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**PS/Minister(DES)**

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24 April 2007

**TREASURY REACTION TO REQUESTED INCREASE IN UOR FUNDING**

Reference: MSU4/5/2 / MSU4/5/3 dated 29 March 2007

**Issue**

Emerging response from Treasury officials to our latest request (at reference) for a UOR envelope uplift of £450M.

**Timing**

2. Routine.

**Recommendations**

3. That Ministers note:

- a) the potentially worrying development that, given the continuing extremely high levels of UOR approvals, HMT officials are suggesting that the current framework for funding UORs is unsustainable; they are also concerned at the lack of incentive under the current arrangements for MOD to manage demand or reprioritise;
- b) it is possible that Treasury officials may advise that the medium-longer term requirements be addressed through the CSR settlement; we are doing some thinking about options should Ministers wish to engage in negotiations with the Treasury, but it is not obvious this could be achieved without significant risk to the Defence programme;
- c) in the shorter term (the latest uplift request and the remainder of 07/08) Treasury officials intend to advise the Chief Secretary to institute a more demanding approvals procedure, and to place more

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pressure on Defence to fund some operational requirements from in-year EP funding;

- d) Treasury officials have also indicated they intend to advise the Chief Secretary that the MOD should fund two UOR business cases relating to the Future Infantry Soldier Technology (FIST) programme, totalling some £70M; we are currently continuing with the FIST UORs at risk and we shall have to consider responding robustly if Treasury Ministers sign up to the advice that Reserve funds should not be used in this case;
- e) It is, however, possible that Treasury Ministers will take a less hard line. We expect them to write by the end of the week.

### **Background**

4. At a meeting on 19 April James Quinault, Head of the Treasury Defence Team, made clear that current approval levels on UORs<sup>1</sup> were generating significant financial pressure on the Reserve such that they viewed the current UOR funding regime as unsustainable. In their view current fiscal pressures are such that without a modification of the approach to UOR approvals and funding the cost will soon be unaffordable. A key Treasury concern is that UORs are currently a 'free good' for Defence, so there is little incentive for us to manage or reduce the level of UOR demand or to reprioritise our equipment plans.

5. For the medium-longer term any change to the current procedures, which are advantageous to the MOD, is an issue to be wound into the Comprehensive Spending Review negotiations, as it has potential implications for the terms of our settlement. While we are doing some work to generate ideas for other possible models, in case Ministers wish us to engage with the Treasury about alternatives to the current funding regime, any alternative will inevitably move risk from the Reserve to the MOD with potentially severe implications for the defence programme. Furthermore, any move away from the principle that net additional costs of operations are borne by the Reserve would risk attracting considerable criticism, which will constrain our options.

6. In the meantime Treasury officials are keen to modify the current approvals process (where there is a pre-agreed envelope for approvals and MOD has delegations to approve business cases for less than £10M within that envelope) from now onwards, and indicated they would propose that the Chief Secretary should agree a much smaller envelope (perhaps £1-200M) for approvals of smaller UORs within the MOD's delegations, with all larger UORs – which are the cost drivers – being negotiated as individual uplifts to the envelope with Treasury officials on a case by case basis. They also indicated that they would expect to be much more difficult to persuade than hitherto of the validity of individual business cases as appropriate calls on the

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<sup>1</sup> Over £760M of UORs were approved in FY 06/07. The bid at reference forecast further approvals of £450M in the first 4 months of FY07/08

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Reserve. This reinforces the importance of the MOD ensuring that our own scrutiny mechanisms, while lean and responsive, remain demonstrably (to the Treasury) robust.

7. Quinault suggested at the meeting that it should be possible for the MOD to find funding from the Equipment Programme in 2007/08 for a substantial proportion of proposed UOR enhancements, from uncommitted expenditure. Whilst it would be possible to re-prioritise in-year spending to deliver a degree of headroom, it would be difficult to create substantial flexibility in year as the in-year programme already carries a degree of risk, and a substantial proportion (in excess of 75%) is already contractually committed. Further, the main programmes which currently have uncommitted funds (eg CVF, ASTUTE, A400M and Watchkeeper) would be considerably disrupted if action to delay or stop work was taken.

8. Quinault said that as part of his advice to the Chief Secretary on the Secretary of State's uplift bid, he would be recommending that in response to the recent approach from MOD for two FIST-derived UORs (to provide improved targeting and situational awareness, and to provide section level real-time soldier tracking), the Treasury should ask the MOD to find the resources. While they accepted the requirement was compelling, and that our approach to funding these UORs pragmatically (with some of the cost being repaid from the EP) was positive behaviour of the kind they would wish to encourage, they argued that the cost should more properly be borne by Defence as a capability enhancement – in part because they baulked at the £70M cost. Given the considerable potential benefit to infantry in Afghanistan, both in terms of effectiveness and force protection, I believe we should continue to argue that these business cases are legitimate claims on the Reserve. These UORs form part of the 'perfect battalion' work which is being undertaken by DEC(GM) on behalf of Minister(DES).

9. All that said, Quinault accepted that Treasury Ministers may take a different view given the evident sensitivities, so we should not assume anything about the formal Treasury response until the Chief Secretary has written, which he expected would be later this week.

#### Presentation

10. The current UOR arrangements have allowed us to maintain the public line (for instance, by Secretary of State in the Commons on 22 Jan 07) that no urgent requests for operational equipment have been turned down on financial grounds. The Prime Minister also said on 7 Oct 06 that "If the commanders on the ground want more equipment — armoured vehicles for example, more helicopters — that will be provided. Whatever package they want, we will do". Any apparent shift from that position would need careful handling.

Paul Taylor  
Director General Equipment

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