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From: J B Unwin

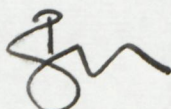
Date: 26 September 1986

MR NORCROVE

DEFENCE RESEARCH AND DEVELOPMENT EXPENDITURE (E(RD) (86) 8)

You may like to see the attached copy of my brief for Mr Channon for next Tuesday's discussion by E(RD) of the above paper.

2. My very firm impression is that MOD have done nothing at all to implement the decision taken by E(A) last February that expenditure on defence R & D should be reduced in accordance with the projections in the 1985 Long Term Defence Costings. What has happened is that the 1986 Costings have thrown up higher figures (the main excuse being that the 1985 figures did not provide for the EFA) and the Defence Secretary is arguing that, although it might be possible to accept these as a compromise, he would prefer to have no quantitative constraint at all.
3. Mr Fairclough and I feel strongly that this is simply not good enough and I am so briefing Mr Channon. What MOD must now do is to put a proper management system in place which would be designed to enable them to live within the R & D figures imposed on them. If genuine problems arise, then the Defence Secretary is always free, of course, to come back to his colleagues. But a genuine effort must be made before he does so.
4. As you will see, I have advised Mr Channon that if E(RD) were minded to except the Defence Secretary's new proposal, the matter would have to be referred to E(A) for consideration under the Prime Minister's chairmanship



J B UNWIN

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SECRETARY OF STATE FOR TRADE AND INDUSTRY.

Defence Research and Development Expenditure

(E(RD)(86)8)

MAIN ISSUE

In this paper the Secretary of State for Defence in effect invites E(RD) to rescind the E(A) decision to constrain future defence research and development expenditure to the path showing in the 1985 Long-Term Costings. In practice such a decision could only be taken by E(A), so that E(RD) have in effect two alternatives:

(i) to endorse the Defence Secretary's recommendation that there should be no quantified restraint on future defence R & D expenditure but instead a general directive to minimise R & D expenditure in all defence procurement choices, for subsequent consideration by E(A); or

(ii) to reaffirm the need for a quantified framework for defence R & D, within which the Defence Secretary would be asked to prepare the best R & D programme he could, taking into account both military requirements and the implications for UK industry, while at the same time indicating how that programme could be improved if the quantified expenditure constraints were to be varied.

BACKGROUND

The reasons for the E(A) decision

2. Nothing has happened since last February to call into question the validity of the E(A) decision to limit future defence R & D expenditure. The case for that decision remains very strong indeed:

(a) defence absorbs a larger share of Government-funded R & D expenditure in the UK than in most other industrial countries;

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(b) defence accounts for a larger proportion of total national R & D expenditure, public and private, than in other countries;

(c) although the Ministry of Defence now approaches procurement in a more business-like way than formerly, the attention of defence contractors remains focussed largely on defence sales, to the exclusion of any consideration of opportunities in civil markets;

(d) preemption by defence R & D of skilled manpower in the information technology/electronics field makes it more difficult for the rest of UK industry to secure the people they need most to improve their competitive position in international markets.

The intention of E(A), in endorsing the recommendations of the MISC 110 and MISC 119 Groups was to encourage a gradual reduction in the extent to which UK defence procurement relies on UK R & D directed exclusively towards defence purposes. The E(A) decision requires a gradual shift of resources out of defence R & D over an extended period of time, thereby minimising frictional costs in the redeployment of those resources elsewhere in the economy and avoiding disruption of the Ministry of Defence's procurement programme.

Ministry of Defence objections

3. The former Defence Secretary, while admitting the potentially important industrial impact of defence R & D, sought to resist the MISC 119 recommendation, on the ground that it would be premature to take any decisions which would constrain defence R & D until his programme, and all other Departmental R & D programmes, had been evaluated on the basis of common criteria from the standpoint of their contribution to the UK economy. (From this argument emerged the proposal to establish the Assessment Office.) The Ministry of Defence further argued that their R & D programme was vital to the strength of important sections of UK industry, and that there could be no guarantee that resources released from defence use would be applied more productively elsewhere in the economy. Although the uncertainty of the Long-Term Costing figures was emphasised by MOD, they did not argue that they gave a seriously misleading impression of the future trend in their R & D expenditure.

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4. The case now made by Mr Younger is rather different. What it boils down to is that the 1985 costings made no allowance for the European Fighter Aircraft (EFA) project. MOD therefore now complain that they may not be able to find room for EFA and other desirable collaborative projects within an R & D programme constrained to last year's figures; that it is wrong to seek to put a programme directed towards military requirements into a financial straight-jacket; and that insisting on constraining future R & D expenditure means giving higher priorities to that objective than to minimising overall procurement costs. Mr Younger says that he does not want to be forced into a position where 50 per cent of UK defence hardware requirements are bought off the shelf overseas, and where the UK has to withdraw from desirable current and future collaborative projects with European partners. He proposes, therefore, that the Government should simply rely on a general directive in his Ministry to minimise R & D expenditure in all future procurement choices.

Implications of the MOD arguments

5. The arguments put by Mr Younger throw a very odd light on the Long-Term Costings. Their usefulness as a tool of management must be very questionable if they could be put forward last year with no allowance at all for a major item of RAF re-equipment (EFA) the need for which was clearly in everyone's contemplation at the time of the MISC 110 discussions. (The point appears to be that nothing can be allowed for in the Costings until it has some kind of Ministerial approval, so that the more distant years' figures inevitably have a strong downward bias attached to them.) It is clear that MOD have no management system in place to control future expenditure on development (future expenditure on research is projected to be broadly flat), and that no steps whatever have been taken to implement the E(A) decision.

6. MOD may argue that it is unreasonable to expect them to regard the volume of defence R & D expenditure as a policy objective; their system is designed to control the total costs of procurement, including both development and production. As part of their efforts to make defence contractors more efficient and competitive, they increasingly try to place fixed price contracts covering both development and production. The decision whether to purchase a new item of equipment off the shelf overseas, or to develop it collaboratively in Europe, or to develop it exclusively in the UK, at the same time

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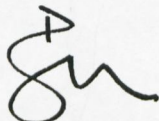
determines the UK R & D effort required. This is all very well: but it ignores the E(A) decision completely. Nor would be consistent with that decision to reduce apparent MOD development expenditure by lumping it all in with the production price by the means of 'cardinal point specification' contracts, correct though this approach may on occasion turn out to be. In principle there need be no incompatibility between the E(A) decision and a policy of cost-minimisation on defence procurement; and in practice decisions whether to take part in collaborative projects or to undertake exclusive UK development have invariably reflected factors other than cost-minimisation.

7. Given MOD's present policies and control methods, it is hard to believe that a general injunction to minimise development expenditure on new weapon systems would have any significant effect. Instead MOD need to install a system enabling realistic projections to be made of their UK R & D expenditure (including the development content of contracts whose price includes production as well as development and some allowance for projects not yet defined and approved by Ministers), taking into account the probable procurement arrangements for each item of equipment covered. A clearer view should then emerge on the scope for collaborative development and the need for off the shelf purchasing R & D expenditure within quantified constraints, so providing an adequate basis for decisions on the future content and shape of the programme. Such decisions would need to be based on an analysis of the military and industrial implications of all the projects within the MOD R & D programme, and on a considered judgment about their order of priority within that programme. (In practice it must be most unlikely that EFA is the marginal project which the Government would choose to sacrifice in order to keep MOD's R & D expenditure within a prescribed limit.) It cannot be excluded that it may at some time be necessary, on military and industrial policy grounds, to relax somewhat the constraints implied by the E(A) decision; but MOD have not yet begun to make a case which E(RD) could commend to E(A).

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HANDLING

8. You will wish to invite the Secretary of State for Defence to introduce his paper. The Chief Secretary, Treasury will wish to respond, and the Minister for Industry and Information Technology will wish to make a substantial contribution to the discussion, reflecting on the one hand the claims of civil industry on the resources currently preempted by defence R & D, and on the other hand the need to maintain a strong and competitive UK capability in certain sectors of advanced technology which are heavily depended on defence. The other Ministers responsible for major R & D programmes may also wish to give their views, which will also reflect their sponsorship responsibilities for non-defence industries.



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26 September 1986

