



SECRETARY OF STATE

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MO 8K

29 September 2003

Dear Paul,

**MINISTRY OF DEFENCE BUDGET**

I do not accept your interpretation of the events which led to the present impasse between the MOD and the Treasury. I reject entirely the accusation that the MOD has lost control of its budget. The issue is rather whether the control framework put in place by the Treasury in Spending Review 2002 was adequate. You are seeking to reopen the SR 2002 settlement. Had I known in July 2002 that the Defence Budget would be constrained as is now proposed, I would not have accepted the settlement. I have agreed that my Accounting Officer should take immediate action to reduce near-cash resource and capital consumption by up to £500M in the current year but, in view of the military, industrial and political implications of going further, I have directed him not to impose a moratorium on all uncommitted expenditure pending further discussion involving the Prime Minister. I do not accept the need to ask external advisers to look at the MOD's financial control arrangements.

The Rt Hon Paul Boateng MP  
Chief Secretary to the Treasury

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Detail

1. I was astonished to receive unheralded your and Gordon Brown's letters of 26 September, particularly when you and I had agreed that MOD and Treasury officials should work together to find a compromise solution to the problem we face and they had been in touch with each other on a daily basis since our meeting on 15 September.
2. I accept that it was most unwelcome to learn that the full extent of the resources transferred from non-cash into cash in the current year is £1.1 billion, which represents a £500M increase from the movement identified in the Spring. The difference arose because Main Estimates are prepared before the end of the MOD's annual planning cycle and movement continued over the intervening period. The control totals issued to Top Level Budget holders thereafter made no distinction between different categories of Resource DEL precisely because no such distinction was drawn in the Treasury DEL controls contained in your letter of 10 July giving the details of the MOD's SR 02 Settlement. The Defence Management Board did, however, issue a control framework ring-fencing certain categories of event, such as changes in assumptions about asset lives. So the issue is not one of a failure to control the Top Level Budget Holders expenditure, it is rather one of defining the controls to which the MOD was expected to operate.
3. You are requiring me to implement a cash control at the cash spending levels set out in Annex E of the SR 02 settlement letter and to carry out the MOD's next planning round on the basis that these cash controls apply in addition to the resource and capital DEL limits. I simply cannot accept this without the opportunity to discuss the consequences for our defence capability and the political and industrial impact with the Prime Minister. The first sentence of Annex E to the settlement letter makes clear that the purpose of translating the DEL controls (on Resource DEL, including depreciation and capital charge costs, and Capital DEL) into the estimated cash consequences of plans was to "allow a reconciliation back to previous plans, *and for use in*

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*presentation*" (italics added). Later in the Annex it makes it clear that "for presentational purposes, so as to avoid double counting of new capital investment and its consumption, the depreciation line above will be netted off." Plainly cash was not a Control Total. If this was a mistake, it was not one of the MOD's making. I took the initiative to contact you about the issue in April. MOD officials have throughout the past six months asked their Treasury counterparts whether it was the Net Cash Requirement or some other definition of cash to which the Treasury attached importance. At no time have they received clear guidance. They have also worked to find a compromise on the types of movement which would be allowable – to no avail. And yet it was not until the end of August that you raised the issue with me formally in writing.

4. Nonetheless, plainly cash is vitally important and our officials need to conclude their work on how best to reflect this in the control framework. But to impose retrospectively the regime set out in your letter is excessive and unrealistic. My Accounting Officer has advised me that in order to comply with the Chancellor's demand that the MOD reduces its cash expenditure by £1.1 billion this year, he would have to impose an immediate moratorium on uncommitted expenditure. I have explained in my minute to the Prime Minister why I believe that it would be wrong and dangerous for the Government to take such drastic measures. My Accounting Officer has advised me that we should implement measures to reduce near-cash consumption by up to £500M in-year. This seems to me to be both reasonable and realistic, although the consequences for the Government's defence priorities will be painful. However, I have directed him not to go further until the Prime Minister has had the chance to consider the implications of doing so. We will not be able to disguise from Parliament that the MOD is underspending on its Resource DEL while at the same time making damaging cuts.

5. Similarly, I feel strongly that to insist on an externally led review of the MOD's financial control arrangements is misconceived. The issue is not the visibility of expenditure by the Top Level Budget Holders to the MOD Centre, but the fact that no controls were placed on cash or on near-cash and no

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distinction was drawn in last year's planning round between different categories of Resource DEL precisely because they were not required under the terms of the SR 02 settlement letter. If we can get clarity on the regime we are to live under, the MOD will be effective in applying the necessary controls. But to reopen the SR 02 settlement and impose unilaterally a new regime is unreasonable. Had I been told in July 2002 that there would be no flexibility to move resource from non-cash into cash I would have been unable to accept the settlement.

6. We made plain throughout the SR 02 negotiations that we needed more resources just to keep the Armed Forces going on a day-to-day basis. The cost pressures amounted to £770M in 2002/3, of which the MOD absorbed £270M and was granted an injection of £500M from the Reserve for which I was grateful. But this did not make the pressures go away and MOD officials have given yours a paper describing the continuing pressures on our budget caused by the fact that in real terms, once the earmarked elements are removed, the SR 02 settlement involved a reduction in resources across defence. If Gordon and you want the MOD's efficiency programme to be refocused on input costs, I will be content to discuss this in the context of the SR 04 negotiations, but I reject the implication that the MOD's problems are all of its own making and if only it was more efficient the problems would disappear. The existing output focussed efficiency regime was agreed with you in SR 02 and the MOD has been transparent in the way it has implemented it. Indeed, Treasury officials sit on the most significant steering boards.

7. You also require greater Treasury visibility of the MOD's Short Term Plan and Equipment Plan. I agree that there should be good transparency between the MOD and the Treasury, although this is a two way process. Your officials were unwilling to set out in detail the fiscal impact of decreasing levels of pain for Defence in closing the gap between us. With greater Treasury involvement in the day to day decisions of the MOD would come greater Treasury responsibility, something which your predecessors have preferred to leave with the MOD. That said, I welcome the fact that the Treasury wants to

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work as a partner with the MOD to ensure excellent and sustainable UK armed forces.

8. Finally, I cannot leave unchallenged the implication that nothing in your letter will affect the work of our Armed Forces in Iraq. I am pleased that Gordon and you have reaffirmed your commitment to ensure the proper resourcing of operations in Iraq. But to suggest that cuts to the core Defence Budget will have no impact on military capability or morale reveals a lack of understanding about how defence works. The net additional military costs are only one element, and a relatively small element, of what goes into creating the military capability deployed in Iraq. Cuts in the core equipment, logistics and training programmes will inevitably affect operations in Iraq. The only question is how quickly. The effect on morale will be more or less immediate.

9. I am copying this letter to the Prime Minister and the Chancellor of the Exchequer and to Sir Andrew Turnbull.

*Yours sincerely*



**GEOFFREY HOON**

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