can I move you on to budget, Mr Thompson? For 2015-16 to 2020-21, you are planning on the basis of 2.7% inflation and 1% real-terms increase—is that right?

Jon Thompson: Yes.

Chair: Is that funding protected?

Jon Thompson: No.

Chair: It is not protected, and you have lost £1 billion in the latest round—am I right? I am looking at page 23, paragraph 45.

Jon Thompson: We have made an assumption which we agreed with the Treasury, but clearly it is for the next Government to make the actual decisions in the 2015 spending review. We are clear that that is a risk.

Q75 Chair: Are you planning for that? People are talking about there being greater cuts over that period. Could you cope with that, so that we do not run back to where we were before?

Jon Thompson: Just to be clear, in the wake of the next general election, there will clearly be two processes that need to link together. There will be a new Strategic Defence and Security Review and a spending review. Those two have to come forward with a strategy and a financial plan that match. If there were to be significant financial austerity that were to cut the assumptions that we have made, we would have to go back and revisit the strategy. That is my opinion.

Q76 Chair: For me to get my brain around this, if we go to the equipment plan, at paragraph 45 on page 23, in previous times when you appeared before us you had that certainty that you would have inflation and the 1% in real terms.

Jon Thompson: Yes.

Chair: But in practice you were asked to find £1 billion in the latest round of trying to find further cuts. Am I reading that paragraph right?

Jon Thompson: Are you reading paragraph 45 on page 23?

Q77 Chair: Yes. It comes up to about £1 billion that you had find from your equipment plan after you had the 2014-15 and 2015-16 spending review—so not the first one, but the second one. Am I right?

David Williams: The SR13 round last year reduced the defence budget in a baselined way by £1.1 billion, resourced—

Q78 Chair: Which, again, was not what they said. To wind us back, originally when you did the SDSR on the first spending review, you were told that you would get a 1% real-terms increase, but actually, in practice, Treasury nicked more than £1 billion off you.

David Williams: The billion covers equipment, infrastructure and other operating costs. The element which relates specifically in a baselined way to the equipment plan is really a reduction in our equipment support budget, which is work that we are running through at the moment and looking to deliver through efficiencies. But the undertaking around the 1% real-terms growth then applies from that new lower figure in 2015-16.

Chair: From the new low?

David Williams: Yes.

Q79 Chair: Thinking of the discussions we have had over the last three or four years, it is the beginnings of a "Do they mean what they say?".

Jon Thompson: The other dimension of this question is whether the Department can be more financially efficient, and undoubtedly it can. Some of the plan is to be more financially efficient. So, renegotiating equipment support budgets to try to save £350 million a year is something that we have agreed to.

Q80 Chair: I understand that you have got to justify it, but the story we got before was slightly different. The other thing I was going to put to you was that if you have this underspend in the year we are looking at, 2012-13, and you have accepted that we are talking about a likely underspend in the coming year, if you are sitting in the Treasury trying to eke money out, that does not feel brilliant.

Jon Thompson: It is definitely a strategic weakness that we are underspending the budget.

Chair: It is a weakness; you accept that, okay.

Jon Thompson: But I would rather be there than overspending and being here for you doing it the other way round.

Q81 Chair: Rather that than an overspend, except remember that you are not getting the equipment.

Jon Thompson: It is quite difficult, isn't it? You don't want me to be sitting here with a £38 billion black hole. The system of my overspending the budget means that automatically the accounts are qualified and I am sitting in front of you. Equally, I can't underspend too far; otherwise I will sit here being criticised.

Chair: I understand that.

Jon Thompson: It is quite tricky. Our aim this year is to get an underspend of under £10 million. Mr Williams has been asked by the board to ensure that he does that.

Q82 Chair: I understand that, but I have never in all my years known Treasury to take the view that you have just taken. IPPR estimated when they looked at the further cuts that you are likely to have to lose a further £5 billion. Are you taking that seriously? That is on the overarching Government cuts and the impact they could have on MOD. Have you taken that seriously or does that figure seem completely off the wall to you?

Jon Thompson: It would seem difficult to me that you could do the maths that the Chancellor has put out into the public arena and end up with a £5 billion-a-year reduction in the MOD budget.

Chair: It is difficult to do that?

Jon Thompson: It is difficult for me to see how you get from what the Chancellor has said in terms of balancing the budget, if there were to be a return of a Conservative Government. You are asking me to speculate on who is going to win a general election and what their spending plans would be, which is difficult.

Q83 Chair: It is slightly about the general election, but it is going to happen whoever is in. There will be cuts in expenditure however that goes forward.

Jon Thompson: My answer is that you would have to revisit the strategy if the cuts were significant. You would have to deliver the outputs. You would have to revisit the outputs if there were significant reductions in the defence budget. You would.

Q84 Chair: Can we look at the urgent operational requirements and the fact that some of that is going to come back from Afghanistan? Paragraph 59 on page 28 suggests that £2.9 billion-worth of equipment could be brought back, but clearly you have not got the money for that. Could you take us through how you are approaching that, please?

Air Marshal Sir Stephen Hillier: The £2.9 billion was the first estimate in the process, and it made the assumption that every piece of equipment that we had in Afghanistan would come back and that we would run it through to the long term, alongside all the other existing Army equipment, which is principally in the Army. Our judgment was that it was not necessary to run on all of that equipment or that it would be affordable, so we trimmed down over time that amount of money to a lower figure.

We then looked at what we could afford post-PR12 to start to bring these items into core. As we went through our planning round process, we have so far allocated of the order of half a billion pounds—a little bit more—to the Army to say, “Start to bring the equipment into your core programme.” The Army have accepted that and have also accepted that the delta between that amount of money that we provided from the centre and their ambition is something that they will have to manage within their budget. Under our delegated model, it is for them to look at the range of vehicles—including the ones out of Afghanistan and the ones that they already had—the support budget that they have and the efficiencies they can drive out of it, and manage that in the best way possible.

Clearly that is not the full amount of the aspiration, but it is part of our discipline in our process that we should only commit the money we have actually got in the budget, and that is what we have done. Where there is a gap, we are going to have to trim back our aspiration in some areas. It is an ongoing process, but we are much further forward compared with where we were this time last year. As I say, we have committed at least half a billion pounds into that.

Q85 Chair: From the taxpayers' point of view, we bought this equipment. I can understand your departmental view: you have had cuts in your budget and you are trying to save money. You can't find the money to manage or run the equipment and keep it in good order. Unless you're telling us that the equipment is such that it's unusable, it doesn't really make sense, from the taxpayer's point of view, having pushed the money out, to then just say, “Actually, in this Department they've had cuts and therefore can't keep the supply going to keep the equipment up to scratch. We're going to scrap it. Maybe we'll sell a bit of it, but I bet we won't in any way get back any of the investment we've made, as taxpayers”.

Air Marshal Sir Stephen Hillier: I absolutely agree, and I should have been clear: we are not aiming to scrap some of this equipment. The vast majority of it—the vehicles and the major equipment—is on its way back, and a lot of it is now back in the UK. We are talking about not the money just to keep it, but the money to operate it and train with it and use it subsequently. That is the money I was talking about. The rest of the equipment we can put in storage, and then we will bring it out of storage and bring it into the front-line inventory and use it, according to our priorities and the available funding at the time.

Chair: But storage will cost you as well.

Air Marshal Sir Stephen Hillier: It will, but not of the same order as training with these vehicles.

Q86 Chair: If you try to look outside the MOD a bit, is this sensible? Is this a sensible way of handling it all, given all the money that we spent out there?

Jon Thompson: Different approaches are taken by different European countries. Denmark, for example, does not take this approach.

Chair: What do they do?

Jon Thompson: They assume that the defence budget can soak up operational costs of up to 10% of the core defence budget, and after that there is a conversation with the treasury. That is a different strategic approach that could be, and is, adopted in other European countries. That is not the way the system works here; therefore, we are working with the system that the Treasury designed. But you are right: there are different strategic approaches that could be adopted.

Q87 Chris Heaton-Harris: In a previous hearing, when we talked about logistics we heard some interesting examples of what was actually being bought and shipped out to Afghanistan, even though there was no need for it.

Chair: Skis.

Chris Heaton-Harris: Toilet roll seems to ring a bell—I think there was 47 years-worth of toilet roll for our visiting operation out there. Have we covered our logistics, so that we are not taking stuff out there that we will not need as we draw down? Secondly, for my peace of mind, can you assure me that we are not going to leave anything out there in a usable form that could be used by people who may not be as friendly to us? In a way, I would much rather see it destroyed completely. I am talking about satellite comms, for example.

Air Marshal Sir Stephen Hillier: To answer the second question first, we're not going to leave anything out there which is either going to be useful to those we would like it not to be useful to, or that we need for the future. As we've covered, we've bought a lot of highly capable, very relevant equipment, and we want to get the best use out of it into the future. So, particular areas like sat comm and other capabilities are really important to us.

On the first question and the examples, it is not something I am familiar with. I haven't heard those stories.

Q88 Chris Heaton-Harris: I might have just dreamt them. But we certainly did a logistics hearing in which we heard that a number of interesting pieces of kit were being taken out to Afghanistan that were already surplus to requirements.

Chair: Yes, we did.

Bernard Gray: If I remember correctly, I was at that hearing—although I certainly don't remember any reference to loo roll.

Chris Heaton-Harris: There was definitely something about loo roll.

Chair: I think it was skis, actually.

Bernard Gray: I don't remember that, either. I'm not saying it didn't happen, but I certainly don't remember it.

Mr Bacon: Chris was having his recurring nightmare about the European Parliament and it somehow got conflated, I think.

Bernard Gray: The combination of loo roll and skis is certainly not something I want to get into.

We have a comprehensive plan that is being worked between Permanent Joint Headquarters, Northwood, and my organisation, about the return of equipment from Afghanistan. As Steve says, effectively we are triaging it. Some things that are acceptable and potentially useful locally we may sell locally—that are not the kind of things we would want to take out. But the vast majority of anything significant—there is a cost of flying a loo roll back that makes it potentially not worth flying back, but worth selling locally, for example.

Q89 Mr Bacon: What about ammunition? Are you destroying ammunition locally?

Bernard Gray: No weapons will stay, and if anything, there may be some destruction locally. But all weapons and ammunition would be brought back or destroyed locally. So there is a comprehensive plan of either destruction locally, disposal locally or repatriation to the UK of all that equipment. We are about halfway through that plan, which obviously has to conclude by the end of this year. That is a subject of regular discussion between us and PJHQ. It is discussed every month in my board meeting with our logistics operation folks.

Q90 Chair: Can we move on to some particular projects? Can you tell us what the delays are with Lightning II and the specialist vehicles? Why have you not yet made a decision about those two? On page 7, in para 13, we are told that they could not be looked at because there are delays.

Jon Thompson: This is about the principle that we only begin to measure after we have been through the main-gate decision. That is why those two are not in this Report, and they might not be in the next one either.

Chair: What is the problem?

Jon Thompson: We only measure it from when the main-gate decision is made.

Bernard Gray: We haven't placed a production order for the scout vehicle and we haven't yet placed a production order for the Lightning aircraft. Therefore, they don't come into this population.

Q91 Chair: Are these the aircraft that are going on the aircraft carriers?

Bernard Gray: That is correct. We are likely to place an order shortly, but we have not yet placed it.

Q92 Chair: So we haven't placed an order for those at all? I thought we had placed an order for them.

Bernard Gray: We have ordered three test aircraft, which are flying with us now.

Chair: We are flying with them?

Air Marshal Sir Stephen Hillier: We have three test aircraft, and last year we ordered a fourth aircraft to join that series. Those aircraft are flying with UK crews in the US at the moment. Committing in to the first operational squadron is the next approval that we are working through the system.

Q93 Chair: We will probably want to ask other questions about the aircraft carriers, but the joint strike fighters is an area where your ability to control costs is much more in the hands of the Americans. I wonder whether you can give us an update there. The last time I looked at this, 98% of the JSF's software code was not fully up to standard—that was in the summer; I don't know whether it has got better—and much of it had still not been properly tested.

Bernard Gray: Much of the software had not been properly tested?

Chair: Yes, including that required to fire weapons—that is what my notes tell me.

Air Marshal Sir Stephen Hillier: In terms of the software development, it is worth bearing in mind that the aircraft is still in development, so you wouldn't expect 100% mature software at this stage.

Q94 Chair: I accept that, but are you worried that, according to my brief, 98% of the JSF's software code was not fully up to standard? I accept that that was in the summer and it may be better now.

Air Marshal Sir Stephen Hillier: We think it is more mature than that. We also maintain close contact with the United States joint programme office. It has confidence that on those sorts of issues—I have heard that figure mentioned—we are much further advanced than that. I don't want to say that this is a risk-free programme. It would be wrong to say that it is risk-free because it is at that stage of its development, but we think it is substantially more mature than that.

Q95 Chair: What control have you got over the costs?

Air Marshal Sir Stephen Hillier: In terms of the costs, you are right that, as a partner among many nations, in principle our control is less because we get a lesser vote, but we have offset that in our planning and we have allowed in our budget for a higher figure. What has come through each time in reality is that the cost of our aircraft is less than we budgeted for. You are starting to see that flowing through into the Report. We have taken a prudent position to allow for the fact that we do not have as much control as if it were a purely national programme.

Q96 Chair: I do not know how much you are allowed over what you expected to pay in the first instance.

Air Marshal Sir Stephen Hillier: I do not think we want to give that, because it is commercially sensitive.

Q97 Chair: Okay; what about a timetable? What confidence do you have that you will be able to have them by 2018? Am I right that that is when you will need them to train people up to use them?

Air Marshal Sir Stephen Hillier: We will start training people through 2016 and 2017 in the US, then in 2017 to 2018 we will be training in the UK, and we will start our initial training with the carriers. We will have our initial operational capability—just operating from land bases—in 2018, and from the sea in 2020. Those are the timelines that we have declared.

Q98 Chair: And are you confident with those timelines?

Air Marshal Sir Stephen Hillier: As confident as it is reasonable to be at this stage. Clearly, there are risks on both the carrier side and the aircraft side. It would be wrong to say that there are no problems along the way. Those are big risks to manage, but we believe that those timelines are absolutely achievable.

Amyas Morse: With other aircraft I remember hearing about minimum viable fleet sizes. Although I appreciate that you are committing incrementally in fairly small numbers, if it is going to be a viable maintainable aircraft type for the long term, in reality you will have to have a minimum number of aircraft, won't you? Roughly how many would that be?

Air Marshal Sir Stephen Hillier: I do not think you can ever be precise—"Here is a minimum number"—but we are part of a joint strike fighter programme, which is buying thousands of these aircraft. A UK order in isolation does not tell you much about viable fleet size.

Amyas Morse: No, but, forgive me, that was not the question. I was asking what you regarded as a UK fleet size. How many aircraft do you think you have to build up to in the UK in order to have a viable joint strike fighter population in our planes?

Air Marshal Sir Stephen Hillier: We will buy the number of aircraft, in the first instance, necessary to achieve that initial operational capability from the carriers. That will give us the first operational squadron. We have said that we will consider in SDSR 15 the number of JSFs we are going to buy over the long term, and what that number is and when we will actually buy those aircraft. I can absolutely guarantee that in 2020 we will have a fleet size that is viable for the tasks we want to conduct. As I say, the viability—

Q99 Chair: What figure do you put on that? What is the figure? What does "fleet size that is viable" mean? How many aircraft?

Air Marshal Sir Stephen Hillier: I cannot remember exactly. Again, I am just stepping carefully here, because there are sensitivities about where we are in commercial negotiations. I am a little cautious about giving exact numbers and exact timelines here.

Q100 Nick Smith: Why can't we say how many planes there will be in a squadron?

Air Marshal Sir Stephen Hillier: I can tell you the number of aircraft—

Nick Smith: That you are going to buy for 2020.

Air Marshal Sir Stephen Hillier: But the number of aircraft in a squadron is not the fleet we would buy to support—

Q101 Mr Bacon: You did not give a single number. I was listening carefully; I have not heard one number. You said that there would be an initial purchase, which will become the first squadron, and you did not say a number. You then went on not to say numbers for everything else. Perhaps you could start by telling us the size of the initial squadron to go on the carrier.

Air Marshal Sir Stephen Hillier: The reason I am not giving an exact number is because we have not yet formally concluded what that first squadron will be—the size—and announced the size of it and said, "This is the number of aircraft we are going to buy." That is running through our approvals process at the moment, so I am reluctant to give you a specific number.

Q102 Mr Bacon: All right. Presumably one of the other issues will be whether we use one carrier or two. Yes?

Air Marshal Sir Stephen Hillier: That is an SDSR '15 issue.

Mr Bacon: That will be another issue determining the size of your initial squadron. Yes?

Air Marshal Sir Stephen Hillier: No. What we are buying at the moment is for the one carrier, which we have said we will operate. That is what we said in SDSR '10.

Mr Bacon: I am using the word "initial" slightly more flexibly than you are.

Air Marshal Sir Stephen Hillier: We will buy a squadron of aircraft to operate off that one carrier. If we then bring into service the second carrier, you would have to buy more aircraft if you were properly going to—

Q103 Mr Bacon: We are still none the wiser. There is a physical limit to how many JSF aircraft one could operate from one aircraft carrier. We know the size of the aircraft.

Bernard Gray: You could fit about 40 on an aircraft carrier.

Mr Bacon: That would be the maximum-ish for one aircraft carrier.

Air Marshal Sir Stephen Hillier: That would be the maximum capacity of the aircraft carrier, but that would not be the number we would build and have to operate.

Mr Bacon: No, because you could have some that are rotating.

Q104 Nick Smith: I still want to find out about the squadron fleet.

Air Marshal Sir Stephen Hillier: A typical combat air squadron—I am not talking about joint strike fighter—would be about 12 to 16 aircraft. It is in that range.

Q105 Chair: We know what you have paid for the three test aircraft, don't we? It is in the public domain. How much were they each? I have a figure here of £154 million each.

Bernard Gray: I was going to say that it was just under £500 million for three.

Q106 Chair: How much more was that than what we originally contracted? How did that compare with the estimate?

Bernard Gray: They were bought five or six years ago. We contracted to buy those in '08 or '09.

Chair: Five or six years ago?

Bernard Gray: Yes.

Q107 Chair: I am trying to get a feel from what is in the public domain on costs for what has happened to costs on it.

Bernard Gray: I think that the US has put some data out about this which would be helpful. We can point you to it, but broadly speaking, the costs have declined significantly—of the order of about a third.

Chair: A third?

Bernard Gray: Effectively, those first aircraft are hand-built prototypes, and you start to get into serious production—

Q108 Chris Heaton-Harris: It was similar with the Typhoon, wasn't it?

Bernard Gray: Something like that.

Lee Summerfield: Can I get some clarity on the numbers? I believe that the Department is publicly admitting to up to 40 aircraft on the JSF and, I think, in January, the Secretary of State announced a purchase of 14, which is in addition to the four training aircraft that they have currently. It is being gradually, incrementally put together.

Jon Thompson: The reason that we are hedging around it, if one might help the Air Marshal, is that I do not think that that has been announced.

Lee Summerfield: The Secretary of State said 14.

Jon Thompson: The reason that we are hedging around it is because we are building up to an announcement, and I do not want to pre-empt that announcement. We are not trying to duck your question; I just think that Ministers have not announced it. That is where I think we are. That is why we are not being clear.

Q109 Chair: There are three aspects to this: one is the costs, the second is the capability—will it do the job?—and the third is the timing. Those are your three risks. Can you prioritise those in any way? What are you most worried about, or are you just worried about all three?

Air Marshal Sir Stephen Hillier: I am less worried about the cost, because we have budgeted at a certain level and we continue to come within that. The time is probably more of a concern, and clearly there is a money aspect to that as well. On the performance, it is a technically challenging programme, so it comes back to making sure that it does what we expect it to do when we need it to do it. Absolutely, they are all linked, but I would be more worried about performance and time than cost at this stage.

Q110 Nick Smith: I am still trying to understand the costs of aircraft. I heard what Mr Gray had to say about the prototypes costing £500 million for three and that they were hand-built and, therefore, the next 12 or 14 he may buy are likely to cost less. But I am looking for some comfort that they will cost less than £2 billion, which is what they would cost if rounded up from that figure. What will the approximate cost be for the 12 to 14 that are in the pipeline, if you can have a viable squadron?

Jon Thompson: Sorry, I am not sure that we can answer your question in the abstract in a world in which we are building up to the Ministers announcing it and giving you the data that you want. I am not sure that this is the platform on which we can answer that question. I am sorry about that. I am not trying to duck it; I am just being up front with you about the fact that we are building up to a ministerial announcement.

Q111 Chair: We are all looking at something that was on the BBC website about 10 days ago.

Jon Thompson: You have a tremendous technological advantage over any of us sitting at this end of the table.

Bernard Gray: Speculation on the BBC website is not a ministerial announcement, as it were.

Chris Heaton-Harris: And almost certainly wrong.

Chair: We do not know about that; we will wait and see.

Q112 Mr Bacon: Can you remind us which Lighting II we are buying? Is it the F-35A, or the F-35B or the F-35C?

Air Marshal Sir Stephen Hillier: We are buying the F-35B.

Q113 Mr Bacon: The B. On that subject, Wikipedia, which is usually a reliable source—although I had an employee who was listed as Tony Blair's communications director for quite some time and he was a recent graduate, so I accept that it is not completely reliable—lists the F-35B at a $196.5 million flyaway cost in 2012. I cannot remember where the dollar is today, but if you divide—

Bernard Gray: It is approximately $1.65.

Mr Bacon: Okay, so you are looking at £130 million or £140 million or something.

Bernard Gray: £120 million, more likely.

Mr Bacon: Well, the number we were always banding around before was £127 million, so it has come down a bit from that.

Bernard Gray: As they ramp up serious production, the price continues to fall.

Q114 Chris Heaton-Harris: How will you deal with currency fluctuation? We have had this question in previous hearings, but I would like to hear the answer again about when you fix your price.

Mr Bacon: Do you keep a secret stash of dollars, Mr Williams?

David Williams: Well, you are not far off. We run corporately a forward currency buy programme for dollars and euros. That covers on a rolling basis, over a three-year period, I think, up to 80% of our likely exposure in those two currencies. Built into the approvals at individual project level is an assumption around exchange rate risks. As I say, we need to cover back as much of that loss as we can corporately through a forward-buy hedging arrangement.

Q115 Chair: I'm just going to ask, having looked at the BBC website, what about the support cost? We have talked capital—it was probably my fourth question mark that I would put over it. Again, you are going to be highly dependent on the Americans, presumably, for that. How is that going? What can you tell us about that area, accepting that you are about to announce?

Air Marshal Sir Stephen Hillier: The work that we have been doing up to the announcement includes the support costs for the initial flying of the aircraft.

Q116 Chair: Are you more certain that you have got those under control, or are they likely to run away?

Air Marshal Sir Stephen Hillier: I think they are sufficiently well understood for the first few years of operation of the aircraft. That is all we will contract for—the first few years—and that will allow us to understand the aircraft better in service and drive through better and more efficient support solutions in future.

Q117 Chair: Or do them yourselves. Or will it always be impossible to build the capability elsewhere?

Air Marshal Sir Stephen Hillier: We want to understand whether it is better to do it by ourselves or with allies. If it is better with allies, which allies? There are a number of European nations also using joint strike fighters as well as the US. It is the initial support package that we will contract for. I think we have a good level of confidence, not least because this aircraft has now been flying for many thousands of flying hours in the test programme. So we are getting a growing understanding of what it requires to support it properly.

Q118 Chris Heaton-Harris: At one of the first hearings we did on this sort of issue when I joined the Committee in 2010, I asked a number of questions about the Typhoon. You had a support contract, a service contract, but at the same time, although it was not admitted at the hearing—I tabled a number of parliamentary questions—there were three Typhoons almost regularly on the ground somewhere being cannibalised for parts, because the service contract did not allow parts to get to them quickly enough. Really I am after an assurance that you recognise that.

The permanent secretary at the time said that cannibalising planes has always been part of the RAF, and that is what we do. That might have been fine 20 or 30 years ago, but when three planes equal the best part of a third of a million quid or more, I would like to think that the huge amount of money we are going to stick into the servicing agreement would cover those eventualities. I would just like your assurance on that, or the best you can give.

Air Marshal Sir Stephen Hillier: The best I can give at this range is that we absolutely understand that problem. It is not good for front-line capability to have aircraft that you are constantly robbing. It is not good for the people who service them or who fly them. What we are trying to do is ensure that every aircraft is used to the maximum practical extent. The balance will just be ensuring that we can afford to do it in that way. Those are more issues going into the long-term support contract rather than the initial support contract, which just gets an initial bit of flying.

Q119 Mr Bacon: On that point, when it comes to the carrier rather than the Astute, when we were discussing this issue, we found that the contract provides for buying enough propellers to last for the lifetime of the carrier, rather than just one, so that when it needs replacing, you have got one. To what extent does the support contract include a quantum of spare parts of stuff that you know will wear out and will have to be replaced, just as part of the furniture in a typical support contract? Is that normal for an aircraft this sophisticated?

Air Marshal Sir Stephen Hillier: They will inevitably be part of that, but potentially one of the big advantages of being part of the F-35 programme is a global support solution. If there are certain key spares that only get used once every five years, rather than buying them all ourselves, we will hopefully be able to tap into a global support solution among all the other JSF users. It is an area that we need to do much more work on. You can only really do that work when you have been using the aircraft and know which spares you are more likely to need over time.

Q120 Chair: Going back to the carriers, you've got an extra three quarters of a billion pounds added to the costs in this Report. If you look back to the horrible start to all this, we are now at over 70% more than we were going to pay, and it is very late, and with one, we don't even know where they are going to use it yet—the decision has not been taken. Are we at the end of this spiral?

Jon Thompson: I don't think we can give you a guarantee that we are at the end, because there remain some risks towards the end, notably about technical fit-out. So can we sit here and say this is absolutely the end? I don't think any of us could ever give a guarantee of that.

Bernard Gray: No. We have increased our level of assurance, but we are not absolutely guaranteed. Part of the discussion that we had with industry, and one of the reasons why the negotiations took as long as they did, was what the price was for complete certainty about that out-turn and the maximum price level. That was a level that we were not prepared to commit to. So we have the current structure, where they share the cost overruns with us 50-50 until they get to down to break-even on the cost of the carriers, as a very sharp incentive for them to control the risks.

But as Jon says, the risks lie in two basic fields. One is the electronics-war fighting integration, and the second is the testing and commissioning of the whole-ship system, including the aircraft, into service. Those two areas continue to contain some risk, and I think it is fair to say that they were a matter of active debate in the closing parts of the negotiation about how much of the potential maximum risk we price in now versus how much we do not wish to take out that level of insurance, which is expensive. We are in a significantly better position than we were, but we are not absolutely cast-iron.

Q121 Chair: Thank you for that straightforward answer. Two other things. First, I do not know in what phase of the contract, but some cost savings had been set out—£200 million or whatever—and were not realised. In your current contract terms, do you have similar opportunities for cost savings about which you have a concern that they may not be realised?

Bernard Gray: Not in that way. In 2010 and into the beginning of 2011, there was the finalisation of the slip that came out of the equipment examination, when we delayed it for two years. That effectively turned into a central case that industry made that the carriers were going to cost £5.4 billion and a cost challenge put on it by the Ministry of Defence that tried to drive the cost down to £5.2 billion. It is hard for me to see into what was in people's minds then, but if I speculated that industry was prepared to say it would have a go at £5.2 billion bearing in mind that it was not bearing any financial risk at all if the cost turned out to be £5.4 billion, I could see it saying, "Sure, we'll give it a shot." I am not entirely surprised that did not turn up. There is no such arrangement in here. In that case, the companies would have made exactly the same amount of profit if the out-turn was £5.4 billion as if it had been £5.2 billion. We have agreed a set of costs for all of the activities, including the test and commissioning, the electronics integration and so forth. If that is wrong on the upside they will pay 50p in every pound, and if it is wrong on the downside we will both save 50p in every pound.

Q122 Chair: Can you send us—I do not expect it today—a description of what you have written off and how you got to your £55 billion of write-offs, so that we can have some understanding of that?

Jon Thompson: Sure. We can, but we do not think it will be finalised until April—that was the last information we had. We can tell you what we have assumed at this point.

Chair: Okay, thank you. Anything else on the aircraft carrier?

Q123 Austin Mitchell: It says at paragraph 1.14 of the Report that in the negotiations with the Aircraft Carrier Alliance, it got £348 million of cost savings. They seem to me to be of two types. One of them is savings and potential areas of cost reduction that you identified, but it also says that some of the costs cut were "over-estimates, inefficiencies and double-counting" in the alliance's July proposal, which looked like attempts to diddle the taxpayer. Can we have some idea of how much was in each category—in other words, costs you saved by pointing out efficiencies, and costs they were trying to increase by double-counting or other fiddles?

Jon Thompson: I'm sure we can give you that information in writing, but Bernard may want to give you a flavour of that.

Bernard Gray: As I mentioned earlier, we pulled the cost assurance team off the work on support in order to direct them into this because, as you will appreciate, there is a tremendous amount of detail going into what is the build-up of a £6 billion programme. To be fairer to the companies involved, and not to get myself in a libellous situation, I am prepared to take the view that there were accounting errors rather than any genuine attempt to mislead, and certainly when we presented to them "Hang on a second, you've got this cost in this line and this cost in this line" they readily enough took it out, so I don't myself see any intent in that. It was a very complicated negotiation, and they were doing a lot of work to re-price the deal.

If I might be permitted one bit of insight into it, I think the underlying cause of the various cost increases can be summarised as the difference between a number that companies are prepared to write down when they are not at financial risk for it and the amount of work they then have to do if they are going to take financial risk. There is a lot of detailed scrubbing that flushes out costs such as "It's going to cost us more than we had previously assumed to commission the second ship" when they are actually on risk for that price. So there was a lot of detail in that. They had to go back into a lot of subjects that they had kind of glossed over slightly in the past. Among other things, that flushed up some errors, but happily, with a lot of work from the CAAS team, we combed those out before we contracted.

Q124Austin Mitchell: Whatever you call them, though—whether you call them accounting errors or fiddles—they occurred.

Bernard Gray: Well, they didn't occur.

Q125Austin Mitchell: How can we be assured that the cost estimates we now have are based on sound assumptions?

Bernard Gray: As I say, we put a tremendous number of person years into getting the right numbers out, so a significant amount of senior effort and a lot of dedicated work by the ships team and the cost assurance team over 18 months went into getting to the right answer.

Q126 Mr Bacon: The total cost now is, I think, about £6.1 billion, and you mentioned that there are still two big risks, so you can't absolutely give a guarantee about a further rise, although the level of assurance is higher. You said the two risks were the electronic war-fighting system and the whole-ship system. In figures, how much of the £6.1 billion is the electronic war-fighting and how much is the whole-ship system?

Bernard Gray: It is not electronic war-fighting; it is the electronic systems that go into the combat system.

Mr Bacon: And the integration of them?

Bernard Gray: And the integration of all of those.

Mr Bacon: Right. And how much is that?

Bernard Gray: I can't remember off the top of my head, but I can certainly check for you.

Mr Bacon: I am just trying to get some handle on the scale of the thing.

Bernard Gray: I have a feeling in my mind that it is a kind of £500 million number, but I'd have to go and look.

Nick Smith: How deep is that?

Bernard Gray: I want to go and check.

Mr Bacon: Yes, please do write to us.

Bernard Gray: But to give you a feel, I would say it was of the order of £500 million.

Mr Bacon: Yes, I was just after a feel.

Nick Smith: So £500 million?

Bernard Gray: Yes.

Q127 Mr Bacon: And essentially what we're talking about is integrating electronic systems and software. We are talking about computer risk really here, are we?

Bernard Gray: Yes, computers and the associated sensors and sending out the right signals—radar or integration and so on.

Q128 Mr Bacon: Okay. When one speaks of the whole-ship system, to what extent is one speaking of, again, electronic kit and software, and to what extent is one talking about making sure that when we turn the tap on at one end of the ship and at the other end of the ship, it works? What is it? Is it infrastructure?

Bernard Gray: It's sort of both. A particular issue that is very important in ships generally but even more important in aircraft carriers is, what is the top speed and how long can you maintain it? Although a lot of design work goes into all of that, it's only when you actually start commissioning the ship that you understand what the top speed is, how robust the diesels and the gas turbines are, and how many hours you can run them at top speed, because you want to do that to launch and recover aircraft. You have the modelling that goes into all of that, but you only find out what the fact is when you send it to sea.

Q129 Mr Bacon: Again, without signing your name in blood, give me a feel for what proportion of the £6.1 billion we are talking about. If £500 million is the electronic war-fighting and integration, roughly, what is the cost of the warship systems?

Bernard Gray: They are slightly different numbers. One is how much it costs us to buy all the electronics for the war-fighting systems, which is the estimate I have had a stab at. The test and commissioning is a different thing. You have bought all the systems; how much work do you have to do in order to make sure? It is a kind of snagging list, if you like, in domestic construction terms. So we have a provision against that, but it's not about buying equipment. I can't remember this, either, but I want to say it's of the order of £250 million. But we will have to write to you with the figures.

Mr Bacon: "Snagging" is a very helpful explanation.

Q130 Chair: There are two or three more areas to cover, one being the complex weapons programme, which is a big programme of yours—£7.7 billion through the next 10 years. You've banked, in your figures—I'm looking at the director of finance—benefits of £1.2 billion on that one. According to the Report, because you've reduced expenditure, already some of those benefits are being whittled away. I don't know how much you've lost of those banked benefits. So there are two questions. First, how much have you lost so far, and secondly, how much credibility can we have on those banked benefits? *[Interruption.]* Who wants to take that one?

Jon Thompson: I am just checking with the team, and we don't think we can answer your first question off the top of our heads.

Chair: You don't know how much you've knocked off?

Jon Thompson: Not off the top of our heads. Not unless it is in the Report.

Lee Summerfield: I think the Report said that it had been netted off. They lost some benefits due to delays, I think, which were then recovered through other means. So the total of £1.2 billion—

Chair: Still stands.

Lee Summerfield: Yes.

Q131 Chair: But the reality is that, where they were hoping to get it, they're not.

Bernard Gray: Part of the point is to take a portfolio approach to the whole thing in order to make sure of a group of activities—for example, we are delayed to some degree on the Brimstone 2 weapon at the moment as a result of problems with its rocket motor. Some of the engineers who are working on that programme have been deployed on to other programmes in order to make those go faster. So we have a set of indicators that we track internally in my organisation—we have set them up because, like you, we worry about tracking the totality of what is going on here—which, broadly speaking, says that we are round about square on our expectations overall. I think we'd be happy to share with the NAO our analysis on that if we—

Q132 Chair: And the concern there is that that's where you have a particular staffing shortage, according to the Report. That's 18%—

Bernard Gray: The last figures I looked at said that the weapons operating centre was over by 48 people. But I appreciate that life is difficult all the way round, and it may be different parts of the weapons operating centre—so, general munitions—and the situation may have changed in the intervening 12 months. But the numbers that I looked at only last week, for our general purposes, showed the weapons operating centre being over by 48 people, not under.

Q133 Chair: Does the NAO want to comment on that? You’ve got it in the Report.

Lee Summerfield: The Report goes up to March 2013. It was an agreed Report, and those are the numbers we were presented with. If the position has changed since then, perhaps—

Amyas Morse: Perhaps you were giving better rewards.

Bernard Gray: Well, art of the reconciliation between the two things might be that there is general munitions, including the handling of general munitions, and complex weapons, where there may be a difference. But certainly, we have been under pressure and we’ve had to reduce staffing by 20% since 2010 as part of the overall austerity drive, so life is harder, and therefore we’ve had to increase productivity by about 20%.

Q134 Chair: You had the SDSR, which knocked some of that off. You’ve had a staff shortage, which you say is no longer true but could cause a delay. The figure suggests that you are spending less than you were, and therefore the benefits that you assume you will get are more difficult to obtain. I want to get a feel from you of where you are on that quite important set of interrelationships.

Bernard Gray: I look at it in a slightly different way from the way that you have it here, but my understanding of the situation from the indices that we track is that, in aggregate, we are broadly on track to deliver the expected outcome. I am more than happy to share with the National Audit Office what we track and how we track it so that they might come back this time next year to give you further and better particulars on that point.

Jon Thompson: You are right that the longer-term risk, if there were to be further austerity and the pipeline were reduced, is that you would obviously have fewer benefits. That is definitely a risk for the future.

David Williams: As a riposte to Bernard’s point, we think we have not simply baked in but delivered about £200 million of savings to date against those 10-year pipelines of benefits. That, broadly speaking, is where we expected to be at this stage. There is still risk downstream. It means that when we are thinking about our planning decisions, we are not simply looking at the individual project level but at the level of spend in the portfolio as a whole. That gives you some flexibility to move the individual components of the complex weapons pipeline around, but it gives you an additional constraint or fact to consider in terms of the overall funding levels.

Q135 Chris Heaton-Harris: I just want to ask a couple of questions on Cipher, which is mentioned in the Report but is an ongoing project. The Committee has come across a number of interesting IT programmes that have caused us concern. I want a general assurance that you are very aware of costs going forward and that you have what you feel to be the appropriate team keeping an eye on all of this. I would like to know that we are not using recycled NHS IT people.

Chair: They are using a very expensive IT person.

Chris Heaton-Harris: There have been some issues on that. I am generally interested because, to me, it is a cross between "The Bourne Legacy" and "Mission: Impossible." It is probably just a dozen overweight people eating pizza and tapping on keyboards, but, whatever it is, I want to make sure that we are in control of costs.

Bernard Gray: It started with me, but it is now with Jon. We started looking at it about three years ago, but two years ago we became concerned about getting into the very difficult problem that one has with IT when a novel solution is applied to something where there is a fixed deadline by which one has to replace a system. That is fundamentally risky, because certain of our codes would go out of useful life at a certain point. I want to be a bit careful about how far I go, but at a certain point in time we were going to lose the use of some of our codes, so we needed to replace them. Some aspects of the way in which they were proposed to be replaced were novel and, generally speaking, we also had some concerns about the ability of the contractor to deliver. That seemed to us to be a very unhealthy situation.

We worked with the contractor to try to resolve the situation over about nine months, and the situation was not resolved to our satisfaction. There were conversations between the Air Marshal and myself on how we might simplify the requirement. Did the customer actually care whether the result was delivered in this novel way, or would they be happy with a more traditional way of addressing the problem? Steve was happy with the traditional approach, and we therefore terminated the assessment phase and closed it out for only a residual cost of about £7 million. Our commercial department did a good job of exiting us from that £1 billion-plus programme.

We then effectively went to a very pragmatic solution to extend one of our other cryptographic programmes to supply the vast majority of what we needed for the programme in a more traditional way. We have taken a much lower-risk approach by effectively stopping what we were doing, recognising that it was high-risk, and expanding an existing programme that was already delivering for us in a different cryptographic area in order to accommodate it, because the customer said, "I don't care about this fancy new way of doing things." That is then passed into the CIO's department as part of the handover of the IT programmes to its own dedicated centre.

Jon Thompson: So we have essentially stopped this programme, because we did not think it would work. We are re-forming a new plan that will go to our investment approvals committee in March or April.

Q136 Chair: Okay. On the future strategic tanker, which we have considered before, you are planning to give it its protective coat. Did you have to do that under the PFI?

Bernard Gray: It is a PFI contract. That provision has been done; I am struggling to remember whether that happened under the PFI.

Q137 Chair: Because when we looked at it here, it was horrific. If you are renegotiating PFI terms, you are into an arm and a leg.

Bernard Gray: No, that does not involve the wholesale renegotiation of PFI. We have provided that capability—

Chair: Separately.

Air Marshal Sir Stephen Hillier: It already came with its own defensive aids. We believed it needed enhancements, because of our increased knowledge out of current operations. I believe it was done through AirTanker, and it was actually delivered three months early.

Q138 Chair: I am not disputing that. When we looked at it, we spent a bit of time on it. The whole argument was about how we were getting these aircraft that were not fit for purpose, and therefore a variation would impact massively on costs. I am interested in if and how you got round that.

Bernard Gray: We had a discussion with them. The additional capability was fitted and delivered early.

Chair: But the cost?

Bernard Gray: It did not have a significant cost impact.

Air Marshal Sir Stephen Hillier: I think we showed that the cost of the PFI has gone down.

Bernard Gray: We can look at the specifics and write to you, but I do not think it was material.

Q139 Chair: Okay. The delay figures look a bit better, but of course we are early on. In particular, there are the ones that were being monitored by the MOD. These are all strategic defence review projects that are being measured. If we turn to figure 12 in the major projects report, we see that there are a couple of things that should have happened—they ought to be happening now. I want to see whether that was in fact the case. The Typhoon should have been delivered in December 2013. Was it?

Jon Thompson: Would you mind repeating the question?

Q140 Chair: Typhoon—aircraft software upgrade. Future capability programme. It was to be delivered December 2013. Was it?

Bernard Gray: Yes.

Air Marshal Sir Stephen Hillier: I believe so, yes.

Q141 Chair: Further up the page—we have just talked about it—is the Tanker aircraft. Is it going to be in service by May 2014?

Air Marshal Sir Stephen Hillier: Yes. It is already flying airbridge missions into Afghanistan and back. This is the formal in-service date; I think it will be seven aircraft that we have. We have about five at the moment.

Chair: Good.

Q142 Chris Heaton-Harris: My final question is on senior responsible owners. The Committee has had some issues with them being turned over very quickly. In the document that you have kindly provided for us, I noticed that pretty much all of them have changed in the last two years, and only one has a planned end date that is listed for longer than two years. I want some assurance that you are trying to keep people responsible for projects in post for a reasonable period.

Jon Thompson: We are trying to keep people in post longer. Lord Levene looked at this for us independently in his second annual update of defence reform; he was sharing the same concerns as the Committee. This issue is to some degree concerned with the posting of military colleagues, because of their career. The evidence that Lord Levene had was that there is more stability. Some officers are serving longer, but if I am straightforward with you, it is still a bit fluid. We are doing better. We can provide you with some of that data, but it is still not stable enough. It would be better to go longer. I do not know whether Steve has a view about that.

Air Marshal Sir Stephen Hillier: I think it is as was said. There has also been the delegation of responsibilities out of head office and into the front-line commands. In large measure, that has changed the responsibilities, but it means that the front-line commands have much closer control over those programmes. I think that is a healthy thing, but to take myself as an example, I am the SRO for that programme, and I will probably do three to four years as such. We are trying to do it as much as possible.

Q143 Chair: My final question is the GoCo question, because that's gone. What is the plan B?

Bernard Gray: As we discussed at the beginning, the purpose of bringing in the GoCo was to improve the skills and control inside the organisation. Our plan now is that we have a bespoke trading entity, which is one of the categories of public entity in "Managing Public Money" that we have talked about. It will have the freedoms that we discussed earlier and a degree of arm's length from the centre of the Ministry of Defence. Everybody there will remain civil servants, but we will be at arm's length, much like a trading fund, with an owners' council, an appointed chair and non-executive directors, a business plan and an overall framework plan that governs the organisation.

The intention is for that to create a boundary within which we can vary our terms and conditions to attract the people whom we need to attract to get the job done, but within which we will not be read across into everywhere else inside government. We can control what we are doing within the DE&S boundary to make sure that we exercise those freedoms solely for the purpose of improving—

Mr Bacon: DE&S?

Bernard Gray: Defence Equipment and Support, the delivery organisation that I run.

Q144 Chair: So the real intention is simply to find a mechanism to allow you greater freedom to recruit people outside the civil service?

Bernard Gray: That is a significant element, but it is not the only one. At the moment, we do not have delegated power to make very many decisions within DE&S about, for example, what our grading structure is, how we promote people and so on.

Chair: So it's all about the people?

Jon Thompson: No. Bernard's original report in 2009 said there were three problems: an overheated equipment programme, interface between the Department and DE&S and giving DE&S the capacity to do its task. By creating a ring fence—an organisation with a separate boundary—you can address the interface question, because you can have a clearer arrangement between Steve and the front-line commanders and Bernard, and address the issue of the people. That is two significant advantages: the interface issue, and the—

Q145 Chair: Why is the interface better?

Jon Thompson: If we have more appropriate commercial arrangements within the Department, it brings some reality to people who are making decisions about what capability they want—what the cost of it is, what the capability trade-offs are and so on. You get a harder conversation than DE&S simply being told to go off and do it.

Bernard Gray: Because historically, we have faced a situation where the customer has been able to be relatively indisciplined about changing the specification or the profile of when they want something delivered—

Mr Bacon: Without any penalty?

Bernard Gray: Without any penalty, and that always costs money, as we know. Therefore, the harder interface allows us to say, "Well, you the customer can have whatever you think is appropriate for the front-line forces, but you must understand that if you previously said you wanted X and you now say you want Y, that has a significant cost implication." The classic example I would offer you is the one we have discussed often—the aircraft carrier.

If we had had that proper boundary at the time, people in my organisation, in response to the question, "How much would it cost to put cats and traps into this aircraft carrier?", would appropriately have said, "I cannot answer that question today; it will take several months of work to determine it" and then have come back with a better-founded answer, which might have caused us to make a better decision at the time than people trying to be helpful, collegiate and so on and offering a number as a guess, rather than on the basis of firm knowledge.

Q146 Chair: And who will this new trading body be accountable to?

Jon Thompson: It's a body within the departmental boundary, so it will produce its own accounts—

Q147 Chair: Will you be the boss, Mr Thompson?

Jon Thompson: I'm getting to that. It will be within the departmental boundary, and therefore auditable by the National Audit Office. We would expect it to produce its own accounts. We would expect the first chief executive—Bernard as CDM—to be an additional accounting officer and also therefore within the remit of the NAO and the Public Accounts Committee. I think that that is probably enough.

Q148 Mr Bacon: Can I just check something? You mentioned earlier the issue of programme management, people, engineers, commerciality and how attracting the right people and keeping them was a big problem. When you have this new organisation up and running, so that you have more freedom to pay, to get the good people, what happens to the person in a similar role who could have left but did not, who is on your books already at, as it were, the old rate? Do they get transferred across into this new organisation under their existing terms and conditions, so that they are all within the same milieu?

Bernard Gray: There is no TUPE transfer here, because—

Mr Bacon: That was not my question.

Bernard Gray: I am just trying to be clear.

Q149 Mr Bacon: So there is no TUPE transfer across. Plainly, they might get wind of the fact that there are people who have been brought into this new organisation who are doing the same job as them, or a similar job, who have been paid more. But if it is not TUPE'd across, are you going to have two parallel organisations or will all the people end up in the same space?

Bernard Gray: One of the things that we have to do is look at the grading structure, because at the moment there is a constraint. There are many civil service grades, but to take a senior one outside of the senior civil service, we have a B2 grade, which is a sort of half-colonel, I think. So everybody on that B2 grade, regardless of what job they are doing, basically gets paid the same, whether they are in administration or they are an airworthiness engineer. One of the things that we could look at doing is say, "Actually, airworthiness engineers at that pay scale should be paid more, because that is a more technically demanding, in-market demand job than administration," for example. So one of the things that we would have to do is go through and conduct a grading exercise for the structure.

Within a grading, however, there is—as is in the outside world—potential for significant variances between what individuals are paid inside a band.

Q150 Mr Bacon: But they would all end up within the same organisation, so to speak.

Bernard Gray: Everybody is in the same organisation.

Q151 Nick Smith: We can all see the value of improved commercial skills in this organisation, and project management skills and good, rigorous cost-questioning, but the obvious question to ask is: what is going to happen to the salaries of these people in this new organisation? For instance, Mr Gray, are you going to get a sizeable pay hike?

Bernard Gray: A sizeable pay cut?

Nick Smith: Hike.

Bernard Gray: Regrettably, I fear that I have myself foresworn any possibility of that happening. Before you think me too generous, I should say that I am sure that Mr Thompson would have foresworn it for me, if I had not done it first. We are agreed that my remuneration will not change at all under this dispensation.

Q152 Nick Smith: And other people within the organisation from the MOD, moving across to the new one: what will happen to their pay?

Bernard Gray: Well, everybody will move into the new organisation on the same terms and conditions as today and then, as I have just explained to Mr Bacon, we would have to go through and conduct a grading exercise. To take airworthiness engineers as an example, we cannot recruit them today, but not only do we need to recruit others, we need to retain and motivate and train the ones whom we already have. So without causing too much excitement in the airworthiness community, I would imagine that our HR department will have to go through and analyse what private sector companies are paying for this, because QinetiQ, BAE and British Airways all employ people to do these kinds of things—Airbus, and so on. So we need to go through and benchmark those salaries against the private sector, and that is probably a good day for the people in the airworthiness community, but not for me.

Q153 Nick Smith: If I could just clarify: you are not going to get a pay increase, but lots of your colleagues are?

Bernard Gray: Some may.

Q154 Nick Smith: What percentage? What is your assessment?

Bernard Gray: I don't know. I haven't done the work. But my point is that, because we are currently under-recruited in those areas, we spend about a third as much as our total pay bill—more than a third—on getting that support from the outside world. So we will face a series of make/buy decisions about whether we continue to contract with the outside world to have that service, because we do not want it all the time, or whether would it be cheaper to hire more people in to do that job.

There is also a significant cost to us if, as Mr Heaton-Harris has observed before, we do not have enough people to certify the aircraft to get it flying. This is not only about robbing aircraft; it is about what happens if we can spend billions of pounds buying the aircraft, but then not clear them. So to my mind, without getting them all too excited, I would think that we are going to want to pay people in airworthiness more than we pay them today. We will have to look at it job by job, until we work our way through what a stable situation for the organisation is. That is how it will work.

Chair: Good. Thank you very much indeed. Thanks for your time.