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PUS-

From: PS/PUS
Sent: 18 June 2004 14:59
To: PUS Outer Office
Subject: FW: NON-CASH CHRONOLOGY

Importance: High

MINISTRY OF DEFENCE
18 JUN 2004
WHITEHALL
LONDON SW1

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From: D Def RP
Sent: Friday, June 18, 2004 2:59:08 PM
To: PS/PUS
Cc: FINANCE DIRECTOR; DG RP; DGFM; D Def RP1-AD; D Def RP1-Mgt Acct; D PandA-Personal; D P+A AD1
Subject: NON-CASH CHRONOLOGY
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Updated AME facts 28 Oct 03.do...

I attach the last note PUS asked for; sorry it's late. Nor would I be surprised if it left PUS not all that much the wiser. But it's the clearest explanation we've been able to come up with in the time. I have to say that it's not an avenue I would recommend going down with Gus O'Donnell.

Seen by PUS.
AH 18/6

CHRONOLOGY OF NON-CASH DEBATE WITH THE TREASURY IN 2003

1. I attach the chronology prepared last year setting out the evolution of the cash/non-cash issue, from SR 02 into STP/EP 03. **This was intended to clarify our internal understanding, not to be handed over to the Treasury.** FAME (Former AME) is what we now refer to as "non-cash", incidentally. The CGEY report is generally consistent with this (because we ensured that it was).

2. PUS asked why we "got it wrong" as the headline number rose from £490M to £870M to £1,152M during the course of September 2003. This is not easy to explain. And it's worth remembering that the Treasury's key accusation – that we lost control of TLBs' expenditure – is wrong. What did happen was that we found it very difficult to re-invent the non-cash and near-cash split in TLBs' budgets, having made the transition to full RAB.

3. The position at the end of Phase 1 of STP/EP 03 (ie before the Options process and DMB consideration) was incorporated in Main Estimates for 2003/4 and submitted to the Treasury in early January 2003. At that stage the non-cash reduction compared with SR 02 was **£806M**.

4. At that stage, we merged non-cash/FAME and near-cash into Stage 2 RDEL (because that was the full RAB control regime), and completed STP/EP 03 on that basis. We no longer tracked non-cash or near-cash centrally. Of course we did incorporate into the programme any further RDEL (both non-cash and near-cash) changes that TLBs reported, including as a result of Options. So while we now know that the non-cash requirement fell further, we didn't track it separately because it wasn't relevant under Stage 2 RAB.

5. It was mid-February before the Treasury began to spark on the variance shown up in our Main Estimates. The discussions ran into June, focusing on explaining the £806M. Our aim was to explain the changes to the Treasury, which we largely managed.

6. Of the £806M, we agreed with the Treasury that £170M was due to "allowable" technical changes. That reduced the headline total at issue to **£636M**. In July, we told the Treasury that our requirement for non-cash had increased by £146M. This was mainly down to a £122M reassessment of its figures by FLEET (though we didn't explain it to the Treasury like that). That reduced the headline figure to **£490M**. Annoyingly, FLEET then changed its mind again and decided it didn't need the £122M after all. We didn't immediately tell the Treasury because we though it would undermine further their confidence in our numbers.

7. It was not until TLBs' AP3 forecasts in late August, when, in the absence of agreement with the Treasury, we tried to work out definitively where we stood on near-cash, that the further non-cash reductions in the late stages of STP/EP 03 were exposed. That is because while the debate with the Treasury had hitherto focused on the difference between our SR 02

settlement and our Main Estimates bid, the actual budgets issued to TLBs were based on the final outcome of STP 03. The main changes turned out to be STP 03 Options (£40M), late technical refinements by TLBs in STP 03 (£200M), and FLEET changing its mind (£122M - see para 6 above). We told the Treasury on 12 September that the headline figure had increased to **£870M**.

8. But we still had problems reconciling TLBs' non-cash and near-cash budgets back to the SR 02 settlement letter. That is because there was never a near-cash control total in the first place, and the Treasury were unable to explain exactly how the presentational near-cash figures in the settlement letter had been worked out. After a lot of analysis, it turned out that the main remaining discrepancy was that cash release of provisions (over £200M) was included in the Treasury's near-cash numbers, but not in RDEL. We had therefore issued TLBs with more than £200M more near-cash than we had available, increasing the size of the problem to **£1,152M**. We told the Treasury about this on 24 September.

9. One postscript. The total variation over the period was from £806M at the start of the year (from which had to be deducted the allowable £170M) to £1,322M (ditto) in late September – ie a 64% increase. The oft-quoted £490-1,152M increase (135%) is therefore misleadingly dramatic.

Chronology

SR 02

- AME in the Treasury's PES database was derived originally from SR 00 (ie STP/EP 00).

- After STP/EP 01 we updated the database; but the total AME was essentially the same. That was the starting point for our SR 02 bid.

- In Dec 01 we had the STP/EP 02 "Estimates Plan" (ie early figures). This showed an AME surplus of some £500M pa compared with STP/EP 01. But we had serious doubts about the figures' accuracy (some of them were clearly wrong). We thought it would be imprudent to adjust the PES database down at that stage.

- The SR 02 bid was therefore submitted in Feb 02, based on STP/EP 01 AME figures.

- In Apr 02 we had the STP/EP 02 "Final Plan" (ie final figures). This confirmed the AME surplus (though we still weren't certain about it). But we assumed the Treasury would wish to scrutinise and negotiate our AME figures; in the light of the Final Plan, we would probably have been prepared to reduce our bid. But they didn't.

- Received DRAc in Jun 02; only then did we start to have more confidence in TLB AME estimates.

- It did mean that when we accepted the SR 02 settlement in Jul 02, while we still didn't trust the exact AME figures we had more confidence that there would be scope to bear down on FAME costs in STP/EP 03. That was why we were able to recommend acceptance of the settlement.

Chronology

STP/EP 03

- When we accepted the SR 02 settlement in Jul 02, it was in the expectation that there would be scope to bear down on FAME costs in STP/EP 03. That was why we were able to recommend acceptance of the settlement.

- We received STP/EP 03 FAME forecasts in Oct/Nov 02. They indicated a significant increase in the FAME requirement compared with the STP/EP 02 estimates; but we had doubts about the figures.

- We therefore conducted a detailed scrutiny of FAME figures in Dec 02. The results, just before Christmas (and reported to the Finance Director at the start of Jan 03), showed that we had a FAME surplus after all, helped by write-offs in 2002/3 and FAME reductions in Phase 1 of STP/EP 03. At that stage FAME and near-cash (Stage 1) RDEL were merged into Stage 2 RDEL, and STP/EP 03 was completed on that basis.

- In producing an STP/EP 03 programme within our overall SR 02 settlement, we reinvested the surplus FAME resource for cash expenditure. The position at the end of Phase 1 was incorporated in Main Estimates, which we submitted to the Treasury in early Jan 03.

- Results of 6-3½% conversion notified to Treasury on 16 Jan 03.

- In the meantime, work continued to complete STP/EP 03 (Phase 2). Programme submitted to Ministers on 7 Feb 03. As well as decisions on Options (which had a FAME impact), TLBs continued to refine their FAME costings, which led to significant further reductions. Further FAME reductions were again reinvested in cash expenditure.

- We briefed the Treasury DDI team on the Main Estimates (at our invitation) at the start of Feb 03. At that stage they said explicitly that they weren't interested in cash.

- In mid-Feb 03 the Treasury (GEP team) started to follow up the non-cash to cash transfer, which they'd picked up off the PES database.

- The Treasury's DDI team became involved on 11 Mar 03. First MOD analysis of reasons for non-cash reductions provided on 18 Mar. Discussions between officials continued for several months (with meetings in Mar, May and Jun), focusing on validating the causes underlying the transfers identified in Main Estimates from non-cash (FAME) to cash. Treasury consulted NAO, who had no difficulty with MOD accounting treatments.

- Final Plan CTs for 2003/4 (broken down between RDEL and CDEL) issued to TLBs on 12 Mar (and updated on 21 May).

- John Dodds confirmed on 2 Apr a temporary increase in cash forecasts of £200M pa, without prejudice to ongoing discussions.

- PUS wrote to Gus O'Donnell on 4 Apr. O'Donnell replied on 8 May, saying that Treasury assumed we would set cash budgets on basis of forecasts in SR 02 settlement letter.

- Colin Balmer spoke to Jonathan Stephens on 10 Apr. They agreed that MOD would provide further detail on the causes for the non-cash reductions. (Provided by Tom McKane in letter of 14 May to John Dodds.) Stephens said MOD must bear risk of not adjusting budgetary allocations now.

- Secretary of State spoke to Chief Secretary on 28 Apr, saying he had been informed just before Easter that Treasury officials were trying to re-open MOD's SR 02 settlement. Chief Secretary said best way forward would be for MOD and Treasury officials to assess each case individually; Treasury would be "sympathetic and flexible".

- Chief Secretary wrote on 20 Aug referring to £490M as the sum at issue, saying he was unable to agree any of the proposed movements, and asking for confirmation that TLBs' budgets would be adjusted downwards accordingly.

- Analysis of TLBs' AP3 forecasts in late Aug exposes further FAME reductions in late stages of STP/EP 03. Advice on AP3 position provided to DMB on 17 Sep.

- New in-year CTs issued on 14 Oct after the AP3 reviews, breaking out for the first time near-cash RDEL.

- Treasury officials (Jonathan Stephens) warned on 12 Sep that sum at issue had increased: latest estimate was £870M (up from £490M).

- Meeting between Defence Secretary and Chief Secretary on 15 Sep. Chief Secretary agreed that aim should be to reach agreement "that we can all live with".

- Meeting between officials on 24 Sep, when Treasury notified of increase in sum at issue to £1,152M.

- Chancellor and Chief Secretary write on 26 Sep suspending Stage 2 RAB flexibilities and setting new near-cash control totals.

- The basis for knowing that it is indeed near-cash that is now controlled (in addition to various oral assurances from Treasury officials) is that:

  - Chief Secretary's letter of 26 Sep 03 requires us to "implement cash control at the cash spending levels set out in Annex E of [our] SR2002 settlement letter". The figures themselves are set out in the Chancellor's minute of the same date.

  - Annex E of the Chief Secretary's SR2002 settlement letter of 10 Jul 02 sets out "an estimate of the cash spending associated with these [SR2002] plans…in order to allow a reconciliation back to previous plans, and for use in presentation". The table describes the line of figures as "cash spending (estimated)". But the explanation of how they were calculated – "by removing the charges for the cost of capital and depreciation, as well as other changes such as provisions" – shows that they are in practice near-cash.

  - The Treasury's SR2002 press release for Defence (issued on 15 Jul 02) and the Treasury's SR2002 White Paper (Jul 02) both describe the same line of figures as "near-cash spending in MOD DEL", footnoted as "consistent with previous [SR2000] control basis".

Quotes

- SR 02 settlement letter said we would have "unlimited ability to move funds between separate resource and capital subprogrammes" within our budget.

- SR 02 settlement letter also said that our "spending plans are fixed, and will not be reopened before the next Spending Review".

- Treasury RAB guidance said the new regime was designed to provide "new incentives to drive down capital costs…allowing resources to be redeployed into priority areas".

- Treasury SR 02 guidance said that the new baselines would be "subject to comprehensive scrutiny by the Treasury".

- Treasury new RAB guidance (dated 10 Sep 03) said:

    - "Parliament…votes the overall cash consequences of the Estimate;"
    - "Budgets [are] split into Resource DEL and AME, Capital DEL and AME"
    - "There is no limit for moving current spending into capital budgets."