

Public Accounts Committee

Oral evidence: Equipment Plan and Major Projects Report 2014 and Reforming Defence Acquisition, HC 1045

Monday 02 March 2015

Ordered by the House of Commons to be published on 02 March 2015

Watch the meeting: <http://www.parliamentlive.tv/Main/Player.aspx?meetingId=17391>

Members present: Margaret Hodge (Chair); Mr Richard Bacon; Mr David Burrowes; Meg Hillier; Mr Stewart Jackson; Dame Anne McGuire; Austin Mitchell; Stephen Phillips.

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

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

Q1 Chair: Apologies for keeping you waiting. We are coming to the end of the Parliament so have a lot of business to clear up.

Let me start with this: there is some good news and things are moving in the right direction. You can take our questions in the context of our having seen a step change and improvement in performance, which is incredibly welcome. I always tell the story of the first sitting I ever chaired, which was on £8 billion of defence procurement money that seemed to me to have been torn up. So well done on that.

Jon Thompson: Thank you.

Meg Hillier: Enjoy that moment.

Chair: Now I am going to go in. I'm going to start on the budget.

Mr Bacon: You're going in and you may be some time.

Q2 Chair: I'm going to start on the budget, then we will get on to the GoCo, and at the end we want to ask a few questions about Army 2020. What happens if you do not get your 1% real-terms increase?

Jon Thompson: It depends on the SDSR. I think I have said to you several times before that our vision is of a balance between the strategy you are trying to deliver and how much resource you have. Were the resource to be less, I expect that the Government of the day would reset the strategy so that you kept that balance. There is also the question of how much more efficient we can be between strategy and resources, but if the resources did not come through, you would expect the strategy to be redrawn. That would then flow into the equipment plan in terms of what orders we would reduce or what we would not procure in future in order to meet the strategy.

Q3 Chair: As you read through the Report, it is so full of ruddy numbers that I found it quite difficult to distil what the key ones were, but it interests me that you are spending a higher proportion of your budget on equipment than you have in the past and than you planned with the Treasury. If my figures are right, you are up to 47%.

Jon Thompson: We are up to 44%, and the long-term plan would reach 47%, if this plan held.

Q4 Chair: Okay, so you are at 44% and going up to 47%, and the agreement with the Treasury was to be at 41%.

Jon Thompson: We have the ability to vary it, but yes.

Q5 Chair: I understand that, but when you agreed it with the Treasury, it was 41%.

Jon Thompson: Do you want me to explain why that is?

Chair: Go on.

Jon Thompson: The funding agreement with the Treasury is flat real plus 1% on the equipment plan, but it is clearly less than that on the remainder of the budget, so over time you become capital richer, equipment plan richer, and the rest of the budget becomes poorer, so the percentage changes over time.

Q6 Chair: Okay. You are left wondering whether, if you do not get your 1% in real terms—I don't know how much flexibility you have, but it is not a lot—you then start eating into people or the estate, which are the only other two big spending blocks, aren't they?

Oral evidence: Equipment Plan and Major Projects Report 2014 and Reforming Defence

Jon Thompson: Yes.

Bernard Gray: Or you have to cut the equipment plan itself.

Q7 Chair: Say that again.

Bernard Gray: You have to cut the equipment plan, the people or the estate.

Q8 Chair: But your flexibility on the equipment plan is getting less and less, because you are not really ordering much new. You are now just delivering what you have agreed.

Jon Thompson: We have some headroom—£8 billion; it is in the Report—but yes, 37% of the budget is on equipment, 38% is on people, and 10% is on infrastructure, so 85% of the budget is tied up in those three things. You are exactly right. To go back, if the budget did not follow this plan, we would expect the strategy to be redone in a balanced way. That might mean that, after efficiency, you would have to balance both people and equipment.

Q9 Meg Hillier: If you find that you do not get the 1%, how long will it take to redo the strategy?

Jon Thompson: You would expect the SDSR to be completed in roughly six months, but it obviously depends. It can take longer, and some in the past have taken longer than that, but in 2010 it was done in roughly six months.

Q10 Meg Hillier: What would be the budget implications if it went on longer than six months? Have you factored all that into your calculations?

Jon Thompson: We have a budget set for 2015-16, so we are currently assuming that an incoming Government would redo the SDSR and do a spending review at the same time, through 2015, with a view to starting in April 2016 and setting a 10-year goal such as “Future Force 2025” or some such strategy. You are absolutely right. We are more able to change our financial position the longer we have to do it. That is what happened in the current spending review. Our budget went up in the first year of the current Parliament, and then went down.

Q11 Chair: So problem no. 1 is the predication on the 1% real terms increase. Problem no. 2 is looking at that budget and some of the assumptions behind it, and then some of the realities of expenditure, but let us deal with the assumptions first. You are assuming a £6 billion efficiency saving is in there.

Jon Thompson: Yes.

Q12 Chair: Let us cut that down into the savings you want in the support and the savings in the capital programme. Let us go to the support first. You are assuming over £4 billion of savings out of the support budget. Yet at the same time your internal guys have looked at less than a third of the budget—just over a quarter—and found that you are spending more than you currently have in your budget. So you are assuming savings while the reality of expenditure is higher than in the budget. I cannot remember the figure. There are so many.

Bernard Gray: They are estimating the total. To be clear, we are not spending more than is in the budget, but there is an assumption over the 10 years that the equivalent support plan will cost £2 billion more than the budget today.

Q13 Chair: But the £2 billion is on 28%, not 100%. Or is it £2 billion on 100%?

Bernard Gray: No, they have surveyed 28%, and that is their projection for the 100%.

Lee Summerfield: I am not sure that that is correct. I think the £2 billion is based on the 29% that they have currently reviewed. I do not think they are yet in a position to give an aggregate view, or they do not want to give an aggregate view yet.¹

Q14 Chair: So the £2 billion—if that is mirrored through the whole of their analysis—could become about £6 billion-plus. So there is a bit of a reality check to be had on this assumption that you are going to be able to pull out over £4 billion on the budget, particularly if your internal verifiers are saying that you may be out by £6 billion. What do you say about that?

Jon Thompson: Perhaps I could get Bernard to give you an update on where we are against the £4 billion, because we have some updated information that we can give you. In relation to the £2 billion, you will recall that we have had this debate several times in the past. We do have a contingency of £4.6 billion.

Q15 Chair: I am not talking about the £2 billion on capital. We will come back to that. This is the £2 billion extra on support, which has been identified by—I am sorry; I cannot remember the name of the group.

David Williams: CAAS.

Q16 Chair: I will come back to the capital saving in a minute.

¹ Note from the Ministry of Defence: The £2Bn ESP cost growth reported by CAAS only covers the 28% of ESP projects where CAAS have produced an independent cost estimate – not the full 100%.

Jon Thompson: The risk, which is assessed by the independent team, is £3.2 billion on the equipment procurement plan, and £2 billion on the equivalent support plan, so that is just over £5 billion overall.² The £5.2 billion is the best information we have, and we have a contingency of £4.6 billion, so there is a gap between those two numbers. On whether we have secured £4 billion, perhaps Bernard can give the Committee an update.

Bernard Gray: So we have been working for the last 18 months, since spending round 13 was settled, on this issue. The current position today is that we have booked and are locked into people's budget measures, which take £2.3 billion of the £4.1 billion out, so we have already sentenced that and agreed it with the front-line commands—it is actioned—and that comes from a variety of sources that we can talk about if you wish to. We have about a further £1 billion currently being worked on, which we confidently expect to be locked in. That leaves us looking for about £800 million over the 10-year period. Importantly, the period for which the savings start is at the beginning of the next financial year in about a month's time. So before we have even entered the 10-year period, we have already either actioned or are in the process of actioning three quarters of the total.

Q17 Chair: And then the reality check against your own internal projections?

Bernard Gray: In quite a few of those cases, when we go into it, we have found ourselves working from a position that, as you say, is worse than is in the budget. On quite a number of occasions, we have had to do quite a lot of work to get to zero. The £2.3 billion and the £1 billion that I just described are after working off the headroom, which we had to do because the reality of the situation was worse than was budgeted. They are effectively a genuine saving against that target. We expect to do the same around the rest of the portfolio. We have started with the largest projects for obvious reasons—they offer the best focus and the most opportunity—but we are basically working our way down the squash ladder of projects by size, and when we have natural renegotiation possibilities with companies.

Sir Amyas Morse: Can I ask, Bernard, typically, what would you be doing? "Work" is a helpful verb, but what specific measures would you take? Most typically, when you see something that is not costing what it ought to and you are working at it, what are you doing? Are you reducing the amount, and how do you bring that across?

Bernard Gray: We have been working with outside teams and the project teams. We go through benchmarking "should cost", which is an activity that I am sure you would recognise. We benchmark what it should cost, and how much productive time people are spending. So, on the support activity again and on maintaining things, we look at how much time maintainers on the job actually maintain, as they are employed to, as opposed to wandering around, and so on. We look at the requirement, to see whether we are over-specifying the amount of work we need—the answer is often yes. We also look at how we generate efficiencies out of what they are doing—how we can

² Note from the Ministry of Defence: Mr Thompson meant "the equipment procurement plan"

cut their overhead and reduce their profit margins. On a significant number of projects, we have achieved efficiencies of the order of 20%.

Sir Amyas Morse: So then you need to make sure that those costs actually come out of the projects, as opposed to being taken out on a planning basis?

Bernard Gray: That is correct. We are locking them into contracts and into the front-line command budgets, and our project team budgets by agreement. That is the £2.3 billion that has already been sentenced.

Q18 Chair: When you talk about projects, are you talking about support projects or capital projects? Is this all support?

Bernard Gray: Yes, support. For example, there is a planned depth maintenance programme for the support of the tornado aircraft. We took a significant amount of money out of that programme—it is one of the first we addressed—at a natural renegotiation point and reduced the cost of maintaining the known output through to the out-of-service date.

Q19 Chair: So both of you are feeling pretty certain on this. The support cost reduction is absolutely key to your predictions of what you can afford to do in terms of capital acquisition, so are you both feeling pretty confident that, sitting here in a year's time, you will be on course to deliver that? That was my great source of scepticism when I read the Report.

Bernard Gray: I'd say yes. We have to save this money over a 10-year period, and before we get to the beginning of year 1, we have already sentenced over half of it and it is all locked in, and we have another quarter that is in the process of that work, when we have not got halfway down the list of projects yet. The returns will get smaller as we get further down because they are smaller and more fiddly projects, but none the less I feel comfortable that we are going to do it, yes.

Jon Thompson: I feel reasonably confident that we can deliver the £4 billion, yes. I would not have agreed the spending review in 2013 if we didn't think there was a reasonable prospect.

Q20 Chair: I understand the £4 billion, but remember also this other bit, which is potentially £6 billion. You are potentially talking about a £10 billion real reduction in the support programme.

Jon Thompson: I appreciate your opening context. I think this is the seventh time in a row I have been to this Committee. Every time we turn up, we feel in a more confident place. That is not to say that it is without risk, and there is significantly more that we need to do, but do I feel more confident than last year that we can now deliver that particular element of it? Yes.

Q21 Mr Burrowes: Is that confidence contingent on the contingency formula?

Jon Thompson: No.

Q22 Mr Burrowes: In an earlier answer, you did pray the contingency formula in aid.

Jon Thompson: Yes. I was trying to separate the Chair's two questions. One is about whether there is risk in the equipment support plan that the cost might go up and the other is about whether we can drive out the £4 billion. Your question was whether we can drive out the £4 billion, and we all think that that is do-able. We can talk about the risk if you want. We can switch to that. Do you want to switch to risk?

Q23 Chair: Yes, go on.

Jon Thompson: The best information we have at the minute gives an estimate of risk at £5.2 billion, and we have a contingency of £4.6 billion. Those figures are not too far apart, but there is clearly more work to be done on the equipment support plan, such as identifying the risks for cost growth in that area. Given that it is a £163 billion forward programme, those two figures seem to be not too far apart. We accept that further work still needs to take place in that area. We are better than we were last year, but we are still not 100% with the programmes. That programme continues, and I am sure we will get a better handle on it next year.

Bernard Gray: We have teams continuing to work on that now, and we have a planned programme of activity over the next 12 months.

Q24 Chair: We are now coming down to the capital—the actual investment bit of it—and one of the ways in which you have managed to cut spending, for example, is foreign exchange movements. That seems to be a big element of the expenditure saving, which is a bit iffy, because they can go either way. It is hit and miss. That is the first thing.

The second thing is paragraph 3.12, which is on page 27, and the demonstration of the savings you are predicting on the submarine enterprise programme—I know the PULSAR is still in concept—and complex weapons procurement. With complex weapons procurement, you are predicting a £1.2 billion saving between 2010 and 2020. We are not quite halfway through that period yet, but you have only got £196 million. Being generous, you are two fifths of the way through and you have one seventh of the savings.

Bernard Gray: May I offer an observation on foreign exchange? We had an exchange on foreign exchange when it went up by £150 million and I said there was not much I could do about it. I am not claiming great credit for the fact that it has fallen by £250 million. That is life and we are not making a big deal out of it; we are just recording what it is. Our basic underlying assumption, which agrees with the NAO, is that the programme is stable. We are not claiming great credit for reductions, much as we did not take great hits for the fact that fuel went up a bit.

So far as the other two programmes are concerned, I have different views on each. The submarine enterprise programme has delivered about half of the benefit that we have expected so far. We need to push further, but I am more confident that we have measures identified that will drill out more on that. We are—certainly I am—sceptical about the benefits from the complex weapons pipeline. The point I would make there is that if we do not drill out the benefits from that, we will basically have to work it out through the rest of the equipment savings plan benefits. I view it against the programme as a whole.

On specific projects we are achieving a higher percentage reduction than we are required to achieve across the programme as a whole. I am reasonably confident that as we comb through all the details of the equipment support plan, where we are spending £7 billion a year, we will be able to find the £350 million or 5% required to make the plan work. Even if the complex weapons pipeline does not produce as many savings as were advertised for it, I am confident that we can mitigate that in savings elsewhere.

Sir Amyas Morse: Is it the first time that you have gone through the support programme in this much detail?

Bernard Gray: Yes, I think it is—with “you” meaning DE&S. In the previous iterations of this, we have all been focusing on the capital works programme, which has had percentage increases of 20%, 30%, 50% or 100% or whatever, and getting that under control. Now that we have got the capital programme under control, we have been able to dig into the support plan, which is not as volatile. It is about maintaining things, rather than the cost of new things, so it does not change as much. There have, however, been inefficiencies in it. We have not had the data historically that we would have wanted. We have put serious effort into it over the past two years.

Sir Amyas Morse: From the cost reduction exercises that one has seen in the past, would it be reasonable to expect that having gone through it once, the learning from that may mean that you can look for further efficiencies in future?

Bernard Gray: Potentially, yes. But of course, we have to achieve the first milestone first.

Sir Amyas Morse: Of course.

Jon Thompson: If you want to know where we are with the foreign exchange, we are not fully exposed to foreign exchange. We have a four-year rolling hedge, which I attempted to explain to the Committee before.

Q25 Chair: There is this ghastly thing that we uncovered somewhere, which is that you are only allowed to trade on a particular day of the month. Is that right?

Jon Thompson: I am sure that the expert to my right can fully explain foreign exchange to you.

Q26 Chair: Is that true? It was when we looked at the Foreign Office or something.

David Williams: I do not think that we are only allowed to trade on a particular day of the month. In the rolling arrangement that we have, we go out on one day each quarter to say what our forward requirements are, so that we can lock in a price.

Q27 Chair: But you do not speculate.

David Williams: No. We are not allowed to speculate.

Q28 Chair: So for one day a quarter, you go out. Is that right?

David Williams: The purpose of the hedge is to minimise financial risk or volatility. It is not for trying to get a gain.

Jon Thompson: It is for planning purposes.

Q29 Chair: Yes, but it might not be in the interests of British taxpayers if you are not actually maximising—

Marius Gallaher: There is a lot of risk if you go in any day you like. It is speculative.

Jon Thompson: If you use the Bank of England, one assumes that they are reasonably good at that.

Q30 Chair: Okay. I just have one thing to pick up. The Report says, on the submarine enterprise performance programme, that you have only received £200 million of savings. Are you saying that that is out of date?

Bernard Gray: No. We have identified around £400 million of savings on it.

Q31 Chair: Page 27, paragraph 3.12.

David Williams: The £200 million on page 27 is as at March 2014, at the end of the planning round covered by our EP.

Lee Summerfield: We have the figures up to March 2014. We have not seen the new figures.

Q32 Chair: If you are going to get on top of it now, into the detail, it comes across in the Report that you have not really managed two things. One is the consistency across your teams. If you look at page 20—you get people treating inflation differently and VAT differently. Risk is looked at very differently, and cost modelling is all different. It is very frustrating, to be honest—I am sure it is for you in the Department—to find that this inconsistency is still there four or five years on, because that is bound to be leaching money out. I do not know if Sir Stephen wants to come in on this.

Jon Thompson: Did you say that there were two things?

Q33 Chair: The other thing is the underspending, but I will come to that in a minute. Let's deal with the consistency first.

Jon Thompson: We are more consistent than we were, but clearly there is significantly more to do on, for example, inflation or risk. I am sure that Bernard can say something about the injection of the managed service partners to improve things like earned value management, financial forecasting and so on. We have done quite a lot ourselves. The quarterly performance and risk process has now been going on for 18 months. That has definitely improved our understanding, but there is more to be done. VAT is a much more complex conversation altogether.

Q34 Chair: What do you mean?

Bernard Gray: What we are rated for and not.

Jon Thompson: It is not as straightforward as you would think. You have previously had evidence from HMRC, I am sure.

Q35 Chair: We have regular evidence from HMRC.

Jon Thompson: Indeed. We have the same relationship with HMRC as, I suppose, many other organisations in which there are various interpretations of the application of VAT on various things that are bought.

Q36 Chair: What difference does that make to you? Are we talking about billions?

David Williams: Over a 10-year period, yes.

Q37 Chair: What are we talking about?

David Williams: If you are looking at, for example, whether you can claim shipbuilders' relief on nuclear reactors in nuclear submarines, a yes or no decision is a material variation over a 10-year planning horizon. Actually, that is a relationship between the contractors at HMRC rather than directly between us, but obviously we are very closely interested in the outcome.

Bernard Gray: We have an example where we buy or intend to buy a section of next-generation submarines from the United States, the missile tube compartments. They would be manufactured in the United States and then sent over and incorporated into submarines for us. Shipbuilding is zero-rated for us; the question is whether the section that we buy from the United States, for example, is zero-rated or not. HMRC says it is not. We had assumed that it was, because it is part of a submarine, which is zero-rated. They say it is not. It is that kind of thing.

Q38 Dame Anne McGuire: So the MOD carried the liability for the VAT? Or is it, as Mr Williams said, the manufacturer or the builder? Who carries the liability?

Jon Thompson: We do.

Bernard Gray: We do, because, sadly, we have to pay them.

Q39 Dame Anne McGuire: So one arm of the UK Government is paying VAT to another arm of the UK Government, which fully funds the first arm?

Jon Thompson: Yes.

Bernard Gray: Well—

Q40 Dame Anne McGuire: Thank you, Mr Thompson, that was a really neat answer. Mr Gray obviously wants to finesse it.

Bernard Gray: Only because we get a budget, and if it turns out that VAT is assessed against us when it was not in our budgetary assumptions, there would be an argument about whether we would get the uplift for that, so it may be a way of taxing us.

Dame Anne McGuire: I think I preferred Mr Thompson's straightforward "yes".

Q41 Chair: It is completely silly. Can't somebody sort it? Tell me, in a year of your capital budget, how much VAT is in there?

David Williams: I would have to write and let you know, Chair.

Q42 Chair: You haven't got a clue?

David Williams: I haven't got it on me.

Q43 Chair: Have you got a clue what you are talking about?

Bernard Gray: It is all project by project.

Jon Thompson: We are just trying to put across the point that HMRC's interpretation of VAT legislation for us exposes us to other financial risks one way and another, and we have to make a judgment about that. Sometimes the HMRC ruling goes in our favour, and sometimes it doesn't.

Q44 Chair: What is particularly worrying in this Report—it is an HMRC point, actually—is that paragraph 2.16 says HMRC “have since changed their policy on applying VAT to some projects”. Perhaps you would like to comment on that. That is just daft. We ought to be able to sort that out.

Marius Gallaher: I think HMRC interpret the rules as they find them. They have to be fair, and everybody has to pay tax. We can't make any exceptions.

Chair: Nobody is asking for exceptions; they are saying HMRC have since changed their policy.

Q45 Dame Anne McGuire: Just let me get my head around this. In terms of the overall UK Government, is this a neutral budgeting exercise? To go back to my perhaps simplistic little picture, one arm of the Government is giving out money to another arm of the Government, which funds the first arm of the Government. Is it a mutual exchange?

Jon Thompson: The reason why Mr Gray's answer is possibly better than my “yes” is that if we are taxed for something we had not assumed, that is an additional cost for us. It does not necessarily result in additional funding for us, so we have less spending power, and the Government, in the end, is ahead overall, I think.

Bernard Gray: But the effective Ministry of Defence budget has gone down.

Q46 Dame Anne McGuire: Sir Stephen Hillier?

Air Marshal Sir Stephen Hillier: The consequence of that is that if it takes spending power out, you buy less capability for the front line. While it might be a benefit in financial terms, it is not a benefit in capability terms, obviously.

Bernard Gray: Effectively, it is a budget cut to us.

Q47 Chair: That is why it would be interesting to know whether it is something we should worry about or just a little bit on the margin that is irritating.

David Williams: In some ways, it is a bit like the foreign currency point. My interest in the tax position is not that I am trying to minimise our tax exposure. As a Department, we should pay the tax that the rules require us to pay. What I am trying to minimise is the volatility and uncertainty in that level of tax payment. One of the challenges is that, although you can get a preliminary view from HMRC as you are developing a project, it is often only after the contract is signed and they have some engagement through the company that you get a different position. But I am happy to let you have—

Q48 Dame Anne McGuire: Sir Stephen Hillier, I thought you nodded.

Air Marshal Sir Stephen Hillier: I was agreeing with David that it is when you get late notice that you get volatility in project forecast costs. That can have a real impact if you are just about to sign a contract for something which is important for military capability and suddenly, as a result of VAT, you have got an unaffordable programme, and you have to make a lot of decisions at very short notice. So it does directly connect the point about volatility and project cost and VAT, and the timeline.

Dame Anne McGuire: Right. Thank you for that clarification.

Q49 Chair: Going back to consistency, if you go down that page, at 2.20, what is more worrying is that only three project teams were applying good practice across all aspects of risk management. That is poor. And about half had generated a range of potential costs. The other thing that really worried me—at 2.22—is that typically risks were excluded, where the risk is outside the team's control, but it is still a risk to the budget, whether or not it is in. You ought to have it in there, in your consideration of the totality of what you are doing.

Bernard Gray: On the last point, we allow for risk at different levels. We want some risks to be held by the project team, which are risks that they can manage. We want some risks to be held at the portfolio level—at my level—because some good things may happen in one area, such as good luck in the foreign exchange, or some bad things may happen in another area, and we need to be able to balance those, but we need some insurance provision at my level, which is the £4.6 billion of risk provision that we put in four years ago. Then we have risk held at the departmental level for overall strategic risk against programmes like nuclear, for example. We want a tiered level of risk. We do not want all of the risk embedded down at the project level, because we hand over all control, then, down to the project level. We would over-provision risk if we were housing it all at that level, because there is some portfolio effect.

Jon Thompson: This is an industry standard way of doing it. Some £10.1 billion is held at the project level, £4.6 billion at the programme level and £2 billion at the organisational level. Those numbers are largely on page 7 of the Report.

Bernard Gray: Overall, while the risk provision process and structuring is good, as far as consistency within the teams is concerned, I agree. What we have done over the last few years is go around and tackle specific problems within what we are doing, to make sure that we have controlled the programme. We are now in the process—through the transformation process we talked about—of trying to put in consistent best practice across the whole of the organisation. In a sense, the first thing to do was put out the fire and, inevitably, that meant going to where the fire was hottest first, rather than saying, “We’ll plan for the long term and ignore the fire.” We put out the fire.

I absolutely agree with you that there is not sufficient best practice across the organisation. That is why we put in the transformation process and hired the managed service providers to come in. They will put down a rule set for earned value management, a rule set for accruals and a rule for project risk provision that is mandatory across the organisation. We are strengthening the functions within DE&S—the commercial function, finance function and engineering function—to make sure that we have consistent good practice across the piece. That is the work of the next two to three years.

Q50 Chair: Okay. It comes out as well in the underspending, doesn’t it, if you look at figure 5 on page 19? We talked about underspending last year, and this year you have done better, because you have brought forward expenditure, so we welcome that. At least you have not sent money back to Treasury. On the other hand, if you look at those elements in figure 5, a lot of them are in your control and should be eliminated, in the best of all possible worlds.

Bernard Gray: If I may, just looking at the top one first, there are two major issues in there: specific accruals, in one case around the Eurofighter Typhoon, which has been built up over a long period of time, which the finance department regularised and cleaned out and then released. The second one, for A400M, would have been applied in the wrong year, so was reversed out of this year and applied to 2011. Three quarters of Item 1—£550 million of the £680 million—applies to our finance department cleaning up our balance sheet.

They are not real world issues—they are us improving the quality of our management information—but your general point that our project teams tend to be over-optimistic about how fast they are going to make progress and call for too much cash in any one year is true. That is part of our improving of estimating across the piece, which is part of the improvement programme.

We had set against that at DE&S level and the departmental level an offset, which has been pretty accurate for the last two years, about how much we think they are over-estimating—how much too much they are calling for. We have offset with additional activity that meant we are broadly speaking square on cash but, yes, absolutely, I would like us to be more accurate at the individual project level.

Chair: Before we move on to GoCo I have got one final issue—I do not know about other Members—about the £8 billion. In my understanding, you have only committed a tiny bit of that, haven't you—under £400 million? Is that right?

Witnesses: Yes.

Q51 Chair: Go on, take me through your thinking. What is happening to that? What one worries is if the confidence you have expressed this afternoon does not become a reality you will eat into the £8 billion, and then there will be less to respond to emerging and new challenges.

Air Marshal Sir Stephen Hillier: The £8 billion is unallocated head room. In other words, we are still holding on to it in head office, but we have asked each of the front-line commands to bid in the projects that they would need in order to achieve Future Force 2020. Again, on that base line we have done a provisional allocation by each of the commands, so they are planning into that space, although we have not actually allocated them the money at the moment.

The key thing is that the £8 billion is essential to the achievement of Future Force 2020 as it is currently defined, so if that money was not available to us, as Mr Thompson said, we would need to have a discussion about our level of ambition. We have a plan for it, which each of the front-line commands have got. As you say, we will release that money when we need to and when it is clear that it is affordable in our plans. The £400 million you have seen has been part of that process. At this stage we do not need to formally release any more of that, simply because the projects are at that stage of their cycle, and most of that £8 billion is towards the latter part of the planning period.

Q52 Chair: Okay, but if you lost some of that on overspending elsewhere, without the savings being achieved or costs going up more than are currently anticipated, you would be in trouble.

Air Marshal Sir Stephen Hillier: There would certainly be a capability impact, but clearly we have also got other layers of protection in the budget. We have got the EP contingency of £4.5 billion and at the departmental level our unallocated provision as well. We would hope that if there were cost increases in programmes which are in the core equipment programme, that is what the EP contingency is for in the first instance. Only after that would you have to start looking at the £8 billion, and, as I say, there would then be a capability impact.

Chair: Okay. I was going to go on to GoCo. Do you want to make a start on that?

Q53 Mr Burrowes: The Report mentions in paragraph 13 that “the Department gained a better insight into its business needs within the context of an affordable equipment programme” following GoCo being halted.

Bernard Gray: Are you looking at “Reforming defence acquisition”?

Mr Burrowes: Yes. Reference is made to having learned the lessons. Just taking you back to why in the first place GoCo was recommended, and the root causes of underperformance, I just want to see how much things have improved since the stage of where we were when the recommendations were made. Perhaps you can tell me whether the lesson has been learned. Root cause 1 of underperformance in terms of the case that was made for GoCo in the first place was this overheated equipment programme—this conspiracy of optimism, the equipment programme being overheated, delays, deferrals, and obviously a drain on manpower. We have touched on this area, but how confident are you that that lesson has been learned and we no longer will have such an overheated equipment programme?

Jon Thompson: Okay. So you are looking at paragraph 6, I think, on page 6. Bernard's original independent report before he joined the Ministry of Defence: three systemic issues. Overheated programmes is definitely a corporate issue, and that is where we are publishing a report and there is a comment on it. The second one is the interface between DE&S and its various customers.

Q54 Mr Burrowes: It's the language of it.

Jon Thompson: And that's all of us.

Q55 Mr Burrowes: I'll come to two and three, but I want to deal with one first.

Jon Thompson: When Bernard did his original report in 2009, we were, famously, in what Liam Fox described as a £38 billion black hole.

Q56 Mr Burrowes: I am happy not to do a history lesson—I just want to know where we are now. We have all said we have learned lessons and we have a better insight into business needs. Given where we are right now, can we confidently say we no longer have an overheated equipment programme?

Jon Thompson: I am confident to reconfirm what the Defence Secretary said—that we had balanced the budget. We have kept the budget stable—

Q57 Mr Burrowes: I didn't ask about the balanced budget.

Jon Thompson: I know you didn't, but I am trying to answer your question. Do I think the budget is overheated? No. Do I think it is in reasonable shape and balanced? Yes. It has some risks, as has just been pulled out by the Chairman and in other questions, but the equipment plan is in a good place, and we are in a much better place than we were in 2010.

Air Marshal Sir Stephen Hillier: From my perspective, I saw both sides of the divide. In the period up to 2011 and 2012, most of my time, and most of the time of my staff, was spent managing

delays and deferrals. It was always just about how you could squeeze the programmes within the budget line. Generally, you did it for a short period, and then things expanded out. Through what we did from SDSR, through the three-month exercise, and into planning round 12, we reduced our requirement to a level we knew would be deliverable, with appropriate levels of contingency.

The success of that process means that, since 2012, as far as I can recall, there has been no major exercise to delay and defer projects as a result of budgetary constraints. Inevitably, technical issues come up in projects, and you have to deal with them, but I have not spent my time saying to Bernard, “How can we slow down spend to stay within the budget?” That has given us a balanced, stable and affordable programme, and that has been compelling, not just for the front-line commands, which can plan with confidence, but for industry as well, and we have been able to say to industry, “We have a stable and affordable programme.”

That stability has stayed right through the period covered by this Report to where we are today. It has been a really powerful process, and a way for Bernard to comment. I don’t think, as a customer, that we are creating any volatility in the equipment programme. The focus is on delivering that equipment programme.

Q58 Mr Burrowes: Six years on, what would your analysis be?

Bernard Gray: I agree with what everybody has said. Although they will not say it themselves, the three people sitting to my right are largely responsible for this. Not only is the requirement stable in terms of the money, but we have not changed our mind about the type of thing we want. Changing the specification, and changing the requirement within that, used to be a hobby. The discipline that Steve and David have imposed on a day-to-day working level, and that Jon has overseen in the Department, has been crucial to us being able to get on with our work. We have today a stable, deliverable programme which is within the risk bounds we talked about earlier.

Q59 Chair: Could I just ask one question? On the joint strike aircraft, for example, you may not, thank God, have changed the specification, but have you changed the number you are going for?

Bernard Gray: No

Q60 Chair: You have not even changed that. You have not used that flexibility on the number. That’s great.

Jon Thompson: Do you remember that I famously said that, since April 2011, we have not done any of those things, like shift the aircraft carrier to save cash in the short term?

Q61 Mr Burrowes: In terms of dealing with the position we are in now, the suggestion was that, between the military and the civilian side, there was an inability to express and maintain an independent position. Everyone was saying, “Yes, yes,” without fully understanding the consequences. Has there been a shift in what was the root cause of these things—this unstable interface between the requester and the deliverer? Has there been a change from when we got GoCo to now?

Air Marshal Sir Stephen Hillier: I am not commenting on the DE&S operating model part of that, but from the customer perspective, there has been a fundamental shift. First, it’s realism—it is fine to have aspiration, but we must be realistic about what is affordable and deliverable. The other thing that has contributed significantly is the move to the delegated operating model, where we are giving the single services—which are ultimately the demanders of these capabilities—the budget and the responsibility. That has changed the culture and the behaviours in a very positive way. I think that the delegated operating model has been a key part of getting those disciplines into the process.

Q62 Mr Burrowes: In terms of the benefits that came out of the business case that was made, do you feel that you have enough human resource freedom?

Bernard Gray: That is my end, probably. Just one additional point on stability, one of the arguments in favour of GoCo was that it would then have locked down that set of arrangements that we have just spent five or 10 minutes talking about into a contract. The situation that we are in at the moment does not have that contractual underpinning; it is between one part of Government and another, so it is dependent on that good discipline continuing to be exercised. I absolutely agree with Steve that the front-line commands having a delegated budget encourages them to do that, but the central Department will need to be continually watchful to ensure that discipline is maintained. If there is not the discipline of a contract, it will take the discipline of the Department’s leadership to continue to keep things on track. That is important to recognise going forward—it is not self-policing in that sense.

As for DE&S freedoms, we have significantly more freedom to manage our affairs—we might talk about that in a bit more depth in a minute—but it is not as much freedom as if it had been contractualised, although significantly better than it was previously.

Q63 Chair: What does that mean? Go on, explain a bit, because the freedom appears to me to be the main change that you have got. I cannot think what else you have got, but your freedom on conditions and salaries is the main one you gained.

Bernard Gray: We are still part of the civil service and we still operate according to civil service recruitment patterns within certain bounds. We operate with—

Q64 Chair: What does that mean? Do you mean your processes?

Bernard Gray: Some of the processes and some of the salary bands, for example—we do not have as much flexibility as if the organisation had been contractualised, but we have significantly more freedom than the mainstream civil service.

Q65 Chair: Sorry, I am really trying to get a handle on it. How many people have you been able to recruit at the salary levels that you wanted in order to fill those jobs and that might have been a bit higher than existing civil service levels? How many? Give us a feel for it.

Bernard Gray: We have recruited about 750 people in the past 12 months—some of that is managing voluntary outflow, so that is a net situation, and it has not gone up by 750—but I can give you two examples of areas where we have changed pay policy. The first is in relation to airworthiness, where we are required to have engineers who can legally certify that an aircraft is safe to fly. They have to be able to sign those forms submitted to the Military Aviation Authority that say, “Yes, the Typhoon remains safe to fly.” We have been short of about 100 people in that area for several years.

About six months ago we put in place allowances, because one of the things that we have to manage is that we want to pay people to do that speciality, rather than having that money bleed into a general pool. We have set up a set of allowances for people doing those tasks, both the people doing the tasks today as well as new recruits, in order to fill that gap. We have started to make progress, having tried and failed to fill the gap of about 100 over the previous three years.

Q66 Mr Burrowes: What have you changed in terms of increasing the higher market value of those specialist areas of project management, commercial financial expertise or technical expertise? Give us an example of where you have increased the value to make it more of a market.

Bernard Gray: I will have to write to you with the exact terms, because I cannot quite remember as I sit here. Broadly speaking, in the example that I have just given, which is about a specific type of engineer, we have allowances worth about 20% of salary. We did a similar thing in nuclear engineering a little earlier, and now one of the exercises that we are doing as part of the managed service provider provision is to benchmark all our skills. At the moment, if you are at a particular civil service level—middle management level such as C2—you are paid the same, whatever job you do, whether you are in administration or you are a nuclear engineer. Those jobs command very different salaries in the private sector, and we are benchmarking our salaries against the private sector. That is going on right now. We are competitive in employing administrators, but we are significantly not competitive in employing various classes of engineer. We have tackled some of the hot spots in nuclear and in air-worthiness, where we have real operational problems today, and we are now systematically trying to benchmark our salaries at the right levels. Over the next 12 months we will adjust that for the generality to make sure that we remain competitive.

Q67 Mr Burrowes: Do you really think that you have the room for manoeuvre in the spending envelope to be able to recruit the expertise that is needed given that £33 million was lost on the GoCo experiment?

Bernard Gray: Well, £33 million was not lost on the GoCo experiment, but we can come back to that. As your Report says, we spend over £450 million a year on third parties—getting people to come in and do work for us. Occasionally that is because there is a particular specialist skill that it is not worth our keeping in-house but is worth our hiring from time to time. But a significant component is the fact that successive Governments held down the number of people we could employ so we could not have the people on our payroll, and we needed to do the work so we effectively hired contractors to do it. The new arrangement brackets together all of that third-party spend and the spend on all our people on staff, allowing us to push down the amount that we spend on third parties and recruit people on to our staff at the right skill level.

We spend about £550 million on civilian staff and £450 million on contractors, and we think that is the wrong balance. That is why we are trying to push down the amount spent on contractors, and why we think that we can afford to recruit people inside a total cost envelope that is falling.

Q68 Chair: I am delighted. It is quite interesting because it sounds to me as though these are not high but middle-tier salaries. These are not people who are paid more than the Prime Minister.

Bernard Gray: No, the majority of our problem is not at that level. It is true that the more specialist and the more senior you get, the more out of whack we are, but the vast majority of what we are talking about are people who are paid—in the current circumstances I hesitate to get too far into this—reasonable professional salaries, not super high-end ones, but we have been unable to keep in the medium term people in finance and engineering and our commercial negotiators.

Mr Burrowes: Hopefully they are paid more than MPs.

Q69 Chair: Just to get to the bottom of this, because we hear this from a lot of Departments, you are spending half a billion pounds on contractors, and your ambition is to pull that down to what by when?

Bernard Gray: We are still in the middle of the work. We have got in the managed service providers and they are due to deliver their plan in June, working with us. At that point we will have a much better feel for how many jobs we can sensibly pull in, where we can put skills and how much we can reduce that third-party spend. At the moment I have a commitment to Jon and the rest of the Department to pull down the cost of running DE&S in total, and the biggest single target for that is third-party spend because, as you say, it is more expensive than in-house staff, but until we got the freedoms we could not do it.

Jon Thompson: It is worth adding that we put a departmental boundary around this and created a separate organisation. Bernard is the accounting officer for those costs. He will have to produce his own accounts which will be audited by the NAO.

Q70 Chair: The £1.3 billion is your responsibility, and you have to bring it down to £1.2 billion.

Bernard Gray: That is correct.

Q71 Chair: Have you brought it down at all?

Mr Burrowes: I think the Report said by £9 million.

Bernard Gray: The Report is for the year that ended almost 12 months ago, when we had not started on that change.

Q72 Chair: So have you brought it down?

Bernard Gray: We are on track to deliver the £1.3 billion this year. We are not quite at the year end. I expect to be inside my budget.

Q73 Stephen Phillips: As far as this piece of work goes, who is conducting it? Have outside consultants been brought in to see how many outside contractors you can get rid of?

Bernard Gray: Well, there is a mixture of us and two serious programme management firms, and an HR firm, and we are managing several hundred—

Q74 Stephen Phillips: The answer to my question is in part yes, isn't it, Mr Gray?

Bernard Gray: In part, yes, but we are taking a strategic view to drive down the total cost.

Q75 Stephen Phillips: Who are the three firms—the outside contractors—that you have identified?

Bernard Gray: Bechtel, CH2M Hill, and PwC.

Q76 Stephen Phillips: How much are you spending with them?

Bernard Gray: Over the three years, from memory, about £250 million.

Q77 Stephen Phillips: £250 million to result in a saving of how much to your 1.3 million staff and contractor budget?

Bernard Gray: We have to live inside of the total cap, so all of that has to come out of the money that we have been allocated. There is no extra money.

Q78 Stephen Phillips: Sorry, you are answering a different question from the one I asked. £250 million to save how much?

Jon Thompson: It is £400 million to £450 million over the three years.

Q79 Stephen Phillips: So £400 million to £450 million a year is what will be saved.

Jon Thompson: I did not say a year.

Q80 Stephen Phillips: I am looking for the annual savings in the DE&S staff and contractor budget that will be generated by spending—

Bernard Gray: It builds up—

Q81 Stephen Phillips: Shall I finish my question? I am looking for the annual savings that will be generated by spending £250 million with three outside consultants.

Bernard Gray: It builds up to an exit run rate of around £250 million a year.

Q82 Chair: I will tell you the worrying thing. These are the three that were in at the end on the GoCo. This was the consortium.

Bernard Gray: Two of them.

Chair: No? I thought they were.

Q83 Stephen Phillips: What about the £33 million, Mr Gray? You said you wanted to come back, and you said it was not wasted. I am interested in that.

Q84 Chair: We will come back to that. Let me deal with this £250 million and the contract. I had thought that the contract was won by the guys who had got through on the GoCo. The concern would then be that the inside knowledge of getting involved in a GoCo development helped them gain that contract. Did you run a fair competition?

Bernard Gray: So, the short answer to that question is yes. In order to avoid that concern, we engaged very heavily in the first half of last year with six or seven potential providers, six of whom I believe bid, and we found no objection in the running of that competition, or in the outcome of that competition, from the people who were not successful. We engaged in a very heavy market dialogue to make sure that nobody had any unfair advantage. Indeed, nobody felt that an unfair advantage was being given to others. Nobody complained about it in any way, shape or form, formally or informally, so we believe that we successfully mitigated that problem.

Q85 Chair: It just looks a bit odd. They have a contract now for three and a half years, and if you go out again a year before the end of that contract, they will have all the experience, so it will be much easier for them to regain that contract.

Bernard Gray: We would assume that at the end of that period we would have significantly less requirement for them, because what we are doing is trying to embed the kind of processes that you were talking about across the piece to get consistent earned-value management, consistent accruals accounting and so on and so forth through the organisation, so that we do not need to depend on third parties.

Q86 Stephen Phillips: Mr Gray, you may not be able to answer this off the top of your head, but this Committee has become concerned that another part of PwC, no doubt, has been helping its corporate clients in the private sector aggressively to avoid the taxes that they ought to be paying to the Exchequer in this country. How much is PwC being paid by DE&S on the contract looking at reducing the cost of your outside consultants?

Bernard Gray: I think I have it somewhere, but I might need to look it up.

Q87 Stephen Phillips: That is fine. Perhaps you could write and let us know how much PwC is being paid.

Q88 Chair: I think you have a figure there.

Jon Thompson: We do. I just do not remember it.

Stephen Phillips: If you could come back to us by the end of the hearing, that would be very helpful.

Jon Thompson: I can come back to Mr Phillips's original question, if you like, about the baseline of cost in DE&S and how it goes down, the more it consumes.

Stephen Phillips: That would also be helpful. Thanks, Mr Thompson.

Chair: It would be quite nice to get that if I can. They have got a figure floating around there on PwC—

Q89 Stephen Phillips: Why doesn't Mr Thompson answer that while Mr Gray has a look?

Jon Thompson: So, in '14-'15, the cost of running DE&S was £1,290 million. The agreement that we reached with the Treasury was that by '17-'18 that would reduce to £1,079 million. I have got the profile here and if you add it all up it is £392 million in net gain to the Exchequer over the four years after you have taken into account the cost of the three managed service providers.

Q90 Stephen Phillips: Did you look at whether you had the expertise in-house to see whether these costs could be reduced without having to pay £250 million to outside consultants, or did you simply let a contract, saying, "Here you go—here is some free money. We know that you will reduce our costs. It will all get swallowed up, so take the £250 million"? It is very odd to those of us who sit on this Committee. Why don't you just look at how to reduce your costs in-house without going to outside consultants?

Bernard Gray: The answer to your first question is £43 million. In answer to the second question, I think we have comprehensively proved over some decades that we do not have the skills in-house.

Q91 Chair: What is odd about the contract, according to the Report, is that you bring in consultants because you do not have the skills in-house, but you do not link the contract to milestones or metrics. According to the Report on page 20, paragraph 2.8, you have not agreed a baseline or the metrics. That seems not a very sensible way of proceeding.

Bernard Gray: To be clear, a complete statement of what we have done is that we have set out milestones and deliverables for the first six months that they are here. So from November to the end of May³ they have milestone deliverables that they have to come in to us, which include, for example, the plan that I have described for how we are going to roll the thing out over the next three years. The issue then is: what milestones do we set down for the implementation phase of the plan? Until we have the plan written down, it does not seem sensible to us to write down what the implementation milestones are.

³ Note from the Ministry of Defence: Mr Gray meant "from November to the end of June"

Q92 Chair: What levers do you have over them to ensure that they agree—

Bernard Gray: We can terminate the contract.

Q93 Chair: If you cannot agree the milestones, you terminate the contract without any detriment to us, the taxpayer?

Bernard Gray: There would be some relatively small exit costs, but yes, we can terminate the contract if we do not like the terms.

Q94 Mr Bacon: Mr Gray, do you think that you should have these skills in-house? Let's leave aside for one moment the question of pay, because if, as you say, it has been problem for several decades, there must be reasons for that and I assume one of them is pay. Do you think that these are core skills that you should have in-house because of the nature of your business, or are they the sorts of skills that you would only be likely to need sufficiently sporadically that it is better to buy them in from time to time? I have my prejudice on what the answer to that is, but I would like to hear your answer.

Bernard Gray: The broad answer to your question is: yes, we should have them in-house. But there are two glosses that I would offer to that. One is that we have probably a small number of more highly qualified people coming in from the MSPs now in order to set the thing up correctly in the first place than might be required to run it in a steady state.

The second issue, which we touched on earlier, is some particular skills. I will give you an example: we do not design enough ships to have a whole ship architects' department fully in-house. We only design a Type 26 every couple of decades or something like that, so we are always going to want to go out to the marketplace to firms like BMT to hire some specific skills for jobs that we do infrequently. There will always be some of that, but broadly speaking the kind of skills that we are talking about here are ones that we should have in-house.

Q95 Mr Bacon: So am I right in supposing that the key reason for not having them in-house is pay levels?

Bernard Gray: Pay, overall working conditions, career prospects.

Q96 Mr Bacon: You have told us in the past about your efforts to reshape and revamp the pay structure to give you more flexibility. Does that revamping give you sufficient flexibility to solve this problem fully?

Bernard Gray: I don't know.

Q97 Mr Bacon: If it has been going on for several decades, then plainly there is an endemic or systemic problem and one might hope that it might require or get a systemic solution and that a big component of that would be pay and the other things, such as the working conditions you mentioned, career prospects and so on. What I am really after is the extent to which this reset that you negotiated with the Treasury has given you sufficient flexibility—you are saying that you don't know.

Chair: Expand on the “don't know”.

Bernard Gray: Only because we haven't done it yet. Our focus is on generating a match-fit, world-class procurement organisation by 2017. That is our objective. We have not yet started down that campaign plan. I am hopeful that we have enough freedom—I mentioned the £450 million and our ability to vary the circumstances—to be able to achieve that end. All of our effort is bent on it, but until I have delivered it I tend not to declare victory. I was reasonably equivocal about the state of the equipment plan until we had worked on it for three or four years; now I can say with some certainty things that I could not say three or four years ago. That is a credible position to adopt. I am putting forward all great efforts to ensure that we get to the position that you describe. Today we believe we can deliver that plan, but we have not yet done it.

Q98 Chair: Jon Thompson? Anyone can come back on PwC, then I will go to David.

Jon Thompson: As a member of the DE&S board, I think the view is that we have done the right tactical issues at the minute to address particular skills. Bernard gave you some examples of that. The May DE&S board should get an overall strategy from PwC that will much more fundamentally address the pay and grading skills issue. At that point we want to try and promote, subject to various consultations, a more systemic approach. We have done some tactical moves to strategic.

Q99 Chair: Sorry, I didn't get that—PwC's contract is £43 million, is that right?

Bernard Gray: That's correct.

Chair: A lot of money.

Amyas Morse: Shut me up if this is the wrong time, please, Chair. Just going back to what you were saying earlier on, that you were relying on contract to lock this into place, by putting contracts outside the organisation—

Bernard Gray: If we had done a GoCo.

Amyas Morse: If you had done a GoCo, exactly, and you haven't. So what event would place great strain on these arrangements? Supposing, for example, it was decided to increase defence

programme spending, because external events caused you to think that you needed to, or whatever, what would you visualise as putting at risk this approach that you have developed? I am sorry; this is just to enable me to be clear in my mind about things. You have got it in agreement, but what you have been doing for the past few years is controlling, and largely cutting back on, expenditure, so it has been a very strong lesson—if you do not stick to and deliver on plan, you will not get good gear, so you had better be controlling. But if you started worrying—are you worried about that? How would you keep to things? I am responding to what you told us.

Bernard Gray: The worry would be that people—not us, because I think we have a demonstrated track record of not being like that—chose to be over-optimistic. They might not have looked at the medium term. It used to be the case that the Department only looked four years ahead, but we now firmly programme for 10, for example. We used to see a bulge of planned expenditure outside of the fourth year, but we now have much better control of that. So if people were too optimistic, or they accidentally or deliberately underestimated what a project was going to cost, those kinds of behaviours, if they were not properly policed, caught and contained, would represent a threat to the programme. The point about the contract was that if people were on the other end of a contract that caused them financial pain, then they would be very careful about what they allowed.

Jon Thompson: It is possible to switch to a trading model if you have the necessary baseline. If you knew what all the stuff did—that is one of the reasons for going down the time-recording route—logically you could switch into a trading model, in which you gave the budget to the customers and if they wanted more work, under your hypothetical example, they would have to pay more for the services delivered.

Q100 Mr Burrowes: You baulked at my suggestion that the £33 million spent on GoCo was lost. Will you respond to that point?

Bernard Gray: About £7.5 million was spent on the GoCo competition itself. We spent that in pursuit of answers which would have contractually locked in savings worth billions—literally. We received one bid which would have saved multiple billions of pounds. We had another bid which was ready to be submitted, but which one of the three members of the consortium decided not to proceed with at the last minute, which also could have saved billions of pounds. So, as far as the GoCo competition is concerned, I am happy that we spent £7.5 million attempting to save the Government, and therefore the taxpayer, billions. Going to the market and seeing whether we could deliver that was a good use of public money.

The rest of the money has been spent on setting up the process that we have just spent 10 or 15 minutes talking about: getting us into a position where we can deliver the kind of solution we are talking about inside the Government over a period of three years.

Q101 Mr Burrowes: So, are you saying that all the remaining amount would have been necessary to achieve the materiel strategy outcomes of greater human resource freedoms, enhanced processes, improved system and tools, and a more robust customer interface?

Bernard Gray: Understanding in detail how we make all those things work has been the majority of our work over the last three years.

Q102 Mr Burrowes: And you don't think that would have been achieved quicker without going through the GoCo process?

Bernard Gray: I don't know, but I think that trying to save the Government and the taxpayer several billion pounds was an objective worth pursuing.

Q103 Mr Burrowes: Of course—I would be concerned if we did not have that objective, even without the GoCo process.

Bernard Gray: But the GoCo process would have been a way of delivering that. We tried to save the taxpayer significantly more money. In the end, it proved not to be deliverable, but I absolutely think we did the right thing by the taxpayer by trying.

Q104 Mr Burrowes: Would any amount involved in going through the GoCo process have been saved by not doing so?

Bernard Gray: If we had not gone down that road, the £7.5 million we spent on the bid would have been saved.

Q105 Mr Burrowes: Finally, you have made the case that that was money well spent, because it made some great deliverable savings. Is there any amount that can't be attributed to deliverable savings that would not have been spent if we had not gone down this route?

Bernard Gray: The £7.5 million did not lead directly to savings, because we were not able to execute a GoCo contract. As to the £24 million that we have spent elsewhere, is it possible to formulate a different way of doing things with the benefit of hindsight? Maybe. I don't know.

Q106 Chair: Just out of interest, how much of the £33 million was spent with consultants?

Bernard Gray: It depends how you count lawyers. They are expensive, but are they consultants?

Lee Summerfield: The split is in paragraph 1.19 on page 16. Some £25 million of the £33 million went on contractors.

Bernard Gray: Contractors includes lawyers?

Lee Summerfield: Yes, it absolutely does.

Q107 Chair: What surprises me is why you suddenly changed your mind—I couldn't quite work out why. I do not want to be overly critical, because the Committee is all for trying to have innovation, but what suddenly led to a change of mind?

Jon Thompson: We pre-agreed with the Defence Secretary that if the competition narrowed to only one initial bid, our joint recommendation would be to stop the competition, because that seemed the prudent thing to do. That is the situation we reached. The bid, we should be clear, was an interim bid—it was not detailed. It would not have been the end of what would have been a planned process that would have involved other stages. We thought the prudent thing to do was to say, "You have a competition in which the market can produce only one result, and we don't think it is prudent to proceed."

Chair: The others fell out—

Q108 Stephen Phillips: One of the consortia fell out because it was bidding for another Government contract. Is that right?

Bernard Gray: If you are talking about the first one, I am not sure they were ever really in.

Q109 Stephen Phillips: You had three people bidding for this GoCo.

Bernard Gray: We had three people express interest at the beginning of that process. But the first of them was somewhat hesitant about whether they were going to participate at all, because of other issues. In my mind, we had two viable external bidders pretty well from the get-go. My personal opinion about the second bidder is based on a number of conversations I have had with people associated with this through the process and subsequently. There were three parties to the consortium—CH2M Hill, Serco and Atkins. They had a deal team, which prepared a bid that was ready to be submitted. Two days prior to the deadline for submission, it was reviewed by the three company chief executives. Two of those companies, Serco and Atkins, wished to proceed, as their bid team wished to proceed, and submit the bid. The chief executive of the third firm, CH2M Hill, didn't wish to proceed because their appetite for risk had declined substantially over the course of the previous few months. My personal belief is that that was because the company had sustained losses in other parts of its business and was unwilling to take the risk of taking on a GoCo contract, but I don't know that for a fact.

Although the deal team wanted to submit, although the bid was ready to be submitted and although two of the three parties wanted to submit, it was not submitted. We found out 24 hours before the bid was due to be submitted, when they came to see us. They had not raised any concern with either me or the commercial director of the Department in the preceding three or four months, despite the fact that we had a number of top-level meetings with them in the course of tracking the bid's progress.

As Jon said, Jon and I sat down with the Defence Secretary in September, when KBR and the team chose not to join the party, and we had a long conversation about what was a viable competition and what was not. The Cabinet Office did some work on that, and it concluded, based on US models and other things, that two was a viable competition in this kind of area, especially with an in-house alternative proposal available, so we decided to proceed on that basis with two viable bids. It was only with 24 hours to go that it dropped down to a situation where we would be negotiating against one party, which we felt was not an acceptable position.

Mr Bacon: What a pity you weren't running the letting for the rural broadband programme, too.

Q110 Chair: Could you go back to it? It is still on the statute book as a potential, isn't it?

Jon Thompson: A future Government would have that option. It is not currently our plan.

Q111 Chair: What you are going to get out of this trading effort, as far as I can see, is greater flexibility on salaries, but beyond that nothing else.

Bernard Gray: We have some flexibility to run the business in a different style.

Q112 Chair: What sort of things? Just explain that to us. It seems to me that wage flexibility is the major change, and it drives me slightly mad that you have to go down the trading company route to get that wage flexibility—looking at the Treasury. We can point to similar things in the Department for Transport, DECC or HMRC when running major capital programmes.

Bernard Gray: I can understand the Treasury's concern to control public sector pay generally.

Q113 Chair: I can understand their concern to get value for money.

Bernard Gray: It is hard when you have 6 million public sector workers, or some number like that, to make sure that public sector pay is controlled. I can understand that, at an individual level, those tools can look quite crude because you are applying it across a work force of 6 million, which is quite hard. I understand their problem.

As I described earlier, what we have is not just pay; it is our ability to mirror that market in how we develop people. We will have a cadre in engineering and a cadre in commercial where we can operate and develop those people in a different framework to that of the rest of the civil service. We do not have to apply the same grades, and we do not have to call things the same job. We can think about how we change people's careers not just in specific pay but in all of their development, which allows people to think about this as a significantly different organisation. That identification with our organisation, as opposed to just being in the generality of the civil service, will be important to them.

Jon Thompson: I was going to say—I have to get off the people point—that it also enables us to contractalise the interface between the customer and DE&S, so we can have support in place for what we call the command acquisition and support plans. So it can say, “We, DE&S, will provide you with these services, and these are the KPIs for those services, which you will be able to use to measure us against our performance.” You are stepping down a route where you could potentially contract that and trade the budget. If you switch the budget off, Bernard, to the customers and move to some sort of charging arrangement, the customer would have both the budget and a set of KPIs. The recommendations from our colleagues are that we continue down that route, and we would agree with those recommendations, which are on page 9, about continuing KPI sets. That takes you further steps towards trading. It would then be for another Government to say how radical you want to be with that trading, but it gives you the option.

Q114 Mr Burrowes: Rather than the trading, how much would it have cost to complete the DE&S+ option—to have completed the outstanding work so as to be in a position to make that viable? Did you come to any costing?

Jon Thompson: You mean in terms of spending public money? We don't think that there is very much that would have continued to have been spent, in that sense.

Q115 Mr Burrowes: I mean to complete the work—for that to have been the fall-back option after GoCo.

Bernard Gray: We have taken a lot of what was in it and implemented it. The question is what the boundary around us should be. We have spent a lot of time thinking about what that boundary should be. What we have has, mostly, the characteristics of a trading fund, but for various technical reasons we cannot be a trading fund, so we have taken most of the organisational design components and put them inside a specific entity that gives it a boundary for the Department. From a legal-control point of view, that gives it a shape that gives the Treasury confidence that we could exercise freedoms inside that boundary, and things will not leak out.

Q116 Chair: Where are you on Treasury approval? Is this case approved, or are you not at that stage yet?

Jon Thompson: The Chief Secretary signed all of this off in order for it to be stood up in April 2014.

Chair: The whole thing?

Jon Thompson: The whole thing.

Q117 Chair: A question to you, Mr Thompson: what would it look like, at the end—what would you want to see, ultimately? I know you might have devolved a bit of your accounting officer responsibility, but how would you measure its success?

Jon Thompson: We would measure its success by continued improvements in the delivery of the programme. Ultimately, we want military capability for the armed forces. We would expect—in fact, the DE&S board also expects—to be able to see improvement in the KPI set, most notably in relation to the equipment support plan. There has been a big focus in this Committee over the years on the equipment procurement plan. How do you then introduce that discipline all the way through the equipment support plan? We will definitely be looking for that. We need continued better financial forecasting, too. You want stability and to nail down some of the consistency issues.

We have been reasonably clear as an owner about what we want. A Minister chairs an owners council, so we are clear about what we are expecting. The corporate governance of DE&S has been significantly enhanced. There is a non-executive chair and four non-executives. They lead the implementation of a plan that we corporately agree with DE&S for their delivery.

Q118 Chair: Who is the non-executive chair?

Jon Thompson: Paul Skinner. We have also hired four independent non-executives. The board of DE&S is majority non-executive led. There are only two executives, Bernard and his finance director. Steve and I are on; I'm on as the owner, and Steve as the representative of the customers.

Q119 Chair: I was going to ask, Sir Stephen, what, as a customer, you would expect from them—how would you measure their success?

Air Marshal Sir Stephen Hillier: The customer would want to make sure that the plan was delivered to performance, cost and time. The customer would want to make sure that there was the right operating model and the right relationship between the front-line commands and the DE&S. The customer would want to see a model that was sufficiently flexible and agile, because circumstances change—our operational requirements change, our budgets change and we want the organisation to have the agility to respond to that. The customer would want those three things.

In general the customer looked at the bespoke trading entity and said, "If that is the best way to deliver those criteria, then we fully support it." What the customer wants to do as well is

make sure that we are the most intelligent customer to support the acquisition process, because unless you get the intelligent customer and the requirement setting correct, the rest of the system will not work as well as it should.

Q120 Chair: Mr Gray and Mr Williams, you are both part of this new organisation, aren't you?

David Williams: I am not.

Q121 Chair: But you are, Mr Gray. You have just signed a new contract with the Government, haven't you?

Bernard Gray: An extension of my existing contract, technically.

Q122 Stephen Phillips: You were supposed to retire, weren't you, but you've extended for 12 months?

Bernard Gray: I don't think I would have retired, but I was supposed to stop working here, yes.

Q123 Chair: Can we know the terms of that?

Bernard Gray: They are the same as the old terms.

Q124 Stephen Phillips: At £220,000 a year?

Bernard Gray: At £224,000, I think.

Q125 Chair: With a bonus potential of—?

Bernard Gray: I have been awarded a bonus of just under £50,000 for each of the last two years. That bonus potential has not changed.

Q126 Chair: And that will go forward at the same level, will it?

Bernard Gray: The bonus—

Q127 Chair: The other figures have been in the public domain, so I am trying to get the proper figures—

Bernard Gray: I am trying to answer. That bonus potential has not changed. It was not offered, and I did not seek to change my terms and conditions from what they are at the moment.

Q128 Stephen Phillips: Don't worry, Mr Gray. The opprobrium to be heaped on your shoulders is nowhere near what some of us have to put up with.

Mr Bacon: At least you get the money.

Q129 Stephen Phillips: Mr Thompson, given that Mr Gray was due to go to pastures greener around now, why did you renew with him rather than appointing someone as a replacement for a significant term?

Jon Thompson: The process of appointing a chief executive to lead Defence Equipment and Support is ongoing, but I would expect it to conclude, hopefully, this month. Ministers will then announce a chief executive to take over from Mr Gray at an appropriate time also to be agreed.

Q130 Stephen Phillips: But was it that you couldn't find anyone or that you were too late in advertising, or was it that Mr Gray needed to remain in post because of things that are going on? We knew he was going last month, but you have had to renew his contract for a year. Was it an error on the part of the Department, could you not find the right person or did Ministers not want to appoint someone this close to a general election? What is the reason?

Jon Thompson: To be transparent with you, we wanted to advertise the post in spring last year. Ministers held up approval for us advertising. It was finally advertised too late, in my opinion, to conclude before Mr Gray finished.

Q131 Chair: When was it advertised?

Jon Thompson: September.

Chair: Six months ago.

Q132 Stephen Phillips: At what salary has it been advertised?

Jon Thompson: It has been advertised at £250,000 basic, with a potential bonus of £250,000.

Q133 Stephen Phillips: That would clearly be the highest-paid civil servant within the MOD, yes?

Jon Thompson: Mr Gray is already the highest-paid civil servant, so—

Q134 Stephen Phillips: It is significantly more than you get as the permanent secretary.

Jon Thompson: Yes, I was tempted to apply, but—

Stephen Phillips: I am quite tempted to apply as well, Mr Thompson.

Q135 Chair: But you haven't applied?

Jon Thompson: Just so you are not surprised, I am not going to become the chief executive of DE&S.

Q136 Stephen Phillips: Are you excluding Members of Parliament from the terms and conditions for applying?

Jon Thompson: I believe it is a free market in which you can apply, but it is a bit late now.

Q137 Amyas Morse: On the protection this gives you, as you accumulate expertise and staff—I think I am right in saying that defence already has probably the largest number of commercial staff in government. As you start accumulating attractive other expertise, are you reasonably protected from people in the rest of government casting eyes on it? Supposing that somebody wanted to pinch some of your staff and have them distributed across government or more widely, are you reasonably proof against that sort of thing?

Bernard Gray: Clearly, anybody can hire an individual at any time. I think the Chief Secretary to the Treasury has given us approval to employ these people, in this organisation, on those terms. If any other organisation wanted to do something else, it would have to get its own approval.

Q138 Dame Anne McGuire: My first question is to Mr Thompson. In response to our last report, the Department states that it tests all proposals for feasibility and considers that the Army was suitably consulted on the proposed changes. That sits at odds with the evidence that General Sir Peter Wall gave when he said that they gave clear advice that they would be working to a figure of 94,000. If I remember correctly, I also identified that the then Chief of the General Staff's body language indicated that there was a slight difference of opinion. I am wondering why your response to that report did not take into account the then Chief of the General Staff's views and the evidence that you gave to the Committee.

Jon Thompson: Because General Wall is not the only general in the Ministry of Defence. You need to go back. You are talking about the Regulars, as opposed to the Reserves. It is the Department's view that the Army was appropriately involved and consulted. General Richards and General Houghton were involved in that. There were appropriate consultations with the Army. General Wall expressed to this Committee that he did not feel he was involved enough, but it is our view that the Army was involved in the decision to go from 94,000 to 82,000.

Q139 Mr Bacon: But not the head of the Army? He said—I remember because I was the one who asked him the question—that there was work going on, of which they were unaware. Since he was the Chief of the General Staff, otherwise known as the head of the Army, it is slightly surprising that he was not one of the people who were aware of this work going on.

Jon Thompson: It is slightly unfair for me to answer questions about what was going around General Wall's mind when he answered your questions.

Q140 Dame Anne McGuire: We are asking you, Mr Thompson, why the Department's response did not reflect the comments made by the then Chief of the General Staff—the head of the Army—at the evidence session.

Jon Thompson: It is my contention that the Army was involved in the development of other options lower than 94,000. Exactly what “consulted and involved” means in relation to General Wall is a matter for General Wall.

Q141 Mr Bacon: We are not asking you to read into General Sir Peter Wall's mind, but are you saying essentially that in your view, he was aware, or had every reason to be aware, or should have been aware, of the work of which he said he was unaware? Your view is basically that he should have been aware of it or was aware of it.

Jon Thompson: Yes.

Mr Bacon: Thank you.

Q142 Dame Anne McGuire: May I take you on to the current recruitment situation? We want to pursue some of the questions linked to the new recruitment procedure with Capita and how successful or not that has been. This might initially be a question for Sir Stephen.

This morning, we were perhaps shocked or embarrassed to find that the US Chief of Staff of the Army indicated that he is now concerned about UK defence cuts. He mentioned it in terms of the spending—the NATO 2%. I want to put that to one side. I want to talk about the capacity and capability issue with a strength in the Army that is now around 4,000 less than would have been anticipated at that time. What credence should we give to the head of the US forces in this respect?

I do not want to get into the 2% issue, because that is a slightly different area and maybe not one for this Committee at the moment.

Air Marshal Sir Stephen Hillier: I cannot comment directly on what the US Chief of Staff of the Army said; I just look at it from a UK perspective. We continue to have, in our planning, the ability to deploy up to a divisional level with sufficient warning notice on a more regular basis than we deploy up to fully formed brigade level on operations. We do so in a way that gives us a coherence and fully integrated force with some pretty exceptional capabilities.

I am confident, from what I see sitting at the centre of the Ministry of Defence, that the British Army remains a highly credible force that is able to work alongside the US army. The current Chief of the General Staff would have to talk about that in more detail, particularly under our delegated operating model. But it is as I described.

Q143 Dame Anne McGuire: Did it not cause a flurry of excitement this morning when you read the interview in the *Telegraph*? Forgive me if I am getting my terminology wrong. You said that “up to divisional level”, we would still be able to deploy alongside the United States as part of our NATO commitment. I think that General Odierno said he would anticipate only a brigade level, which is about 6,000.

Air Marshal Sir Stephen Hillier: It depends on the task, obviously, but there is a difference between what you would deploy and sustain on what we would call an enduring basis, so for years and years—for example, our commitment into Afghanistan—versus what we could deploy as a best effort, in other words in response to a major contingency operation. In those circumstances, we could employ up to divisional level, but we would not expect to be able to deploy a division and leave it there for ever. We need appropriate warning time, just as you need for any operation, to build up to that level.

Q144 Dame Anne McGuire: Right, so even with the current recruitment figures, which are, to say the least, disappointing in terms of Regular recruits?

Air Marshal Sir Stephen Hillier: I cannot comment directly on the recruiting, because it is not my specialist area, but the Army 2020 vision, as signed off by the Chief of the General Staff, includes that aspiration to deploy up to divisional level. That is against the manpower that we are currently assuming.

Q145 Dame Anne McGuire: Maybe I can come to Mr Thompson now. One of the conversations at the previous hearing was about when you start to react in terms of activating some contingency. Given the disappointing recruitment figures and the fact that even though I understand Capita would probably say they are throwing everything but the kitchen sink at recruitment just now, we are still so far down in terms of anticipated figures, when do you think you are going to look to your contingency plans about recruitment and retention?

Jon Thompson: On Regulars?

Dame Anne McGuire: The Army now has this confusing mix—well, not confusing but logical, according to your interpretation—of 87,000 plus 30,000, and I think we are down both on Regulars and on the Reserves.

Jon Thompson: On Reserves, the second quarter of the current year was the best quarter for recruitment that we have had, and the third quarter was an improvement on that. Year on year on Reserves, we are up 80%.

Q146 Dame Anne McGuire: What is that in real numbers?

Jon Thompson: In terms of the target that we were requested to meet at the end of the current year, the target was 19,900. The Army Reserve currently stands at 20,480, so we are actually slightly ahead of the trained strength. We are around the low 80s in terms of the number we wanted.⁴ In a sense, you could argue that we wanted to be slightly further on than we were with recruitment. You will recall that this was a matter of some debate, but quarter 2 was better than quarter 1, and quarter 3 was better than that, so we are heading in the right direction. The challenge is from 2015-16 onwards, because then the target further increases, as it were, in terms of the number you need to recruit. We are having a good period on Reserve recruitment. It is improving, but there is still a long way to go and there are still many risks. To come to your actual question—

Dame Anne McGuire: That was just a preamble, was it?

Jon Thompson: That was the preamble.

Chair: The good news.

Jon Thompson: It is worth getting in the numbers, isn't it? Quarter 2 and quarter 3 were good.

Q147 Dame Anne McGuire: Okay. That was your thinking time. Now give me the answer.

Jon Thompson: The Chief of the Defence Staff and I met the Chief of the General Staff last Thursday to talk about where we were with Regular manning. We are recruiting between 80% and 85% of the number that we would ideally like in the current year. The Chief of the General Staff, of course, has changed since General Wall. General Carter has already implemented some further changes to improve the recruiting. What we are now being given at the board level is both a trajectory, as it were, unadjusted and a trajectory adjusted for the changes that General Carter believes we need to make.

⁴ Note from the Ministry of Defence: Mr Thompson meant “low 80s in terms of the percentage”

Q148 Chair: Can I just go underneath that figure a bit? I read something in *The Times* that said that you were only at 66% of your target on Regulars. When you say you are at 80% to 85%, put that into Anne's real numbers as to where you want to be and the actual number of Regulars you have in the Army.

Jon Thompson: I haven't got those numbers available to me right now. I am very happy to write to you with all the detail that you wish. The Defence Board gets monthly information about the numbers leaving the armed forces and the numbers joining, why they are leaving, and whether it is Regulars or Reserves joining and so on. We went through it on Friday, but off the top of my head I cannot put it in absolute numbers.

Q149 Chair: So 60% of strength could be right, even if you are at 85% of recruitment?

Jon Thompson: No, not of strength. In terms of strength, for the Army, we will be at around 96% at the minute—sorry, I was expecting you to ask me some questions about your recommendations, but not to get right into the detail of the numbers, otherwise I would have brought a briefing note with me to give you all the numbers.

Q150 Dame Anne McGuire: Except the detail does link back to the evidence that we received in the previous hearing.

Jon Thompson: Yes, but—I am sorry; I was expecting to have a conversation about the equipment performance review acquisition support side, and not to get into the absolute detail.

Q151 Chair: One of the things we now try and do regularly—it is part of our implementation—is always to pick up recommendations from previous Reports.

Jon Thompson: Sure, and I am happy to talk about the recommendations, but I am being asked a series of very detailed questions about the exact numbers as at last Friday, and I do not have them available to me right now.

Q152 Dame Anne McGuire: Right, fine. Can you advise the Committee whether the refocus that you mentioned, which the Chief of the General Staff—the head of the Army—is looking at, is linked in to the Capita contract? Is it about adjusting their targets, their methodology and their relationship with the Army? Could you just give us a step for a hint?

Jon Thompson: Sure. We are underwhelmed—I think that is the best way of putting it—with Capita's response. I think it is fair to say that the witness that you saw here was quite forward-leaning and assertive about what was happening, but I think their performance has been rather mixed. There are definitely some things that they are doing rather well; they are clearly committed

and are putting people on it. They have helped us with the diagnosis of what we can change and they have streamlined the processes, but in terms of the famous IT system that you debated, we still are working with the interim fix. The long-term fix that has been proposed to us is, in my opinion, unacceptable. The Chief of the General Staff—General Carter—and I are heading towards a meeting with the group chief executive of Capita to make it clear that it is—

Q153 Chair: Unacceptable because it doesn't work.

Jon Thompson: Well, it would work, but I do not see why I should have to pay the sum that is proposed, frankly.

Sir Amyas Morse: Does it involve replacing the IT system with something else?

Jon Thompson: Yes. As I said, there is an interim fix that works, but it is not a long-term solution. What we need is a proposition from them that says, "This is a fix, long term," and the proposition we have at the minute is not acceptable. It went through the investment approval committee with my friend to the right. It is not acceptable, so we are heading towards a meeting with the CEO of Capita to make it clear that the taxpayer does not feel well served in this particular regard.

Q154 Stephen Phillips: Can I say how refreshing it is, Mr Thompson, actually to have a permanent secretary turn up and say that about an outside consultant?

Mr Bacon: Mr Thompson started at Norfolk County Council finance department, so while it is refreshing, it is hardly surprising.

Dame Anne McGuire: Everything goes back to Norfolk.

Jon Thompson: I brought my Norwich City club tie especially for you.

Q155 Stephen Phillips: In the context of the shortfall in recruitment for the Regular Army, may I ask where that shortfall lies at present? Is it in the infantry, the cavalry or the mechanised Army? Where is it?

Jon Thompson: I would prefer to give you a written answer, but we do have a look at the operational pinch points. It is in specific higher-value trades, so it will be engineering, logistics, information management and so on. At the Defence Board each month, we track those operational pinch points where there are significant shortfalls, which then flows into the annual report—but again, I can write to you.

Q156 Stephen Phillips: That would be helpful. In terms of the Reserve recruitment arguments, it is very good news that you are ahead of where you should be, but the trained strength of the Reserves was only supposed to rise from 18,800 to 19,900. Then we have some really big jumps coming up. Next year is another easy year—you only have to go up 1,000—but then you have to shoot up 2,700 and then 4,000-odd, and then another 4,000-odd. There is a big task ahead of you and I wonder, because you will no doubt be back, Mr Thompson—even though Dame Anne will regrettably not be here—how confident you are that these targets are going to be met.

Jon Thompson: I think in my answer to the Chair, I was clear that it does indeed step away from us. If you want me to give you my view, I think we will meet the 2016 target, but beyond that, clearly, we need to ramp up significantly.

Q157 Stephen Phillips: Which is another way of saying that actually, you are not very confident at all that you can meet the 2017-18 and 2018-19 targets. As you sit here today, it is perfectly acceptable for the permanent secretary to say, “Actually, it is going to be very difficult.”

Jon Thompson: It is going to be very difficult. It involves many risks and a significant amount of work by the Army and various others, so I am hedging my bets.

Q158 Stephen Phillips: I want to come back to something that Dame Anne was asking Sir Stephen about: the story in this morning’s *Telegraph* and the concerns expressed by the US Chief of Staff. What is the Department’s view on two things: first, where we are currently in terms of whether the Army is capable of fighting credibly alongside the United States in deployments, particularly overseas; secondly, what would happen if there was a reduction in the amount spent below 2%?

Jon Thompson: I think that, if the current Chief of the General Staff was here, he would assure you that the Army can do what it is asked to be ready to do, in accordance with the strategies set in 2010. I think that that answers your first question. In relation to your second question about 2% of GDP, clearly we would like 2% of GDP, but that is for the next Government to decide.

Q159 Stephen Phillips: But I am asking whether you think that a capability gap would open up if we did not comply with the NATO commitment of 2% of GDP. Is that the view inside the Department?

Jon Thompson: 2% of GDP is actually slightly more than what we currently plan for, so it would not open up a gap. We would have slightly more spending power in the latter years of the next Parliament.

Q160 Stephen Phillips: Let us put it in concrete terms: if there are significant cuts in the percentage of GDP spent on defence by the next Government, after May, would you agree that that would inevitably affect the ability of the United Kingdom and its Army to fight effectively alongside its allies, particularly the United States?

Jon Thompson: No, not necessarily. It rather depends on how deep the cut is and how much further financial efficiency we can drive. If it was more than the level of financial efficiency that we can drive then, yes, that would affect capability.

Q161 Stephen Phillips: In terms of the percentage of GDP, what is the financial efficiency that you think you can drive?

Jon Thompson: We are currently doing the work to advise the next set of Ministers on what kind of financial efficiencies they might be able to get.

Q162 Stephen Phillips: Are we looking 0.01% or 0.05%? It is clearly not 1%. What about 0.5%? What ballpark are we in, Mr Thompson?

Jon Thompson: If I could generate 1% of GDP, I think I would be in a different job!

Chair: I want to get back to something he said—

Q163 Stephen Phillips: Let's just have an answer to this question.

Chair: You're not going to get it.

Jon Thompson: I am not prepared to give you that information, on the basis that we have not given it to current Ministers, never mind the Public Accounts Committee in public.

Q164 Chair: I was more interested in your first answer to Stephen's question, which was that on your current plans you do not need 2%—so what percentage are you at?

Jon Thompson: Just to be clear, you have asked us several times about flat real plus 1%, and I explained what our assumption is on the other side of it, which is flat real. GDP growth is currently predicted by the Office for Budget Responsibility to be more than that.

Q165 Chair: Are we at 2% at the moment?

Jon Thompson: Yes.

Q166 Chair: Right, so GDP goes up and you do flat real.

Jon Thompson: GDP goes up faster than we assume our budget rises. It depends on what you like to assume, but even with some redefinition of what 2% means, which I think we will implement, at some point in the next Parliament we would cross over.

Q167 Chair: What do you mean by redefinition?

Jon Thompson: The defence budget is currently measured net, for example, whereas the NATO definition is gross of income.

Chair: Right.

Jon Thompson: That makes a £1 billion difference.

Q168 Chair: How does VAT count in all this?

Jon Thompson: Well, indeed, if only we knew. That's going to go down well in the record. I think that rather changes the relationship.

Q169 Chair: So we can add the VAT in.

Jon Thompson: Our departmental budget, for example, does not include the cost of the annual pensions fund. The armed forces pension scheme is separately accounted for and runs an annual deficit of some £900 million.

Q170 Chair: So you can play around with the figures, really.

Jon Thompson: Indeed—endlessly.

Chair: Good! I'm there—is everyone happy? Right. Thank you very much indeed.