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CHIEF SECRETARY

From:

Date: **4th July 2003**
Extn:
Room:

cc: Ed Miliband
Nick Macpherson
Jonathan Stephens
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c£2bn MOD Cash Increase over SR2002

Issue:

MOD seek to exploit RAB unfairly and ignore agreed SR2002 cash forecasts, to increase their cash spend uplift by over 40% over SR2002.

An additional £2bn cash spend would have a big impact on the fiscal position.

Recommendation:

We should initially rebut 100% of the switches: they are neither legitimate nor affordable and contradict the whole ethos of RAB.

Timing:

ASAP – MOD is already spending the money

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Background:

The last Spending Review for MOD was mainly done on a "near-cash" basis, which as good as equates to the cash spend. This near-cash settlement was jointly agreed between HMT and No.10 after discussions with MOD.

The non-cash figures necessary to put the settlement onto a Stage II RAB basis were agreed between MOD and HMT and laid out in the Settlement letter. MOD forecast a non-cash requirement of about £11bn a year.

In February 2003, MOD's forecast non-cash requirement fell substantially from the SR2002 figures. This was due to a mixture of delayed procurement projects, changes in accounting treatment and a surge in write-offs in the Spring Supplementary Estimate.

MOD unilaterally re-allocated the reduced non-cash costs into increased cash spending – totalling up to £1bn a year by year 3. This was on top of the significant increase in cash, already agreed in SR2002.

Over the last 3 months senior officials have met, Permanent Secretaries have written to each other and you have discussed with Mr. Hoon on the telephone. The main arguments put at various levels are summarised below.

Officials have worked co-operatively and refined the figures downwards c30%, but still remain poles apart – or c£2bn over 3 years.

In the meantime, for practicality's sake, MOD's Main Estimate last year included a limited switch from non-cash into cash of £200m pa, on the understanding that it would not prejudice any future decision.

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Cash impact summary:

Cash Spend £bn	2003-04	2003-05	2005-06
SR2000 baseline	24.9		
Cash increase in SR2002	0.7	1.6	2.5
SR2002 outcome	25.6	26.5	27.4
Further cash increase sought by MOD	**0.5**	**0.6**	**0.9**
New MOD figures	26.1	27.1	28.3

MOD view:

MOD keep their argument very simple:

- they are working within the existing RAB framework which rightly rewards them for lower non-cash costs, delivered by extracting value from their assets.
- they claim HMT has focused them on DEL totals, and that they were lead to believe that cash was irrelevant.
- MOD point to their Settlement letter that specified unlimited flexibility to move funds between sub-programmes.

HMT argument:

The big picture is that MOD have acted in bad faith. RAB sets out guidelines and principals, but cannot cover every eventuality. There are no hard and fast rules in some areas and they can be open to interpretation. Treasury is ultimately responsible for refining the guidelines over this transitional phase. Equally, we need to be able to trust departments to work within the spirit of RAB and check with us where clarification is obviously required. If we cannot trust departments to behave in a co-operative manner, we will have to consider tighter controls – undoubtedly a backward step.

The key specific points are:

- These switches are not affordable and threaten the Golden Rule. Cash fluctuations of this scale cannot be determined

unilaterally, 6 months after agreeing figures in SR2002. Given fiscal pressures, if MOD had forecast their non-cash costs more accurately at the time of the Spending Review, they would have received a significantly different settlement.

- MOD have generated this improved cash flow from a mixture of accounting changes, exploitation of the transitional phase between RAB Stage I and II, and ineffective management of procurement contracts. Thus this cash windfall has nothing to do with the RAB principles of efficiency or improved asset utilisation. Allowing it would set a costly precedent.

- MOD have constantly reassured us, until the very last minute, that non-cash forecasts in SR2002 were understated, not overstated. It would appear that they have misled us.

- The sub-programmes referred to in the Settlement letter are clearly MOD's internal budget holders, as they very well know. It was always understood (although admittedly not put in writing) that significant movements in cash / non-cash would have to be agreed with HMT.

- The quality of MOD's forecasting has remained poor and does not instil confidence. NAO are yet to confirm some of the accounting changes. Even more reason why they should protect us both against future swings in the other direction, by adding these non-cash reductions to the non-cash DUP we prompted MOD to create in SR2002.

- It is not credible that MOD can really have believed that cash was not relevant. We disagree that RAB lead them to this conclusion.

Discussion:

We need a starting position that takes into account the following factors:

1. Which switches are legitimate?
2. Consideration of affordability
3. Wider pressures on MOD baseline
4. What MOD might accept / Plan B

1) Which switches are legitimate?

As the table shows, the switches break down into 4 main subcategories, and our logic is laid out below on each:

	2003-04	2004-05	2005-06	SR2002 TOTAL	%
Changes in Accounting	229	211	281	721	35%
Procurement Slippage	160	181	127	468	23%
Misc	-127	45	83	1	0%
Accounted for	262	437	491	1190	
Unforecast 1.97bn write-down	252	225	202	679	33%
Not accounted for	-24	-31	255	200	10%
Total	490	631	948	2069	100%

Changes in Accounting Treatment – 35%, or c£240m pa
These have been presented by MOD as rectification of accounting errors, mainly in the way they depreciate assets. In actual fact, MOD instructed their Top Level Budget holders to seek ways to free up cash. One way they found was to depreciate certain assets more slowly.

The fact that these "corrections" were cash-driven is of concern, in that it could be storing up future movements in the other direction. MOD feel they can manage these risks, but on recent performance we don't share their confidence. This will increase future pressures on a budget that is already under strain (see 3 below).

We cannot agree to these changes. RAB was intended to reward better asset utilisation, not rectification of basic accounting errors. MOD think that they have found a loophole in RAB which we must close now, or be prepared for further costly movements.

This approach could leave us open to claims that go the other way: i.e., increased non-cash costs for other accounting changes. However, we can protect ourselves by confirming that we will deal with the impact of major accounting changes on budgets on a case by case basis.

Procurement Slippage - 23%, or c£150m pa
In-service dates for MOD's large kit purchases (e.g. Nimrod, Astute, Typhoon) tend to slip to the right. This also means that large R and D costs will not hit their balance sheet and be depreciated as expected.

We think this is where MOD have the strongest point. Under RAB departments should legitimately benefit from the lower non-cash costs of a smaller asset base. Indeed, MOD's calculations show that they will incur an additional £100m of expenditure to compensate for procurement delays.

However, there is still a reasonable argument that this rewards MOD for poor supply chain management and inaccurate forecasting.

Additional £2bn write-offs – 33%, or c£225m pa
Last year write-offs went through AME; this year they go through DEL. MOD took advantage of the transitional phase between RAB Stage I and II to write off £3.6bn of assets in the Spring Supplementary Estimate. This has recently been adjusted to closer to £3bn - but this is still c£2bn above the forecast figure of £1.1bn upon which their SR2002 non-cash forecast was inaccurately based.

The key question here is one of symmetry. In RAB Stage II, departments feel the pain of write-offs as they go through their DEL, but then are rewarded with lower non-cash costs from reduced assets. MOD have sought to transfer the pain to HMT by stuffing un-forecast write-offs into AME at the end of last year, but still want to reap the rewards. This is a transitional issue, where we must reserve the right to make sure that anomalies between RAB I and II do not create windfall gains. (We did so with MOD provisions late last year, treating a % on a Stage 1 basis, so that they go through MOD's DEL when they are drawn down). Equally, we have a duty to ensure departments do not unfairly take advantage of the transitional phase. We feel that the transitional issue / symmetry argument is a strong one which we can defend.

Not accounted for: - 10%, or c£250m, mostly in year 3
MOD have only explained the largest switches. This category theoretically is made up of the smaller ones, but the figures do not

bear this out. They are likely to be a mixture of the above i.e. not legitimate. Hence we should disallow these switches.

So having assessed MOD's proposed switches on a purely legitimacy basis, our view is that at a push, a maximum of c£150m pa, or 23% of the proposed switches are acceptable to us. These stem from the procurement slippage category.

2)Consideration of affordability

Any switch from "non-cash" to "cash" spending has a direct impact on Public Sector Current Expenditure and is broadly equivalent to granting a Reserve Claim. In the current fiscal situation and in light of known spending pressures (including those from MOD – see below), there is very little headroom to accommodate increases in PSCE without significantly threatening the achievement of the Golden Rule – on the cautious case over the economic cycle. In this context, DDI/GEP judgement is that £200m pa is the maximum that HMT could afford to concede in this area.

3)Wider pressures on MOD baseline

If we do concede at any point, we will need to stress that any switches are one-offs. As in the case of a Reserve claim, MOD should not see this as a permanent step increase to their near-cash baseline for SR2004. The danger is that MOD will transfer this spend into steady state activities.

MOD's budget is under considerable pressure from a number of different sources. Any concessions we do make on this issue will need to be considered as we address other areas that may lead to future Reserve claims:

- Increased pension contributions: due to increased life expectancy MOD contributions are likely to increase by c£150m pa. In keeping with our treatment of OGDs we propose that MOD should manage this increase out of their existing DEL. (You will shortly receive advice from the Pensions team on this.)
- Post-Iraq recuperation: early estimates to replenish equipment are around £1bn over the SR period. To protect

the reserve we could push MOD to re-prioritise other capital spending, but this will be difficult and go against precedent.

- Hawk trainer jets: as you are aware this procurement is likely to lead to MOD requesting additional funds of £126-£332m over the SR2002 period, depending on which financing option is chosen.

4) What MOD might accept

MOD have been ruthless in seeking to exploit any perceived loopholes in RAB and in misleading us on the risks of non-cash costs moving downwards. They now sense a clear opportunity, and will seek to maximise political leverage. We should not expect them to accept our opening position if it is less than 50%. They will fight to get as much as they can. Our best guess, is that they could live with 20-30%, but would set their sights higher.

Recommendation:

We should start by rejecting 100%. MOD have sought to mislead us and, although we may ultimately be forced to compromise, we want to keep the pressure on to make MOD realise that their behaviour is unacceptable. We have arguments to rebut all their main switches, which go against the whole ethos of RAB.

This would potentially leave MOD with a significant un-allocated non-cash budget. But, given recent NAO reports on useless stock and forthcoming force rationalisation pressures, they should be able to make good use of their non-cash allocation. Indeed, this will protect us from future MOD non-cash pressures, which they have always lead us to believe were building up. We can ease the pain by offering them EYF on non-cash.

If MOD push further, and you are persuaded to compromise, we should focus on switches occurring due to procurement slippage. These make up c£150m pa and are the only changes that we can see any possible justification for.

If push comes to shove, we could then compromise further and concede on a % of the write-off related switches, to take the total up to a maximum of £200m. Because this transitional issue is a

one-off, conceding here would not set any precedent. This would allow us to stick to our line on disallowing switches stemming from simple changes in accounting treatment.

Handling:

The ball is firmly in our court – if we do nothing then MOD will continue to spend the cash.

We feel the next step would be for you to write a strong letter to Mr. Hoon, rebuffing the switches.

Any further discussion at official level will only play into MOD's hands in that the longer this goes on, the more painful it will be to get back this year's switches from the Service Chiefs.

The attached letter is currently being agreed with No.10 via CX's office.

Presentation:

MOD will look to maximise leverage from their current high profile both politically and in the media.

They label the Treasury view as equating to "cuts in defence" and "re-opening the SR2002 Settlement", and have said as much to the Prime Minister.

Clearly neither are true: their cash uplift in SR2002 led to the biggest increase in Defence spending for 20 years and this remains intact; only MOD are deviating significantly from agreed SR2002 figures.

MOD allocated the cash windfalls to their key budget holders such as the Army, Navy, RAF and Defence Logistics Organisation in January 2003. They did so without HMT agreement, knowing that their senior military will see any subsequent reductions as cuts and cry foul to the media.

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However, we understand that if MOD do have to revert to the agreed SR2002 figures, the main reductions will be in the procurement and logistics areas ie: manning and training should not be affected.

MOD military will talk to the Daily Telegraph. We will have to work closely with No.10 and MOD centre to and present a strong case. There are a range of arguments we can deploy, depending on how strong we need to be, and these are included in our defensive lines (Annexe A).

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LETTER FROM PAUL BOATENG TO GEOFF HOON

IMPLEMENTATION OF SR2002 SETTLEMENT

After discussions between our departments, my officials understand from yours that you still propose making very substantial switches within your Resource DEL budget, from non-cash into cash.

While our officials have resolved some technical issues with the effect of marginally reducing the apparent size of the switch, I understand that you still propose to transfer £490m / £631m / £948m, over the current spending review period – ie a total of over £2 billion.

We discussed this over the telephone in April, and our Permanent Secretaries have also exchanged correspondence. I have also noted Peter Watkins' letter to Matthew Rycroft of June12th. **After careful consideration, I am unable to agree to any of the proposed movements.**

As you know, this is the first year of full Resource Budgeting. We negotiated the 2002 Spending Review settlement on a near cash basis. The final figures then took into account your department's forecast of your non-cash requirement.

During this transitional phase, the Treasury and departments clearly need to work very closely together to ensure that the new budgeting system delivers its aims – i.e. supporting the fiscal framework and providing incentives on departments to manage their assets more efficiently. We need to be able to rely on departments to work within the spirit of RAB and check with us where clarification of the budgeting system is required – especially where large changes from the agreed spending review settlement are involved. If this fails, our only other option is to consider tighter controls in future. I am sure that you would agree that this would be a backward step for both parties.

Unfortunately, your department has not engaged the Treasury effectively during its internal budgeting process. From the end of the Spending Review period, until January 2003, your officials consistently lead mine to believe that you were struggling to

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manage a lack of non-cash resources, not the opposite. In consequence there was no discussion about the implications of a massive switch from non-cash to cash until your internal budgets had been set and allocated to your Top Level Budget holders. Given the tight fiscal situation, it was never credible that such a significant and unexpected increase in public sector net expenditure would be something that Treasury could allow your department to unilaterally decide on. Such a movement puts at risk the achievement of the golden rule.

RAB is designed to incentivise departments to manage their asset base more efficiently and it is right that departments are rewarded for better asset utilisation. However, it is my firm view that the cash windfalls that occur due to procurement slippage, changes in accounting treatment, or departments taking advantage of the transitional phase between the first and second stages of Resource Budgeting, do not fall into this category.

I must also reiterate a key point. There is no question of Treasury re-opening the Spending Review Settlement. The underlying "near-cash" (ie: Resource + Capital DEL) SR2002 settlement remains as agreed: the best planned Defence spending settlement for 20 years. To put this in perspective, the changes your department proposes would almost double your already sizeable cash uplift in year 1 and increase it by over 40% over the spending review period.

Given that it appears you have freed up some of your non-cash forecast, I am happy for our officials to engage on how this non-cash can be best used. Options that they might consider could include adding to your non-cash DUP, or considering an EYF agreement to allow further write-offs in subsequent years.

Finally, I understand that without Treasury agreement, MOD centre has allocated additional cash to your Top Level Budget holders already. I would be grateful for your confirmation that these budgets will be adjusted downwards accordingly.

I am copying this letter to the Chancellor and the Prime Minister.

PAUL BOATENG

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Annex A – Oral Defensive Lines

We have just fought a military campaign – this is bad timing to re-jig our budgets

Treasury has been extremely flexible and accommodating to MOD over funding Iraq, and will continue to assist. This is a separate issue about MOD deviating from agreed cash totals by over £2 billion over the Spending Review 2002 period. If MOD had given prior warning it would not have arisen now.

Treasury is seeking to cut agreed MOD spending

There is no question of cutting the MOD Resource DEL control total. The underlying "near-cash" (ie: Resource + Capital DEL) SR2002 settlement remains as agreed: the best Defence planned spending settlement for 20 years.
But we do need departments to seek our approval for significant deviations from agreed cash / non-cash totals.

Treasury lead us to believe that DELs are what matters, not cash

Simply not the case. Treasury has sought to get departments to focus more on Resource spend, but cash is still crucial to the fiscal balance – we can't spend what we haven't got. Don't forget that RAB stems from the private sector – do they ignore cash?

You are denying us the full benefits of RAB

We are happy for MOD to benefit from improved asset utilisation and disposal of surplus assets, but technical changes in accounting treatment and taking advantage of the transitional phase of RAB do not fall into this category.

We are working within the rules of the RAB framework

RAB does not have a hard and fast rule for every occasion. We expect departments to work with us refining them over this transitional period, rather than unilaterally seeking to unfairly exploit perceived loopholes.

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