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PREM 19/1977

PART 9

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CONFIDENTIAL FILING

THE DEFENCE BUDGET

DEFENCE

MILITARY ASSISTANCE SCHEME (URT MAS)

PART 1: 1744/1979

PART 9: JULY 1982

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
<del>19.7.82</del>		29.4.83					
<del>30.7.82</del>		- Pt Ends					
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● PART 9 ends:-

C (83) 11 29/4

PART 10 begins:-

RTA to PM (A083/1244) Rec'd 4/5/83

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
OD (82) 67	02.09.1982
CC (82) 52 <sup>nd</sup> Meeting, item 1	09.12.1982
OD (83) 6	14.04.1983
OD (83) 4 <sup>th</sup> Meeting, item 1	18.04.1983
C (83) 11	29.04.1983
OD (83) 5	12.04.1983

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate CAB (CABINET OFFICE) CLASSES

Signed     *AWayland*    

Date 13 March 2013

**PREM Records Team**

CONFIDENTIAL

Defence of RJ.



MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1  
Telephone 01-20307022 218 2111/3

MO 21/2/28

29th April 1983

Dear John,

A.J.C. 29/4

p.a.

STATEMENT ON THE DEFENCE ESTIMATES 1983

Thank you for your letter of 27th April forwarding the Prime Minister's comments on the draft Statement on the Defence Estimates. I can confirm that the Defence Secretary is very content to include all the suggested amendments listed in your letter. These include some changes to the "no first use" paragraph in the essay on "Nuclear Disarmament - Alternative Approaches" (paragraph 3 on page 2-11), which Mr Heseltine believes will also meet the concerns expressed by the Lord Privy Seal and the Home Secretary. A suggested redraft of this paragraph was included in the Foreign Secretary's comments, but Mr Heseltine hopes that the amended version will also be acceptable to Mr Pym. The remaining FCO comments mentioned in Brian Fall's letter of 26th April have been taken into account in the redraft (apart from one or two which have been overtaken by other amendments).

A revised draft of the White Paper incorporating all these changes is being circulated for consideration by the Cabinet on 5th May.

I am copying this letter to the Private Secretaries to other members of OD and to Sir Robert Armstrong.

Yours ever,

Jane Ridley  
(J E RIDLEY) (MISS)

A J Coles Esq

CONFIDENTIAL

29 APR 1983

MINISTRY OF DEFENCE  
READING WHITEHALL LONDON SW1

1102  
B  
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E T C



Defence Budget Pt 9



10 DOWNING STREET

cc: HO

R. Jackson

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27 April, 1983

From the Private Secretary

Statement on the Defence Estimates 1983

Following the discussion at OD on 18 April, the Prime Minister has looked again at the draft Statement on the Defence Estimates. She is content with the draft in general but would be grateful if the following points could be considered.

The last sentence of paragraph 104 may be regarded as too sanguine, given the motivation which appears to underlie the Soviet military programme. The sentence might be redrafted as follows:

"Only if they are faced with a resolute approach may they eventually be brought to recognise that a balanced agreement ...."

With regard to paragraph 111 it is perhaps questionable whether the accession of Spain to NATO is evidence of the Alliance's "continuing vitality". Perhaps the penultimate sentence of that paragraph could read: "1982 saw the accession of Spain, the sixteenth member of the Alliance ....."

The reference in paragraph 115 to "the maintenance of adequate forces" as being necessary to deter aggression in the Falkland Islands might invite criticism of the Government's actions prior to the Argentine invasion last year. Could the second and third sentences of the paragraph be re-drafted as follows:

"But above all it made abundantly clear that successful deterrence rests crucially on the perceptions of a potential enemy. The Argentine Government miscalculated our ability and resolve to defend our territory and our people. The result was war."

It might also be useful to insert an additional sentence before the penultimate sentence of paragraph 115 as follows:

"Nor

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"Nor by the same token should we fail to carry through measures which we and our allies have judged necessary to maintain the effectiveness of our common defence."

As to the "essay" on NATO strategy, the Prime Minister thought that paragraph 7 was rather over-elaborate and might with advantage be recast to emphasise the essential point about deterrence along the following lines:

"NATO's possession of nuclear weapons for deterrence does not make their use, and therefore nuclear war, more probable. Rather by deterring attack, it makes any kind of war - but especially nuclear war - less likely. Its sole purpose is to keep the peace. It may not seem an attractive way of doing so; but in an age in which nuclear weapons exist and cannot be disinvented it is the surest way we have. It has worked for more than 30 years and there is no reason why it should not continue to do so."

In the chapter on Nuclear Forces, the penultimate sentence in paragraph 202 may be open to misunderstanding. Perhaps it could read:

"Moreover, effective deterrence requires that NATO must be seen to have a credible response to Soviet aggression at any level - conventional or nuclear."

It would be useful in paragraph 206 to underline the importance of a US capability to counter SS20s. This could be achieved by amending the third sentence of that paragraph as follows:

"This takes no account of the Alliance's need for a modernised American capability in Europe to deter the modernised Soviet intermediate range capability which the SS20 represents. It also ignores the fact that the British systems which the Russians want to treat as matching theirs are sea-based, independent, strategic systems, which provide a 'last resort' deterrent and thus have a completely different role from the land-based Soviet SS20s."

The Prime Minister believes that it may well be necessary to include in paragraph 210 of the White Paper a reference to the arrangements for joint decision on the use of Cruise missiles based in this country. But it will not be possible to decide upon the wording of this reference until nearer the date of publication.

As to the essay "Nuclear disarmament: Alternative Approaches" the language towards the end of paragraph 3, raises too clearly, in the Prime Minister's view, the possibility that NATO might have to use nuclear weapons. Perhaps the following could be considered:

/"NATO



"NATO can have no similar confidence in Soviet motivation nor, in the light of the conventional imbalance, can the Alliance be confident of deterring any Eastern aggression by its conventional forces alone. Without the deterrent of possible first use of nuclear weapons by NATO, the Soviet Union might be prepared to risk a conventional attack. NATO for its part has foresworn the first use of any form of force. Experience teaches us to be wary of Soviet undertakings of this nature: the Soviet invasions of Afghanistan and Czechoslovakia ....."

In paragraph 4 of the same essay the Prime Minister was inclined to think that the passage from "Indeed the Palme Commission" to "differences of geography" is rather too specialised for the average reader of the White Paper but will be happy for the Defence Secretary to decide on its retention or otherwise, in the light of the promotion by the Social Democratic Party of ideas of this kind.

Finally, the Prime Minister would prefer that the essay "The United States Forces in the United Kingdom" did not include a reference to the Attlee/Truman and Churchill/Truman agreements. We shall be referring to these in the context of nuclear weapons, and to do so in another context could confuse the issue.

I am copying this letter to the Private Secretaries to other members of OD and to Sir Robert Armstrong.

Richard Mottram, Esq.,  
Ministry of Defence



Foreign and Commonwealth Office

London SW1A 2AH

26 April 1983

*Dear Richard,*Statement on the Defence Estimates 1983

Following their discussion of this year's Defence White Paper on 18 April, members of the Defence and Overseas Policy Committee were asked to send to the Defence Secretary further proposals for amendment of the draft White Paper.

We have already informed DS 11 (in the enclosed letter of 19 April from Defence Department) of a number of amendments which we should like to see incorporated in the draft. We believe that these are important and hope that they will be accepted.

The Lord Privy Seal has already commented (in a letter of 19 April to the Defence Secretary) on the difficulties in presenting the Government's case on 'No First Use' of nuclear weapons and, given OD's remit that we should try to ensure that material in the White Paper cannot be used out of context to support criticism of government policies we agree on the need to look again at para 3 of the essay 'Nuclear Disarmament: The Alternative Approaches'. I would suggest replacing this with something on the lines of the enclosed draft which draws on a line we have been taking in public and which has been cleared with MOD officials in the past.

I am copying this letter to John Coles and to the Private Secretaries of other members of OD.

*Yours ever,  
Brian*

(B J P Fall)  
Private Secretary

R C Mottram Esq  
Private Secretary to  
Minister of Defence

'The NATO Heads of Government made a promise at their meeting in Bonn in June 1982 that no NATO weapons, nuclear or conventional, would ever be used except in response to attack. A declaration of 'no first use' of nuclear weapons would not reduce the chance of war, but in fact increase the risk, for the following reasons; NATO is confronted by massive Warsaw Pact conventional forces. In foreseeable circumstances, therefore, there could be a temptation for the Russians to threaten to fight a successful limited war in Europe which, they might gamble, need not provoke the Americans into using intercontinental nuclear weapons. NATO policy is to ensure that the Russians could never be certain that they would be able to fight a limited war in Europe. If NATO were to make a 'no first use' declaration it would risk removing the uncertainty in the Russians' minds and thereby greatly increase the risk of their being tempted into a conventional attack on Europe. They would also be in a far stronger position to limit our freedom by threatening such an attack. This does not mean that NATO are in any sense committing themselves to any decision in principle to use nuclear weapons first if they found themselves losing a conventional war. It means that would be wrong, in the interests of preventing war, to volunteer to renounce the option.'

D Petch Esq  
DS 11  
MOD

DPN 060/2

20 APR 1983

Your reference

Our reference

Date 19 April 1983

*Jim Smith,*

STATEMENT ON THE DEFENCE ESTIMATES 1983

1. When we spoke on the telephone earlier today I mentioned that Mr Onslow was briefed to make four points during this afternoon's discussion in OD of the draft White Paper. You may find it helpful if I were to record them. They are as follows:

(a) paragraphs 104 and 206 of the draft suggest that the Russians have made more of a concession than is the case in the INF negotiations. Richard Gozney of Defence Department has discussed this with DS 17, who have, I gather, agreed that some amendment should be made. I believe that they may have discussed appropriate language to take account of the point. Perhaps this might best be done by re-drafting the 9th, 10th and 11th lines of paragraph 104 to read, "They have more recently made new offers, the details of which are discussed further in chapter 2", and by deleting the second half of the next sentence ("But they nevertheless .... can be achieved"). The 5th sentence of paragraph 206 might then be amended to read: "However the Soviet Union has now at least shown signs of a recognition of the special nature of INF missiles". In the penultimate line of that paragraph, "for any" read "(a)".

(b) The reference in paragraph 202 to the Warsaw Pact proposal for a non-aggression pact is too harsh. The language needs to be moderated. A formulation was suggested in paragraph 2(m) of my letter of 28 March which should meet the bill.

(c) We believe the arguments against limited nuclear weapon free zones in Europe, in the essay of nuclear disarmament, should be strengthened by refuting the widespread claim that they would raise the nuclear threshold. This point was made in paragraph 2(t) of my letter under reference. Again, I believe Richard Gozney has discussed wording with DS 17.

(d) We are unhappy about the reference in paragraph 402 to a 4% annual real increase in Soviet military expenditure. Our understanding, based on a recent CIG meeting (at which representatives of the defence intelligence side of the MOD were present) is that the UK defence intelligence experts believe the figure to be no higher than 2% in recent years, and under 3% on average since 1970. We

/recognise

recognise that 4% is the latest agreed NATO figure but it could prove to be a hostage to fortune for us to appear to give it full endorsement. If, nevertheless, you feel obliged to retain the 4% figure, it might perhaps be hedged about by opening the second sentence of paragraph 402 with some such phrase as "According to the latest NATO estimate".

2. I note that the third draft of the White Paper does not take account of a number of other points made in my letter of 28 March, namely those at paragraph 2(a), (c), (r), (s) (we note that there has been some strengthening of paragraph 3 of the essay on nuclear disarmament in this respect, but it still does not, in our view, go anything like far enough, and we retain a strong preference for our formulation), and (aa). We should still like to have these incorporated.

3. If any of these points raise any difficulty for you, I should be grateful if we could have a word on the telephone. Otherwise, I assume that you will be able to incorporate them in the draft which goes to Cabinet later this week.

*Yours ac,*

*Howard.*

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H J S Pearce  
Defence Department

Defence: Budget Pt 9

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QUEEN ANNE'S GATE LONDON SW1H 9AT

25 April 1983

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ATL <sup>26</sup>/<sub>4</sub>

Dear Michael

OVERSEAS AND DEFENCE COMMITTEE: 18 APRIL MEETING

— file with A/C.

I have seen a copy of Janet Young's letter of 19 April about the draft White Paper on Defence and would like to endorse what she says.

I fear that to include this paragraph will only lead to a worthless argument with some church leaders. I really think it would be better simply to reserve these arguments for the debate.

I am copying this letter to the Prime Minister and to OD colleagues.

Janet  
Young

DEFENCE: Budget A 9.

26 APR 1983





PRIME MINISTER

DEFENCE WHITE PAPER

You said that you wanted to go through this Paper with Mr. Goodall and Mr. Jackling. An opportunity has been provided at 0930 hours on Tuesday 26 April. You may wish to concentrate on the essay at Flag F on NATO Strategy and the essay at Flag G on Nuclear Disarmament.

Following your meeting I will convey to Mr. Heseltine's office such suggestions as you have for amendment.

A. J. C.

25 April 1983

PRIME MINISTER

Defence White Paper

It was agreed at OD yesterday that those who wished would send the Defence Secretary written notes on his draft. Would you like me to write as in the enclosed letter?

A.J.C.

I need a little more work to answer the question. Could

19 April 1983

! go through it with the Council in the framework of

CONFIDENTIAL

DRAFT LETTER FROM MR. COLES TO RICHARD MOTTRAM IN THE MOD

DEFENCE WHITE PAPER

It was agreed at OD on 18 April that those members of the Committee who so wished should send written comments to your Secretary of State about the present draft.

The Prime Minister considers that the various sections of the White Paper which are concerned with the role of nuclear weapons ~~and~~ <sup>in</sup> deterrence need to be considered carefully with a view to their likely impact on the present public debate about nuclear issues. Statements which would normally have attracted little attention may, in the present climate, be seized upon to fuel the arguments of the Opposition Parties or of CND.

[Flag F] The Prime Minister has a number of comments on the essay on "NATO Strategy". The second sentence of paragraph 7 states that because the West and the Soviet Union now have accurate intermediate range nuclear forces, any attempt to use these weapons in a limited war fighting role would involve a high risk of retaliation and escalation to the strategic level. Does this not invite the comment that, if this ~~risk already exists~~ <sup>is already the situation</sup>, there should be no need to modernise existing INF? Furthermore, in the light of my paragraph 1 above, perhaps language should be found which does not emphasise so clearly the risk of escalation.

In the next sentence should the reference to "broad parity" be qualified by "between the Soviet Union and the United States"? Then, in the next sentence, is it correct to imply that nuclear war was more probable 20 years ago (when the United States had clear strategic superiority) than it ~~has~~ <sup>is</sup> now?

Paragraph 210 of the draft will need further consideration in the light of possible developments before the publication of the White Paper. But you may care to consider rewording the sentence, "cruise missiles would only be used after a joint decision by the two Governments at the very highest level". In view of the considerations in paragraph 1 above, perhaps this

/ could read:

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could read: "the purpose of cruise missiles is to deter, and therefore not to be used - the understanding provides that they cannot be used without a joint decision by the two Governments at the very highest levels".

[File 6] The Prime Minister also had some comments on the essay on "Nuclear Disarmament: The Alternative Approaches". In the seventh sentence of paragraph 3, the wording could be read as implying that any Eastern aggression would have to be met by nuclear response. The following sentence, with its reference to possible first use of nuclear weapons by NATO, might also attract controversy in the present climate.

As regards the section on Nuclear Weapon Free Zones (paragraph 4), the Prime Minister doubts whether we should imply that this idea is attractive, albeit superficially. The last sentence of this paragraph might be a hostage to fortune in that the case for some formulations of the NFZ concept is perhaps rather stronger than it implies. There has, for example, as you know, been a good deal of discussion about the vulnerability of nuclear warheads situated close to the inner German border and their limited military utility.

I am copying this letter to the Private Secretaries to the members of OD and to Sir Robert Armstrong.

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C.C.R.T.

FROM THE LEADER OF THE HOUSE  
HOUSE OF LORDS

19 April 1983

The Rt Hon Michael Heseltine MP  
Secretary of State for Defence  
Main Building  
Whitehall SW1

N.B.P.N.

M 4/4

Dear Michael,

OVERSEAS AND DEFENCE COMMITTEE: MEETING APRIL 18

*attached* You asked colleagues to put in writing any points they had on the draft White Paper on Defence.

My concern is on the paragraph headed 'No First Use of Nuclear Weapons' in the essay 'Nuclear Disarmament: Alternative Approaches' (page 2-11). It is of course a matter of political judgement whether or not to include this paragraph in the essay and I fully support the other paragraphs which answer arguments frequently advanced in the whole nuclear debate. But on the particular paragraph we are talking about a hypothetical situation: that is, what would happen if the Soviet Union attacked, using conventional weapons. Whereas the whole point of the nuclear deterrent is that it deters, and that nuclear weapons have kept the peace since 1945.

In a sense, therefore, we weaken the argument by suggesting that nuclear weapons may not keep the peace. Furthermore I am sure that we do not wish to indicate what might happen if conventional war did break out, and therefore the arguments cannot, and should not, be fully set out.

I raise these points because I feel sure that this whole section of the White Paper will be examined in great detail by all those opposed to our policy of nuclear deterrence.

I am copying this letter to the Prime Minister and to other colleagues on OD.

Yours ever

Baroness

BARONESS YOUNG

Reference: Estimates Pt 9



20 APR 1983

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*Defence*

Ref: B06761

PRIME MINISTER

c Sir Robert Armstrong

Statement on the Defence Estimates 1983

## BACKGROUND

The draft White Paper which the Defence Secretary has circulated as OD(83) 5 follows the pattern established over the past three years. As the Defence Secretary says, it is a general review of our defence effort rather than a major new statement of policy. Its main themes are the case for NATO's policy of nuclear deterrence and for the multilateral approach to arms control and disarmament. It starts with a chapter covering developments in East-West relations, progress in the various arms control negotiations and the role of United Kingdom forces. Chapter 2 then describes NATO's nuclear forces with particular emphasis on intermediate range nuclear forces (INF) modernisation. The remaining chapters cover equipment, the military balance between NATO and the Warsaw Pact, financial and organisational matters, and the relationship between the services and the community. A corrigendum amending paragraphs 502 and 503 has been circulated following discussion between the Treasury and the Ministry of Defence: these paragraphs are now agreed by both Departments. The volume of statistics is being circulated separately.

2. I understand that the Defence Secretary intends to publish in mid-May.

3. The Minister of State, Department of Industry (Mr Lamont), in the absence abroad of the Secretary of State, and the Chief of the Defence Staff have been invited: the Chancellor of the Exchequer is unable to be present as he will be away at a Finance Ministers' Meeting in Luxembourg. The Chief Secretary, Treasury, will attend.

## HANDLING

4. You should invite the Defence Secretary to introduce the draft White Paper, and then invite general comments, particularly from the Foreign and Commonwealth Secretary and the Chief Secretary, Treasury.

5. The draft White Paper contains a paragraph (210) dealing with the control of United States nuclear weapons based in this country, which appears in square brackets. I understand that the Ministry of Defence have shown this paragraph to the Americans, who have objected to some of the proposed language. Meanwhile you have sent President Reagan a personal message on this issue. It would be best to avoid substantive discussion in the Committee: you might inform them that the Government is engaged in consultations with the Americans about what might be said in public, and that meanwhile it would be better if this paragraph were omitted from the White Paper.

6. The Committee will wish to focus particularly on the passages dealing with nuclear weapons and arms control, especially the essays inserted in the text on NATO strategy (pages 1-11 to 1-15) and on nuclear disarmament (pages 2-10 to 2-15). Other passages of general interest are those dealing with activities outside the NATO area (paragraphs 340 and 341) the Falklands garrison (paragraphs 343 and 343) and the essay on United States forces in the United Kingdom (pages 3-22 to 3-25): in this latter essay there is an important paragraph (paragraph 7) dealing with the argument that the presence of American forces in this country increases our chances of becoming a target in war. It could be argued that the language rather overstates the chances of Britain being a target when it says that it would be a target "in any conceivable conflict affecting Western Europe". There is no doubt that the presence of United States bases here increase the number of targets which would be attacked in all out war: the point to get across is, of course, that the presence here of United States forces reduces the risk of any form of war breaking out. To make this clear, it might be worth adding a sentence at the end of paragraph 8: "So far from putting the United Kingdom at greater risk, the presence here of United States forces is a vital element in ensuring that war does not break out".

7. Chapter 4, on the military balance, includes a paragraph (402) dealing with Soviet military expenditure. The second sentence says that "since 1970 this has risen by an average of 4 per cent a year in real terms". The intelligence evidence now suggests that this figure is too high, and there were press leaks in Washington a few weeks ago to the effect that the CIA had recently revised its figures for the growth

Can we get away with saying nothing? You may wish to consider again, in a smaller meeting, when we have the President's reply.

A.J.C. 15.  
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rate in Soviet defence expenditure downwards, and now believed that in recent years it had not exceeded 2 per cent. The JIC will be considering a fresh assessment shortly. Four per cent is, however, still the current agreed NATO figure, and paragraph 402 would be accurate if it were amended to read "NATO's current estimate is that since 1970 this has risen by an average of 4 per cent a year .....".

CONCLUSION

8. Subject to the discussion, the Committee might be guided to agree that the White Paper, taking account of any points made in discussion, should be circulated to the Cabinet for discussion on 28th April and thereafter, subject to Cabinet agreement, published in mid-May.

14th April 1983

*David Goodall*

A D S GOODALL

CONFIDENTIAL



MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000  
DIRECT DIALLING 01-218 2111/3

MO 26/16/1

11th April 1983

N. B. P. R.

A. J. C. 4/4

EH 101

Thank you for your letter of 24 March. I note what you say and am grateful for the approval you have given. My officials will keep yours closely informed of the progress of events on the Italian side.

I very much support Patrick Jenkin's comments in his letter of 30 March about the insufficiency of your figure of £26M as an offer for launch aid. There is inevitably interaction between the funding arrangements for the various elements of an integrated programme such as that proposed for EH101, and I fear that an unrealistically low offer of launch assistance on the commercial side could well lead Westlands to withdraw from the incentive contractual arrangements which we on the Defence side have been negotiating, with Treasury and DOI support, or to demand a higher safety factor by increasing the level of the target price. Since in the development phase the block of work covered by these incentive provisions includes the basic technology items common to all versions of the helicopter the loss of this spur to efficiency on the part of the company would in my view be detrimental to the Government's overall interests in the programme.

-1-

The Rt Hon Leon Brittan QC MP

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I accept of course that what constitutes an appropriate level of launch assistance is primarily a matter for you and Patrick to decide. I simply wish to make the point that if we are not careful we shall find ourselves attempting to secure one advantage at the expense of another of equal or greater value: what we need is a reasonable overall balance.

I am copying this letter to the recipients of yours.

*Yes Sir*  
*[Handwritten signature]*

Michael Heseltine

DEFENCE  
Budget Pt 9.

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JF3114  
Secretary of State for Industry

DEPARTMENT OF INDUSTRY  
ASHDOWN HOUSE  
123 VICTORIA STREET  
LONDON SW1E 6RB  
TELEPHONE DIRECT LINE 01-212 3301  
SWITCHBOARD 01-212 7676

30 March 1983

The Rt Hon Leon Brittan QC MP  
Chief Secretary  
HM Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

N. S. P. R.

A. J. C.  $\frac{31}{3}$

P. C.

Dear Leon,

EH101 LAUNCH AID

I am glad to see from your letter of 24 March that you agree that the EH101 is a viable programme and that some launch aid is justified. Yet I am very disappointed to find that you have heavily discounted the arguments I advanced for a realistic opening offer to Westland.

2 Against the background of the Westland 30 launch aid arrangements I think you are being unrealistic in believing that Westland should be able to make do with £26m, ie 12.5% of their estimated costs. At the MISC 25 discussion last month the majority opinion, shared by the CPRS, was that we should aim to agree launch aid support in the region of 50-75% of that being sought by the company, and that our opening offer should be 50%. As Michael Heseltine has pointed out, under-financing the programme is the surest way of condemning the EH101 to failure, and, I think, of ensuring we do not get any return on the taxpayers' money.

3 In the meantime, we are losing valuable time and I have therefore instructed my officials to open negotiations with Westland to find out whether your figure of £26m is as you put it a feasible option. If not we shall need to get back to you very promptly, particularly since your fall-back proposition - that a 12.5% contribution towards the costs of this commercial programme entitles HMG to a five per cent real rate of return, but that a 25% contribution (ie £53m) demands a real return of ten per cent - will require careful consideration if we are not to find ourselves changing the nature of launch aid.

44 Meanwhile ...



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4     Meanwhile, in the light of paragraph 4 of your letter of 24 March to Michael Heseltine, I consider it appropriate to respond positively to a fresh invitation by my Italian counterpart, Signor Pandolfi, to visit Rome towards the end of next month to sign a conditional Memorandum of Understanding.

5     Although my Department has no PES provision for any new launch investment I will, of course, examine the extent to which it may prove possible to absorb the additional expenditure from my existing PES provision. But I am sure you will understand that, as we agreed at our PES bilateral last September, I must reserve the right to press for access to the Contingency Reserve if necessary when we see the outcome of negotiations with Westlands.

6     I am copying this letter to recipients of yours.

*You are*  
*Rattee*

Release : Budget : 199.

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MAY 1983

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MAY 1983



Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Michael Heseltine MP  
 Secretary of State  
 Ministry of Defence  
 Main Building  
 Whitehall  
 London SW1A 2HB

N. S. P. R

AR 25/3

24 March 1983

*Michael,*

THE EH101 MEDIUM HELICOPTER

Thank you for your letter dated 15 March. I have also seen, and will be responding to separately, Patrick Jenkin's of 11 March.

Your detailed explanation of the defence operational case for this helicopter was helpful. I note that there is provision in the Long Term Costings for the full, estimated, MOD development and production costs. However, this is a major new project, with significant industrial and international interest and a large degree of risk, financial and otherwise. I would have found a collective discussion, perhaps in OD, useful; but if the others to whom your letter was copied are content, we can try to cover the defence issues in correspondence.

My first comment is on cost. I note your assurances that all potential alternatives have been explored, but fall far short of the RN's needs in the critical and essential anti-submarine role. I note also that the defence costs would be significantly higher without collaboration and the contribution expected from civil programme. But £1,100 million at current prices is a very expensive way of acquiring just 50 helicopters, whatever their capability. Even at this early stage, development is forecast to cost as much as production. Last year's Defence White Paper (Cmd 8529) comments unfavourably on the fact that, in the UK, projects generally start with a production to development ratio of 3:1 or 4:1 but, as development progresses and unforeseen costs rise, the ratio deteriorates to around 2:1. A major project which starts development with a ratio of 1:1 requires very careful consideration. I am sure that it will be given plenty of public attention over its life.

You mentioned the Treasury's concern about the Italian position. Neither I nor Treasury officials found the Italian Prime Minister's



comments odd. Rather, they sounded like a prudently cautious extract from an official brief which advised Signor Fanfani that he could not guarantee acquiescence of the Italian Parliament. Nor am I surprised that the Italian Defence and Industry Ministers should have struck a more optimistic note than their colleague. My main concern is that no action should be taken that could have the effect of reducing the UK's room for manoeuvre, or increasing its potential liability, should the timetable slip further. If you and Patrick Jenkin are convinced that signing a conditional inter-DOI MOU would not carry such risks, as well as being advisable tactically, I would not object.

I note that you are seeking approval for the UK defence budget share of the programme cost only on the basis that all of the other participants - the Italian MOD, the two Departments of Industry and Westland and Agusta - can also proceed. On the assumption therefore that a satisfactory agreement can be reached with Patrick Jenkin and Westlands on civil launch aid, and that the other colleagues to whom you copied your letter have no comment, I would have no objections to your indicating to the Italians that the UK would be in a position to launch full development as soon as their procedures were complete. If any of the partners were unable to proceed we would certainly need to look again very closely at this project, and I welcome your assurance that you would return to me and colleagues with fresh proposals. There must also be a risk of substantial further slippage and I would hope that in such circumstances you would also keep the cost-effectiveness of your proposals under review.

I have instructed Treasury officials to give yours the conditional approval that you seek on the normal basis.

Copies of this letter go to the recipients of yours.



LEON BRITTAN

24 MAR 1983





Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Patrick Jenkin MP  
Secretary of State  
Department of Industry  
Ashdown House  
123 Victoria Street  
London SW1E 6RB

N. L. P. R.

ML 45  
/ 3.

24 March 1983

*P. Patrick,*

EH 101 HELICOPTER PROGRAMME

Thank you for your letter of 11 March about the civil aspects of this programme. I have also seen and am replying separately to Michael Heseltine's letter of 15 March about the defence aspects.

I agree that this is a viable programme and some launch aid is justified but I believe that the negotiations should be within a lower range than the one that you propose. My agreement to some launch aid would be conditional on the money being found from within your existing PES provision. I could not accept a claim on the Central Contingency Reserve for the sums involved.

I have studied the attachment to your letter which argues that an agreement with the company should be reached at a figure between £53 million and £79 million. I believe that a sum of £26 million should be sufficient. It would involve breaches of the ratios that Westlands have set themselves as internal targets during some years but those ratios are ultra-cautious and the company's profit forecasts are similarly cautious. The company is in the risk business and should be prepared to accept some deterioration from the ideal for the prospect of large future profits.

For these reasons I think that Westlands should be satisfied with launch aid of £26 million which would mean that the company would not make any contribution towards the project until 1986. I believe that our negotiators should try very hard to achieve this figure. If, however, it proves impossible to reach agreement at this figure I would be prepared to accept some upward movement provided that the increase in aid was matched by an increase in the real return to the Government. The most that I could accept would be launch aid of £53 million accompanied by a 10 per cent real rate of return, but before doing so, I would need to be persuaded that a lower figure was not a feasible option. In any event the funds would have to be from within your existing PES provision.

I am copying this letter to the recipients of yours.

*2 ew*  
*Leon*  
LEON BRITTON

24 MAR 1968





FCS/83/58

SECRETARY OF STATE FOR INDUSTRY

Await  
Chief Secretary's  
response

Do

EH 101 Helicopter

1. Your letter of 11 March to Leon Brittan mentions that officials have recommended development of the military and civil versions of the EH 101 helicopter. As I minuted to you on 25 November, I support this project and see it as a valuable expression of Britain's interest in working with the Italians in a practical way.

will request  
if required

2. I think it important that we now make the final arrangements with the Italians as soon as possible. On the civil side they have had funds available for some time, and, after the encouraging comments we made at the recent Summit, can justifiably expect us to reach a decision quickly. I therefore hope that it will be possible for you to visit Rome soon to sign the confidential Memorandum of Understanding. Signor Fanfani's officials have told us that this would be helpful to him in piloting through the Chamber of Deputies legislation necessary to authorise, in turn, the military version. British and Italian Ministries of Defence would then be able to sign their Memorandum of Understanding.

3. This argues for a realistic approach to negotiations with Westland on launch aid terms. It is, I understand, accepted by officials that Westlands will in due course be able to meet a 5% return on launch aid at the levels you suggested in your letter. I agree with you therefore that our opening bid should not be so low as to stop negotiations in their tracks. EH 101 is a good project which both HMG and the company want to launch, and the sooner the negotiations are completed the better.

/4.

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4. I am copying this minute to the Prime Minister, Michael Heseltine, Leon Brittan, Arthur Cockfield and Norman Tebbit. Copies are also being sent to Sir Robert Armstrong and John Sparrow.

FP

(FRANCIS PYM)

Foreign and Commonwealth Office

21 March, 1983

CONFIDENTIAL

DEFENSE  
A-9 Aug 82  
Defense budget.

21 MAR 1982

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Defence  
Budget

p/9



BF

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000  
DIRECT DIALLING 01-218 2111/3

MO 26/16/1

15th March 1983

Await Chief Secretary

reply.

A.F.C. 15/3

THE EH101 MEDIUM HELICOPTER

In his letter of 11th March Patrick Jenkin mentioned that I would be writing to you with further details of the Defence case for this Project. With his letter Patrick forwarded the draft paper prepared by his officials and mine against the possibility of collective discussion, together with annexes setting out in greater detail the commercial case and estimated programme costs. To complete the picture I am now sending you the draft annex dealing with the defence aspects.

It seems to me that the papers make it apparent that the defence case is strong, clear and, I believe, uncontroversial. I also fully support Patrick's proposals for launch investment. In the light of the positive approach adopted by the Prime Minister in her recent discussions with Signor Fanfani, and of the general support of Misc 25 for the commercial proposals, I now seek your agreement to the defence elements of this integrated naval/commercial programme.

The Rt Hon Leon Brittan QC MP





In doing so I would like to highlight a few points. EH101 breaks new ground in bringing together the resources of Government and private industry in a programme aimed equally at meeting defence needs and at maximising exports. The potential benefits of this approach are very substantial and I hope that EH101 will be the forerunner of similar projects in future. But it is very much a trial horse - if it is not a success the chances of launching similar projects will be seriously reduced. I believe that the surest way of condemning EH101 to failure would be to over-manage and under-finance it. We on the Defence side have therefore adopted a flexible approach to management, giving more responsibility to industry. We have also arrived at funding arrangements with Westlands which represent a sensible balance between incentive to efficiency and adequacy of funding in the light of the firm's financial prospects.

My second point concerns the Italian position. I understand that your officials are concerned that Signor Fanfani's rather odd reference at the post-Bilateral press conference to the "enormous workload" on Italian MPs might presage some change of heart on the Italian side. In addition I gather that there is some scepticism in the Treasury that an early UK decision would speed up the decision-making process in Italy. I can only say that in my own discussions Signor Lagorio was at pains to emphasise the Italian Government's firm commitment to securing parliamentary approval for the defence funding of EH101, and he confirmed that he expected Senate approval - the major hurdle - shortly. The proposals will then go to the Chamber of Deputies and subsequently to a special "legal" committee. We have to recognise that in Italy the government of the day has less direct control over the scheduling of parliamentary business than we do, and that more is done by governmental and industrial lobbying than is the case at Westminster. That is why Patrick Jenkin and I are anxious to secure an early decision on the UK side in order to bring the maximum possible pressure to bear upon the Italian system.



As to costs, the papers attached to Patrick's minute set out the estimated overall costs of the project, the UK share, and the division of that share between MOD and industry. The calculations are not straightforward - principally because of our need to make provision for the RN's mission system requirements, which were excluded from the companies' figures, and also because of our judgement that it would be prudent in the light of past experience to include allowances for contingencies for our own budgetary purposes. Taking account of these factors we estimate the cost to MOD of our share of the development phase, at September 1982 economic conditions, to be £348.5M VAT exclusive, equivalent to £393.5M inclusive of VAT. It is the latter figure for which I am now seeking your approval.

For completeness, you will wish to note that we expect the cost to MOD of subsequent phases, again at 9/82 prices and including contingencies, (but exclusive of VAT to facilitate comparison with the attached papers), to be as follows:

	<u>£M</u>
Production investment	38.6
Production of 50 aircraft	411.7
Initial support and training	158.9


These figures have to be seen in the context of the critical importance of Anti-Submarine warfare to our defence and the essential role which surface ships like the new Type 23 and their helicopters will play in our ASW effort. We have carefully looked at all potential alternatives, particularly the American Sea Hawk, and the possibility of up-rating the Sea King, but all fall far short of the RN's needs, which are met by EH101. The proposed programme will cost some £111M less than would a collaborative purely naval project and provision has been made for it in the Long Term Costing.



I should make it clear that the approval I am now seeking is strictly related to the UK MOD's share of the cost of the programme described in the attached papers - that is, with participation by the Italian MOD, the two Departments of Industry, and by Westland and Agusta. Should one or more of our partners be unable to proceed I would come back to you and colleagues with fresh proposals.

To summarise, I am most anxious that development of EH101 be launched as soon as possible. There has already been slippage - if Italian procedures can be completed in time to permit development launch by the end of July, the RN's first operational squadron should form in November 1993, almost a year later than called for in the Naval Staff Requirement. This delay will cause highly unwelcome operational penalties; and I share industry's view that the commercial versions must be available at the earliest possible time in order to maximise market penetration. There is no cost-effective means of significantly advancing in-service dates by shortening the development programme and it is essential that we make an early start. I very much hope therefore that you will feel able to give the approval to development on the basis proposed.

I am sending copies of this letter and its attachments to the Prime Minister, Francis Pym, Patrick Jenkin, Norman Tebbit, Arthur Cockfield, Robert Armstrong, and John Sparrow.

Yours  
lhw  


Michael Heseltine

## EH101 - THE MOD POSITION

1 The Royal Navy has a requirement, approved by the Operational Requirements Committee, for a new medium helicopter which will progressively replace the Sea King in the anti-submarine warfare role in the early 1990s. Anti-submarine warfare is going through a period of substantial advance: new sensors are being developed which will be fitted in frigates (modified Type 22 and the new Type 23) and which will detect submarines at very much greater ranges than conventional sonars. To take advantage of this increased performance a helicopter is needed which will possess greater endurance than Sea King while carrying on a significantly better on board sonics system.

2 A key additional feature of the requirement is that the new helicopter must be able to operate from ships of frigate size in the poor weather and rough sea conditions frequently experienced in the North Atlantic: Sea King can only operate from such small ships in relatively good conditions. In simple terms, therefore, the Navy needs a helicopter of Sea King size, with better endurance and avionics, but with the agility of the Lynx. EH101 meets this requirement.

3 The MOD has, however, a strong interest in keeping down costs: earlier, national, projects such as WG34 were rejected as being too expensive. As a step in this direction, collaboration was established in 1979 with Italy, whose Navy (MMI) has a requirement for a helicopter with a very similar performance to that needed by the RN, although the MMI would use a different sonics system matched to their operations in the Mediterranean. A joint Project Definition Study was completed last year by EHI Ltd, the joint company established by Westland and Agusta, under contract from the UK and Italian MODs. At both official and industrial level collaboration is working well.

4 This joint Project Definition work was successful in producing a design which meets the needs of the two Navies. It has been tailored to provide a sensible balance between performance and risk and cost. The airframe employs new techniques, such as composite fibre materials and CRT cockpit displays, where these have been sufficiently tested and their application is advantageous. Use of the well proven General Electric T700 engine is proposed (though the RTM 322 would be considered if it were proven in time and offered cost advantages); and in the RN version the sonics system will be an evolution of the well-tried Nimrod system.

5 However, the search for economy has not stopped there. Both the MODs and industry were anxious that the commercial possibilities of the new helicopter should be fully exploited. During Project Definition an independent market survey commissioned by

industry showed that very good sales prospects exist for passenger, utility and export naval versions of the helicopter whose design was emerging. Studies also showed that many important elements of the design could be common to all versions. So was born the concept of the integrated programme.

6 It is important to recognise that the integrated programme does not represent a shotgun marriage of potentially incompatible partners. The market for the commercial versions exists in the same timescale as our own and the Italian navy's requirements. Using the same dynamic system - essentially the heart of a helicopter - for the complete range of naval and commercial versions, and maximising commonality elsewhere, makes good engineering sense as well as financial sense. By developing the naval and commercial versions in an integrated programme, based upon the same technology core, commonality can be built in at the design stage wherever possible, and duplication of effort can be avoided by such means as the read-across of structural and flight testing results. Such a programme offers valuable benefits to both defence and commercial interests at all stages from development through to in-service support.

7 It has been realised from the outset that such a programme, in which neither military nor commercial interests dominate, requires some adjustment of attitudes on the part of both MODs and industry. MOD have accepted that they cannot run the project as they would a purely military, wholly MOD-funded programme; likewise, industry recognise that they have to take proper account of the interests of the MODs who are, as well as being contributors, also substantial early potential customers with a requirement for some 88 helicopters (50 RN: 38 MMI). MOD are therefore proposing to give more responsibility to industry for the day to day running of the project than would normally be the case, though MOD will, of course, need to be kept fully up to date with what is going on. Common problems will be resolved by discussion with industry. As a safeguard, however, MOD are negotiating contract conditions which will place an incentive upon industry to control the costs of the naval elements of the programme as well of those of the commercial elements.

8 The funding arrangements for the UK share of the integrated programme have occupied a great deal of attention over the past months. MOD were of the view that the right arrangement was for industry and the MOD to share the costs of the common technology work equally as they arose, with each side additionally funding the further work of direct interest to it. After considerable discussion, however, MOD accepted that, whatever the merits of this proposition in principle, Westland were in no position to finance their share of it in the short term. A compromise arrangement has therefore been arrived at under which MOD would fund the UK share of the common basic and common naval development work up to a target price based upon the development cost plan (DCP) estimate; any excess costs would be shared in the ratio 70% MOD: 30% Westland. A converse arrangement would apply to production investment. MOD regard this arrangement as meeting their objective of placing an incentive

upon the company to control costs in the naval area, while at the same time being realistic in relation to the company's forecast cash flow position.

9 The fact that MOD's financial contribution to the integrated programme will, unlike that of DOI, not be a fixed sum leads us to a different approach to estimating costs for approval and budgetary purposes. On EH101, as on other projects with which we deal, there are essentially 3 levels of estimate involved:

- (a) the firm's DCP figure, which in the case of EH101 (and this is not unusual) assumes a high degree of first-time success at the design and testing stage;
- (b) our own Directorate of Project Time and Cost Analysis (DPTCAN) estimate of "mean probable outturn", which is arrived at by a line by line analysis of the DCP making allowances for re-work or exclusions on the basis of experience with other projects;
- (c) DPTCAN's "unlikely to exceed" estimate, which is the figure at (b) above, but with addition of a block contingency allowance.

It is on the basis of (c) above that we seek financial approval and make budgetary provision. This practice has been followed for EH101 and explains why MOD's estimates are higher than Westland's. An explanation of the different figures is at Annex B.

10 One aspect of the EH101 programme which is of increasing concern to MOD is timescale. The Naval Staff Requirement calls for the first operational squadron to be formed in 1992, which could have been achieved if development had been fully launched, as hoped a year ago, by June or July 1982. In the event it has taken much longer than expected to finalise the arrangements for the project, while on the Italian side the finance bill, which will provide funds for their MOD's contribution to the naval elements of the programme, has been delayed in its passage through parliament by the government crises of last Summer and Autumn. We are now at a point where passage of the bill by the Senate is expected very shortly which should enable the parliamentary process to be completed by the end of April. If that timescale is met subsequent administrative procedures in Italy should permit development to be launched in July 1983. On that basis formation of the RN's first operational squadron would not take place until November 1983, which would entail highly undesirable operational penalties.

11 MOD consider that the time has now come for the UK to take a firm decision that EH101 should proceed in the proposed form as an integrated programme. Such a programme will never get off the ground if each participant waits for the other to secure the necessary approvals before taking its own decision.

CONFIDENTIAL

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Approval on the UK side will

enable us to bring pressure to bear upon the Italians to avoid further slippage which would increase the operational penalty to the RN's anti-submarine capability and be of advantage to potential competitors in the commercial market.

9 March 1981

-4-

CONFIDENTIAL

18 MAR 1983







Secretary of State for Industry

DEPARTMENT OF INDUSTRY  
ASHDOWN HOUSE  
123 VICTORIA STREET  
LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 3301  
SWITCHBOARD 01-212 7676

11 March 1983

The Rt Hon Leon Brittan QC MP  
Chief Secretary to the Treasury  
HM Treasury  
Parliament Street  
London SW1P 3AG

*Dear Leon,*  
EH101 HELICOPTER PROGRAMME

You will know that officials have been examining in depth the question of Government support for an integrated Anglo-Italian helicopter project namely, the EH101. This is designed to meet the needs of the navies of both Italy and the UK for a replacement anti-submarine warfare helicopter in the 1990s, and at the same time to enable the industrial partners in the proposed project (Westland and Agusta) to tackle what is believed to be substantial additional market for this type of helicopter.

2 In the light of the inter-departmental discussion in MISC 25, I am now writing to seek your agreement to the provision of adequate launch aid for Westland to enable them to go ahead with the development of the civil version of the helicopter, and to meet their share of the other non-recurring costs of the integrated programme. I understand that the Secretary of State for Defence is also now writing to you about going ahead with the development of the naval version of the helicopter.

3 I think you will find that the enclosed paper written in conjunction with the MOD provides all the information needed to reach a judgement on the amount of launch aid which should be offered to Westland. The majority of MISC 25 considered that we should aim to agree launch aid support in the region of 50-75% of that being sought by the company, and that our opening offer should be 50%. Treasury officials, however, reserved your position on the amount of launch aid which could be justified, suggesting that the case for launch aid at half this level should be explored.

4 For reasons which have been spelt out in more detail in the MISC 25 minutes and in the attached paper, I do not believe that it would be at all realistic to try and open negotiations with the company by offering less than 50% of the aid being sought, ie



below one quarter of Westland's total estimated costs. If we are to have a realistic, though rigorous negotiation, this should be based on an opening offer of 50%. Any lesser figure is likely to stop the negotiations in their tracks and make all the more difficult the task of securing our objective of a 5% rate of return on the launch aid sum finally negotiated. If we want Westland and Agusta to make a success of this programme as a whole there is really little point in starving Westland of a reasonable level of support.

5 A decision is now urgent. If the start date is delayed beyond July this will endanger the required in-service date and damage market prospects. Although a UK decision now in favour of the programme must be conditional on Italian defence funds becoming available shortly, such a decision should serve to bring the Italians up to the mark promptly.

6 At the end of the Anglo-Italian Summit the Prime Minister expressed the hope that we should be able to go ahead this summer, the joint development of the EH101 being extremely important to both countries. This will not be achieved unless the Italian Parliament approves the defence funding shortly. The Italian Ministry of Industry has long pointed out that our formal commitment to the joint programme will do a great deal to hasten this approval. My counterpart, Signor Pandolfi, and I therefore expressed the hope during the Summit that we would be able to sign an agreement before Easter covering the civil side of the programme. (The Confidential Memorandum in question will not, of course, be brought into effect until the two Ministries of Defence sign a joint Memorandum activating the development programme; the text also makes clear that the provision of launch aid support is conditional on each company satisfying national criteria for such support.)

7 Although the exact amount of launch aid support cannot be determined until negotiations with Westland are complete, I should remind you that my Department has no PES provision for any new launch investments. I will therefore need to look to the Contingency Reserve to meet any agreed commitment to the company.

8 I am copying this letter to the Prime Minister, Francis Pym, Michael Heseltine, Norman Tebbit and Arthur Cockfield. Copies also go to Sir Robert Armstrong and John Sparrow.

Yours ever  
R  
Faulkner

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## EH101 HELICOPTER PROJECT

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### Introduction

1 In this paper we seek agreement to the provision of financial support for the EH101, an Anglo-Italian project for a new medium sized helicopter. For the first time in the aerospace field this project would bring together government and private venture finance in both the UK and Italy in order to meet domestic naval needs and at the same time attack a substantial commercial market for this type of helicopter. But adequate finance and an early start are essential if the project is to succeed.

### The Proposed Programme

2 Westland and the Italian firm Agusta have been working together for 3 years and the project is now ready to proceed to development. The design concept is that a common dynamic system (rotors, drive and gearbox) will be used in versions for the RN, Italian Navy (MMI) and other navies; for civil passenger transport; and for utility work. New but well tested technology will be used. The RN/MMI and commercial versions will be developed in parallel from a common technology base. This integrated programme approach will (by avoiding duplication of effort in design and

testing, and by maximising commonality) bring economies at all stages of the project from development through to in-service support.

3 In order to meet programme timescales current plans call, initially at least, for American General Electric T700 engines (3 per aircraft) to be used, different models covering particular customer needs. However, launch of EH101 on this basis would not prejudice a subsequent decision on the Rolls-Royce/Turbomeca RTM322 engine, proposals for which are currently being assessed, since it could be introduced later if development were to proceed and the engine proved sufficiently attractive. (Any case for Government support for the 322 must await a full market analysis; a clearer picture of the collaborative arrangements under discussion; and an assessment of the consequences for the UK's small engine capability of the project not proceeding).

4 The RN has a firm requirement for 50 new helicopters to replace the Sea King in the anti-submarine warfare role progressively in the early 1990s. On 23 February the Defence Equipment Policy Committee endorsed the development of EH101 as part of an integrated naval/commercial programme, to meet this need. The MMI has a similar requirement for 38 helicopters in the same timescale.

5 Westland and Agusta last year estimated sales of 1050 helicopters over the period up to the year 2008, including up to 345 civil sales. The companies' estimate is on the prudent assumption that a new competitor will emerge - although none is at present in sight - and that the EH101 will capture no more than one third of the potential market for helicopters in this class. The Defence Sales Organisation estimate of other than civil sales is in the range of 600-700, close to Westland's latest forecast of just under 700 sales. DOI analysts considered that the companies' 1982 forecast of civil sales was rather optimistic and Westland themselves have very recently adjusted their estimate of civil sales downwards to just under 300 in the light of the delayed start to the programme. Sensitivity analyses conducted by the DOI show that even with sales significantly below those originally forecast by Westland the project as a whole would still

produce a healthy internal rate of return. The Westland launch-aid case is described more fully at Annex A.

6 The aim which has been agreed between ourselves and Westlands, and with the Italians, is that work on the programme would be shared equally between the UK and Italy in terms of both value and technological content. This objective would apply to equipment as well as to the airframe itself.

#### Costs and Funding

7 The estimated total cost of development and production investment, and the expected UK and Italian shares of it, are set out in Annex B, Table 1. Table 2 breaks down the UK share between MOD and Industry, reflecting MOD's agreement that, in the light of Westland's short term cash flow limitations, it is prepared to pay for the whole of the UK share of the common technology and common Naval development work up to a target level. Any overrun on development would be shared 70:30 with a converse arrangement on production investment. (MOD would of course pay the whole cost of RN-specific work such as the mission fit). Although the companies' cost estimates are based upon a detailed development cost plan, MOD considers that it would be prudent to add contingencies for its own financial ~~planning purposes~~ and proposes to budget for a development cost of £393.5M at 9/82 ECs (inclusive of mission fit and VAT). Provision for this has been made in Long Term Costings.

8 Because of their heavy financial commitment to the existing WG30 programme, Westland are unable to finance the whole of the UK share of the commercial elements of the project themselves and have sought launch aid of £81M at 1982 ECs (£105M at outturn prices). This represents 50% of Westland's estimate of their share (including a 10% contingency figures) of the non-recurring costs of the project. A meeting of MISC 25 on 24 February concluded that Westland's case was good enough to justify the Government's providing launch aid, though not at the level requested by Westland, and that a 5% real rate of return on such an aid should be sought.

9 A majority of the Committee considered that the aim should be to agree launch aid in the region of 50% - 75% of that sought. The Treasury indicated however that it is not convinced that aid on this scale is justified and wishes the case for only 25% to be explored further. The DOI view is that this would be regarded, justifiably, as totally inadequate by the Westland Board and that a realistic, though rigorous, negotiation should be based upon an opening offer of 50%, with the aim of settling between that level and a maximum of 75% - that is, between £41M and £61M at 1982 ECs (£53M - £79M at outturn prices).

10 Both DOI and MOD believe firmly that an HMG contribution to the cost of EH101 should be pitched at a level which would provide a real spur to efficient management by the companies. But under-financing a project of this nature is likely to severely prejudice its chances of success and prove a false economy.

11 There is a further difficulty in that DOI has no PES provision for any new launch investment projects. Nor could DOI expect to find any off-setting savings to meet the launch aid cost of the EH101. The DOI would need therefore to look to the contingency reserve to enable it to discharge any agreed launch aid commitment.

#### The Italian Position

12 At both Government and industrial level Italian support for EH101 is strong. The Italian Department of Industry already has funds available for launch investment support to Agusta and is anxious to sign an inter-Ministerial memorandum on this aspect of the programme as soon as possible. The Italian MOD, however, is dependent upon a new finance bill for its contribution to EH101 development. This bill has been delayed by successive Governmental crises but its passage is expected by late March/early April. We are anxious to secure an early decision on the UK side in order to bring pressure to bear on the Italians to speed up their processes and avoid further prejudicial delay.

The Benefits

13 EH101 offers a unique opportunity to sustain the UK's very substantial helicopter capability at Westland. The Company's overall strategy must be to reduce its dependence on wholly MOD-funded contracts, an objective which we endorse in the interests of efficiency.

14 Collaboration with Agusta, with its efficient management and good sales record, fulfils a primary DOI objective of encouraging international collaboration in the aerospace field to spread risks and costs, and to widen market opportunities. The companies are well matched and will form a very powerful European grouping to compete with the Americans.

15 The UK share of the proceeds of forecast sales (including spares) would amount to more than £5 billion at 1982 prices.

16 At peak production EH101 would preserve or create some 5000 jobs at Westland plus a similar number in supporting UK industries.

17 The RN would obtain, at substantially less expense than that of a purely military programme, the helicopter which it needs to fulfil a vital role in its critically important anti-submarine operations. No other helicopter offers comparable performance.

Conclusions and Recommendations

18 EH101 represents a new and promising approach to an aerospace project by harmonising to a large degree defence and commercial requirements from the outset. Harnessing government and industrial financial resources in both the UK and Italy will enable defence needs to be met while at the same time providing industry with a positive incentive to attack a substantial commercial market. If success is to be achieved, however, it is important that development be launched as soon as possible and that the project should not be under-financed. An early

commitment on the UK side will enable pressure to be brought to bear upon the Italians to speed up their decision making.

19 Accordingly we invite colleagues to agree:

- a that MOD and DOI should provide financial support for the proposed Anglo-Italian integrated naval/commercial programme;
- b that DOI should seek to negotiate launch aid for Westland between a minimum of 50% of that sought and a maximum of 75% (£41M-£61M at 1982 ECs); and
- c that funds for this DOI launch investment should be made available from the Contingency Reserve.



## CONFIDENTIAL

## ANNEX B

## EH101: ESTIMATED UK SHARE OF DEVELOPMENT AND PRODUCTION INVESTMENT COSTS

The following is a comparison between the figures in Table 2 attached (which have been prepared by the Ministry of Defence as their estimate of EH101 development and production investment costs, including RN specific costs not part of the common collaborative programme falling to the UK) and those supplied by Westland in support of their launch-aid case in which they have asked for £81m (£105m in outturn prices) representing 50% of their share of the costs of the common collaborative programme.

	<u>Westland Estimate</u>		<u>MOD Estimate</u>	
	<u>UK Costs</u>	<u>Westland share</u>	<u>UK Costs</u>	<u>Westland Share</u>
	£m 6/82	£m 6/82	£m 6/82(9/82)	£m 6/82(9/82)
Development	208	40	345* (352.7)	51 (52.2)
Production Investment	25	25	70* (71.5)	37 (37.5)
Other non-recurring costs	82	82	80 (81.6)	80 (81.6)
Total	315	162 /	495* 343 (505.8)	168 (171.5)
MOD total including block contingency			575* (586.2)	195 (199.1)
MOD total including block contingency but <u>less</u> RN specific costs			411.4 (419.6)	195 (199.1)

/ including 10% contingency

\* figure includes special to RN costs outside common collaborative programme

TOTAL INTEGRATED PROGRAMME COST SHARES (£M, 9/82 ECs VAT INCLUSIVE)

<u>DEVELOPMENT</u>	<u>UK</u>	<u>ITALY</u>	<u>TOTAL</u>
(i) Common basic and Common Naval & EMI costs	158.3	151.3	309.6
(ii) Commercial	44.8	44.8	89.6
(iii) RN/EMI Specific	149.6	77.7*	227.3
<u>Total Development</u>	<u>352.7</u>	<u>273.8</u>	<u>626.5</u>
 <u>PRODUCTION INVESTMENT</u>			
(i) Common basic and Common Naval (incl engine P.I.)	41.1	41.1	82.2
(ii) Commercial	13.3	13.3	26.6
(iii) RN/EMI Specific	17.1	18.7*	35.8
<u>Total P.I.</u>	<u>71.5</u>	<u>73.1</u>	<u>144.6</u>
<u>Totals for Development and Production Investment</u>	<u>424.2</u>	<u>346.9</u>	<u>771.1</u>
 OTHER WESTLAND NON-RECURRING COSTS			
	81.6		
Total	505.8		
TOTAL WITH BLOCK CONTINGENCY	586.2		

\* These figures are very rough estimates, due to uncertainties about the EMI avionics fit.

Note Contingencies have been excluded in second and third columns because the Italian MOD has not yet finalised its view of the level of contingency to apply to the Italian element of the Naval programme.

BREAKDOWN OF UK COST SHARE (£M, 9/82ECs VAT Exclusive)

<u>DEVELOPMENT</u>	<u>MOD</u>	<u>INDUSTRY (DOI/WEL)</u>	<u>TOTAL</u>
(i) Common basic, Common Naval & EHI Costs.	150.9	7.4	158.3
(ii) Commercial	-	44.8	44.8
(iii) RN Specific	149.6	-	149.6
<u>Total Development</u>	<u>300.5</u>	<u>52.2</u>	<u>352.7</u>
Contingency on Development	48.0	*25.0	73.0
<u>Total Development, inclusive of Contingency</u>	<u>348.5</u>	<u>77.2</u>	<u>425.7</u>
		*MOD Estimate-WEL's estimate is £15M.	
		/With VAT added this figure is £393.5m.	
<u>PRODUCTION INVESTMENT</u>			
(i) Common basic and Common Naval	16.8	24.4	41.2
(ii) Commercial	-	13.3	13.3
(iii) RN Specific	17.0	-	17.0
<u>Total Production Investment</u>	<u>33.8</u>	<u>37.7</u>	<u>71.5</u>
Contingency on Production Investment	4.8	2.6	7.4
<u>Total Production Investment, inclusive of Contingency</u>	<u>38.6</u>	<u>40.3</u>	<u>78.9</u>
<u>OTHER NON-RECURRING COSTS</u>			
(i) Learning	-	25.5	25.5
(ii) Plant and Equipment	-	17.3	17.3
(iii) Marketing	-	18.4	18.4
(IV) Maturity Development	-	20.4	20.4
<u>Total other non-recurring costs</u>	<u>-</u>	<u>81.6</u>	<u>81.6</u>
<u>TOTALS FOR DEVELOPMENT, PRODUCTION INVESTMENT AND OTHER NON-RECURRING COSTS (Incl Contingencies)</u>	<u>387.1</u>	<u>199.1</u>	<u>586.2</u>
	220.5	100.1	419.6

## EH101 WESTLAND CASE FOR LAUNCH AID SUPPORT

## WESTLAND'S STRATEGY

Westland Helicopters Limited took a conscious decision in 1978 to move into the civil helicopter manufacturing field. The decision was prompted by a realisation that their existing range of military aircraft was ageing and that they would be faced with a rundown of defence orders towards the end of the present decade. Exploiting the civil market was therefore calculated to secure the company's future in terms of balance and growth; to improve financial performance; and to provide better employment prospects.

2. On their own initiative and using their own resources Westland immediately set about developing their own civil helicopter (WG 30 - Series 100) albeit based on military Lynx technology. The first few of these aircraft have already gone into service. Westland are now pursuing -200 and -300 series developments of the WG 30 with launch aid support, agreed by Ministers in 1982 of £41m spread over four years.

3. The WG 30 and its developments are expected to provide Westland with a healthy workload in the medium term. But for the 1990s and thereafter Westland will need a new product to sustain their civil and military business and their proposal is to participate in the Anglo/Italian EH101 project to produce a helicopter in three main versions - civil; utility and naval. The project will serve to maintain a world class helicopter design and manufacturing capability in the UK and enable Westland inter alia to consolidate their position as civil aircraft manufacturers over the next decade. The EH101 will be developed on a collaborative basis through a joint company (EH Industries) with funding support from the Ministries of Defence and Industry Departments of both the UK and Italy. Westland will take responsibility for the civil programme; Agusta of Italy will develop the utility version; and the two companies will share in the naval programme. Development and production plans have been based on equal work shares between Agusta and Westland with a final assembly line in each company capable of producing 40 helicopters per year.

## WIDER BENEFITS TO UK INDUSTRY

4. There will be a wider benefit to UK industry particularly in terms of equipment supply. The aim for the commercial helicopters will be to source components and equipment more or less equally between Italy and the UK, provided they are fully competitive in price, time-scale and quality with equivalent products obtainable abroad. Since some third country sourcing may be necessary the object will be to allow Westland and Agusta the maximum commercial flexibility consistent with giving the Italian and UK equipment industries a reasonable opportunity to secure business on an airframe programme which will have been fully funded by the two countries. Westland have estimated that the equipment buy in the UK over the production life of the project could be of the order of £1.5bn.

## MARKET

5. Westland believe that sales prospects for the EH101 are good. Their 1982 forecast for orders of all variants of the helicopter by the year 2008 was 1050, split as between 136 for the RN and Italian Navy; 293 for naval export; 277 utility (mainly for overseas land-based military and para-military forces) and 345 civil. The Defence Sales Organisation estimate that military/naval EH101s in the range of 600-700 could be sold by the year 2008 which, at its upper end is in close agreement with the Westland total of 706 non-civil sales. DoI analysts however believe that Westland's civil sales forecast of 345 may be optimistic. Depending on engine availability (see para 8 below) DoI analysts have estimated sales of between 220 and 255 by the year 2008. Their lower forecast is based on the fact that the civil version of the EH101 is aimed primarily at the offshore oil and gas transport market the future trends of which are currently difficult to forecast and where prospects may not be as bright as Westland think.

6. The entry into service date of the EH101 is also critical. The Defence Sales Organisation perceive most military requirements arising in the 1990-2000 time frame and Westland have said that a delay of one year could cost 30% of their civil sales. This latter estimate is probably pessimistic but it is likely that at around the end of the century the EH101 will face competition from more technically advanced aircraft and it is important for all sales beyond 2000 that the EH101 should have established itself as early as possible in the market place.

7. Sensitivity analyses show however that even with sales significantly below 1982 estimates by the company the internal rate of return (IRR) to Westland on the project as a whole would still be of the order of 11% - 12% at an exchange rate of £ = \$1.60. (The IRR given in Westland's launch aid application was 13.4% based on an exchange rate of £ = \$1.80. At an exchange rate of £ = \$1.60 the base case in Westland's launch aid application would have shown an IRR of close to 16%). In aerospace terms an IRR in the region of 11% - 12% is good and it is certainly much better than the WG 30 launch aid application which was approved on the basis of an IRR of 8.3%. It is moreover well above the Treasury required rate of return on public sector projects of 5%.

## TECHNICAL RISK

8. MoD have assessed the technical risk which, overall, they believe is relatively low. Much of the technology used in the airframe, the dynamics system as well as in the avionics has already been proved and demonstrated. The engines for the development phase are the American GE CT7-2A and CT7-6. These will provide sufficient power for most of the EH101's performance target although something larger such as the proposed GE CT7-8 or the Rolls-Royce RTM 322 will be required for some civil applications in extremely hot and high conditions. Until such an engine is available 10-15% of the aircraft's civil sales potential can not be realised. Even so sensitivity analyses indicate that the project should remain commercially viable.

\*Westland have just adjusted their sales estimate in the light of the delayed start to the programme: just under 300 civil sales, with non-civil sales at just under 700.

## CASE FOR LAUNCH AID

9. Westland have asked for assistance of £105m at outturn prices, payable on a front-loaded basis to equal the non-recurring costs incurred in the years 1983-1990. The figure of £105m represents 50% of the UK industry share of the total non-recurring costs of the common programme plus a contingency of 10%. The case for launch aid is based on the impact which the project would have, if unaided, upon the Group's balance sheet and profit and loss account. Westland contend that the profits available on both development and production, (which until 1980 were largely funded by the MoD to provide aircraft which met its specific military requirements), have not allowed any margin to finance private venture developments. Their ability to meet such PV costs out of their own resources will therefore depend on having a number of mature products yielding profit margins and generating a positive cashflow sufficient to support the development costs and initial investment required to bring new products to the market place. It was for that reason that launch aid was sought for and given in the WG 30 case and the company's view is that, if it is to evolve over the next decade into a civil helicopter manufacturer, the adverse consequences of heavy launch costs upon its profit record and balance sheet must in the meanwhile be mitigated by launch aid. The fact that a return on the investment could be achieved only over a very long period (the aircraft will not go into service until 1990 at the earliest) rules out the prospect of alternative private funding.

10. Westland believe that they will nonetheless have to raise an additional £50m of equity to strengthen their capital base and reduce gearing to acceptable proportions. It is likely that Westland will try to raise £25m of fresh equity this year and the remainder at a later date. But since making a loss in 1978 Westland have been viewed with caution by investors and by the financial press. Reestablishing investors confidence will only be achieved by the company establishing a steady and satisfactory level of profits and dividends. Westland's argument for launch aid is based on the view that, without assistance, their profits in the early years of the project would be insufficient to provide the necessary market confidence to raise the additional equity considered essential to reduce gearing from a level which otherwise would range between 75% and 111% during the years 1985-1991 inclusive. The company consider that launch aid as requested plus fresh equity would reduce maximum gearing to an acceptable 38% in 1986.

## DOI VIEW OF LAUNCH AID CASE

11. The DoI accepts that Westland have made a good case for launch aid assistance but not at the level requested. The DoI's view is that launch aid in the region of 50% to 75% of the company's request (ie between £53m and £79m) would be sufficient to meet their needs. In particular the DoI believes that Westland's target gearing ratios are more conservative than necessary. An average of 50% with occasional peaks up to 75% would be acceptable. Because 50%-75% of the aid requested would facilitate a satisfactory level of profits throughout the period with broadly sustainable gearing ratios, it

was the DoI's proposal to MISC 25 that a figure for launch aid should be negotiated within that range. The object would be to negotiate the minimum launch aid acceptable to the company but sufficient to ensure that the project had a chance of success.

#### LEVIES

12. Westland have proposed a levy repayment of 3% on aircraft sales and 8% on spares over one-half of the total civil, utility and export naval sales. This postulates a return to DoI of 6.5% calculated at 2% real above the assumed 4½% rate of inflation. The precise levy rate will however be a matter for negotiation with the company first because the MoDs of both UK and Italy will wish to impose levies and second because levy will have to reflect the degree of risk borne by HMG. However, given that the project promises to achieve a good IRR the DoI believes that it would be reasonable to seek a real rate of return to DoI of 5% above the assumed rate of inflation. But care will have to be taken to ensure the total levy is not such as to price the helicopter out of the market. At the same time it will be necessary to ensure DoI's contribution to development costs are recovered.

#### MISC 25

13. The DoI presented the Westland launch aid case to the MISC 25 committee on 24 February. The committee noted that DEPC had approved the MoD case for proceeding with the military element of the programme and after detailed discussion accepted that the civil project had a sufficient prospect of viability for the Government to encourage Westland to proceed. The committee however thought that there were sufficient risks involved (ie market uncertainties and the fact that the return would only be achieved over a very long period during which the company's finances would otherwise be stretched) for the Government to consider offering launch-aid. The committee agreed that the Government's objective should be to secure levy payments at a level sufficient to provide a 5% real rate of return.

14. A majority of the committee thought that the Government should aim to agree launch aid in the region of 50-75 per cent of that sought by the company; and that the Government's opening offer should be launch aid of 50 per cent of the company's bid. The Treasury, however, was not convinced that launch aid on this scale could be justified, indicating a wish for the case for launch aid of around 25 per cent of that requested by the company to be explored further. Since it is important that the company has sufficient funds to carry through the programme successfully, DoI remains firmly of the opinion that funding in the region of £53m - £79m will be necessary to secure the successful outcome of the project for Westland. An offer of 25% would in DoI's view be inadequate in the light of the company's gearing and likely earnings trend over the development phase of the project.

FROM: P L GREGSON CB, DEPUTY SECRETARY

1. Mr Cole ✓ M L 1/8  
2. Mr Selkirk  
Defence



CABINET OFFICE  
70 WHITEHALL  
LONDON SW1A 2AS

01-XXXXXXXX 233 8339

P.0973

Air Marshal Sir John Rogers KCB, CBE  
Controller/Aircraft  
Room 2171, Main Building  
Ministry of Defence

1 March 1983

CONFIDENTIAL

*Dear John,*

**EH101 HELICOPTER PROJECT**

When MISC 25 met last week to discuss the EH101 helicopter project, it was left that the Cabinet Office would consider how the matter might most conveniently be taken forward at Ministerial level. I am now writing in response to that remit and, since there are both civil and military aspects to the project, I am doing so both on my own behalf as head of the economic secretariat and on behalf of my colleagues in the defence and overseas affairs secretariat here.

We consider that it would be premature to seek the Prime Minister's agreement to the inclusion of this project on the agenda of any of the Committees which she chairs (for example OD or E) until we have established whether there is some difference of view between Ministers which can only be resolved in this way and, if so, what that is.

We therefore suggest that the best way to move matters forward would be for the Secretary of State for Defence to write to the Chief Secretary, Treasury, with copies to the Prime Minister, other members of OD, the Secretary of State for Industry and Sir Robert Armstrong, seeking Treasury approval for the EH101 project in the defence context. The letter would of course need to draw attention to the civil launch aid proposal which the Department of Industry has in mind. The Secretary of State for Industry would then follow with a separate letter to the Chief Secretary, Treasury, copied similarly, which would seek approval for the civil launch aid proposal. We would look to the Chief Secretary, Treasury's reply or replies to make clear what difference of view there was at Ministerial level. In the light of that the Cabinet Office would be able to

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advise the Prime Minister whether Ministerial discussion was required in OD or E, depending on the subject matter. If such a discussion were to be required we would of course try to arrange for it to take place as soon as possible.

You and Mr Croft to whom I have spoken have indicated that you are happy to proceed in this way and we shall look to you to coordinate and despatch the letters from your respective Secretaries of State. I had earlier warned Ivan Wilson in the Treasury that, subject to your views, I would be writing to this effect.

I am sending copies of this letter to John Sparrow, CPRS, to Roy Croft, Industry, and to Arnold Lovell and Peter Kitcatt, Treasury.

*Yours sincerely*

*Peter Gregson*

P L GREGSON

3 blind copies:

- 1 1. Mr Facer  
2. Mr Goodall o/r
- 2 1. Mr Buckley  
2. Mr Moyes
- ③ 1. Mr Coles No 10  
2. Mr Scholar "

CONFIDENTIAL

Defence  
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10 DOWNING STREET

From the Private Secretary

31 January 1983

British Atlantic Committee

At the end of today's ad hoc Ministerial meeting, which discussed nuclear issues and public opinion, there was a brief discussion of the problem of the Government's financial contribution to the above Committee. The Secretary of State for Defence said that some £50-60,000 was needed to increase the present contribution of £48,000 to the £110,000 which the Committee had requested. The Foreign and Commonwealth Office did not have sufficient funds available. The Ministry of Defence had the money but doubted whether it was prudent for the sum to be paid from the Defence Vote.

The Prime Minister said that she believed that the contribution to the Committee should be increased by the amount suggested and it seemed right that the payment should be made by the Foreign and Commonwealth Office. She hoped that suitable arrangements could be made between the Ministry of Defence and the Foreign and Commonwealth Office with regard to the payment but she did not wish to be further involved in this matter herself.

I am copying this letter to Richard Mottram (Ministry of Defence).

AJC

J.E. Holmes, Esq.,  
Foreign and Commonwealth Office.

Confidential .

Defence (2)  
Prime Minister



Mr Nott has  
done very

Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

well for me  
Defence Budget.

Michael Scholar Esq  
10 Downing Street

MSF December 1982

Saw Michael

MS 21/12

UK DEFENCE SPENDING

The Chancellor has suggested that the Prime Minister might like to see the attached extract from a speech made on 1 December by the Defence Secretary to a closed session of the NATO Defence Planning Committee in Brussels. In the Chancellor's view, its positive presentation of the UK defence effort is exactly right, and one that all Ministers should be able to take when speaking to audiences in this country as well as abroad.

Yours ever  
J O KERR

## Yemen (Earthquake)

3.42 pm

**Mr. Guy Barnett** (Greenwich) (*by private notice*) asked the Minister for Overseas Development if he will make a statement about the recent earthquake in North Yemen and if he will say what preparations the disaster unit in his Ministry has made in order to be able to answer such requests as may be received.

**The Minister for Overseas Development (Mr. Neil Marten):** An earthquake, believed to have reached the intensity of 6 on the Richter scale, struck the densely populated Dhamar region of the Yemen Arab Republic yesterday. The earthquake lasted about 40 seconds and caused extensive damage to the town of Dhamar and 99 villages in the area. So far as is known, there have been some 2,000 casualties—dead and wounded.

The Yemen Arab Republic Foreign Minister has informed heads of mission that full details of the damage are not yet available. The Foreign Minister is arranging a fact-finding visit by helicopter to the area tomorrow, 15 December. The British ambassador will accompany him. There are no reports of deaths or injuries to British expatriates serving in the Yemen Arab Republic. I have asked the British ambassador, pending receipt of the specific requirements from the Yemen Arab Republic Government, to purchase any locally available supplies that he identifies as being necessary.

**Mr. Barnett:** I am grateful to the right hon. Gentleman for his statement. The House will be relieved to know that members of British aid teams working in the area are safe. Can he confirm a particularly horrible disaster—the killing of 125 schoolchildren in one school? Can he confirm that an international appeal has been launched by the Red Cross in Geneva? Can he say more about the readiness of his disaster unit and of voluntary agencies such as Oxfam to respond to the situation?

**Mr. Marten:** I cannot confirm the horrible rumour that the hon. Gentleman mentioned. We are awaiting details of the disaster. Communications are extremely difficult, as the Yemen Arab Republic Government said, because of the mountainous nature of the country. The disaster unit in my Ministry is poised and ready to fly out whatever the Government require, which will probably be tetanus vaccine, plasma, dressings, food, blankets and tents. We shall be ready to go when we get the request.

**Mr. Andrew Faulds** (Warley, East): Is the right hon. Gentleman aware that his prompt and expeditious attention to the problem will be much appreciated in the Arab world and will go a small way towards offsetting the immense damage that the Prime Minister has recently done to British-Arab relations?

**Mr. Marten:** Without agreeing with the last part of the hon. Gentleman's remarks, I am grateful for the first part.

Defence

## Falkland Islands (White Paper)

3.44 pm

**The Secretary of State for Defence (Mr. John Nott):** With permission, Mr. Speaker, I would like to make a statement.

The Government are publishing today a White Paper on the Falklands campaign. It is now available in the Vote Office.

Part I of the White Paper consists of a brief description of the operation to repossess the Falkland Islands; part II analyses the principal lessons to be learnt from the campaign itself; and part III describes the steps which we are taking to make good losses of equipment, to provide for the future defence of the Falkland Islands, and finally the additional measures now proposed to increase the mobility and flexibility of our Armed Forces for future operations in the NATO area and elsewhere.

First, we intend further to improve the airborne and other capabilities of 5 Infantry Brigade for out-of-area operations. It already has two parachute battalions, an infantry battalion and engineer support. To these we have just added and armoured recce regiment and in the course of next year we will add an artillery regiment, an Army Air Corps squadron and certain logistic units.

RAF Hercules aircraft are already earmarked for deployment of the brigade and the fitting of station-keeping equipment to a number of Hercules will give the brigade a parachute assault capability by 1985. Those enhancements should represent a significant improvement to our capability for airborne operations out-of-area. Taken together with the amphibious capability of the 3rd Commando Brigade Royal Marines, they will give us an improved capability to respond to the unforeseen in a flexible and rapid way.

For out-of-area operations we also need an improved air-to-air refuelling, which was of such vital importance in the Falklands campaign.

Subject to final scrutiny of tenders and to satisfactory contractual negotiations, our intention is to add to our tanker fleet by buying from British Airways six Tristar aircraft for conversion into tankers. We plan to convert four of those Tristar aircraft so that they can also carry freight.

This purchase of a strategic tanker capability will enormously increase our existing tanker capacity. For example, a single Tristar tanker will be able to do the work of eight Victor refuelling aircraft in the South Atlantic. It could also carry up to 120 troops, even while refuelling. It will therefore increase the RAF's troop lift; enable easier support and much more rapid reinforcement of the Falkland Islands; and, most significant of all, it will multiply the effectiveness of all the RAF's combat aircraft, including the Nimrod and the air defence Tornados and Phantoms.

As well as greater strategic mobility to be provided by the Tristars, we also need greater tactical mobility and battlefield logistic support. After the loss of three Chinook medium lift helicopters on the "Atlantic Conveyor"—and the Ministry of Defence is participating with Cunard in the design of her replacement—the one medium lift Chinook was invaluable in the Falklands campaign.

To add to the two Chinook squadrons, we now intend to purchase a further eight Chinooks, of which three will be replacements. Each Chinook can carry up to 80 men

[Mr. John Nott]

and substantial quantities of stores and ammunition. The extra medium lift helicopters will greatly enhance battlefield mobility and logistic support in the NATO area and elsewhere.

As I have already announced, all the Sea King and Lynx helicopters lost are being replaced and an additional six anti-submarine warfare Sea Kings are being purchased for the Royal Navy as well as seven more Sea Harriers, in addition to the replacement of all naval and RAF Harriers lost in the conflict. All these aircraft orders will be subject to satisfactory terms of contract, including price.

In the light of the campaign and the future needs of the Falklands garrison, we must take further steps to improve our air defence capability. Subject to the satisfactory completion of negotiations, we will purchase at least 12 additional Phantom aircraft from the United States; and 24 additional Rapier fire units for the RAF and the Army are to be bought.

The air defence of the Royal Navy must be strengthened by the provision of an organic airborne early warning capability, based on the Searchwater radar, for each of the operational aircraft carriers. We also intend to provide a modern point defence weapon system for all the carriers, the assault ships "Fearless" and "Intrepid", HMS "Bristol", and all the type 42 destroyers—the choice of system is still being studied.

The White Paper describes a number of other new purchases of equipment, weapons and stocks—including a list of the new weapon systems such as Harpoon and laser guided munitions, purchased during the conflict, which remain as a general addition to our force levels. On the subject of war stocks, we saw again during the campaign the key importance of staying power and of the need to allow for delays in resupply. We plan to increase substantially—by at least £10 million—the number and range of items in the stockpile specifically earmarked for the support of operations outside the NATO area.

I now come to ship numbers and new ship orders. Under the plans set out in Cmnd. 8288, we would have had about 55 frigates and destroyers either running or in refit next year, with no ships in the standby squadron. The total number of ships would have remained at around this level for the following two years but two ships would have gone into the standby squadron by 1 April 1984, and two more into the standby squadron by 1 April 1985. The plan was that by 1989 up to eight ships would have been in the standby squadron out of a total of 50.

With the additional funds now available, and to meet the needs of the garrison, the two standby ships in 1984 and the two further standby ships in 1985 will now remain in the front line fleet for these years.

We are at present covering for the four ships lost in the campaign by running on older hulls but, to sustain our proposals in Cmnd. 8288 for a total force of about 50 ships in the longer term—that is beyond the mid-1980s—new build replacements are needed urgently. We have decided that these replacements should be type 22 anti-submarine frigates and that an improved batch III design, taking account of the Falklands campaign, should be introduced as soon as possible.

Competitive tenders were sought for the first of the replacement ships and for another type 22 frigate already in the programme and not related to the Falklands losses. In the light of the tenders submitted, an order for two new

type 22 frigates of an amended batch II design has been placed today with Swan Hunter, together with an order for a further two replacement ships of the new batch III design from Yarrow (Shipbuilders) Ltd.

Initial design work is in hand for a replacement for the logistic landing ship "Sir Galahad". "Sir Tristram" will be brought back to the United Kingdom and we hope that it can be repaired.

I am also able to announce today, although it is unconnected with the Falklands replacements programme, that an order for two further Hunt class mine countermeasures vessels has been placed with Vosper Thornycroft.

Last year, in pursuance of our policy of modernising the fleet, we spent more in real terms on ships and their weapon systems than for the past 19 years, and almost 50 per cent. more again than in 1978-79. The total value of the ship orders placed today is £585 million. When added to other naval orders amounting to £161 million already placed this year, new naval shipbuilding will be maintained at a very high level.

We plan that the fourth and final Falklands replacement ship will be a further batch III type 22 frigate. It will be ordered as early as possible next year by competitive tender when Yarrow (Shipbuilders) Ltd. has completed the redesign work. Cammell Laird Shipbuilders Ltd. and Vosper Thornycroft (UK) Ltd. will be strong contenders for this order.

The success of last year's review of the defence programme in matching resources to our revised forward plans had already won us some flexibility to make adjustments to the defence programme. The Government have now provided extra funds to meet the additional costs of the garrison and the replacement of all equipment lost.

All the measures that I have announced can be met within the announced defence budget for 1983-84 and the planning totals for later years.

In many respects, the Falklands conflict was unique. We must be cautious therefore in deciding which lessons of the campaign are relevant to the United Kingdom's four main roles within NATO. These roles remain our priority, and the modernisation of our forces devoted to them must still have the first call on our resources. The measures that we are taking will significantly strengthen our ability to perform our main defence tasks but they will also increase the flexibility, mobility and readiness of all three Services for operations out-of-area as well as within the boundaries of NATO itself.

**Mr. John Silkin** (Deptford): The Secretary of State referred to the success of last year's review of the defence programme—a programme that Sir Henry Leach referred to as

"a major con trick and a catalogue of half-truths".

There still seems to be no maritime out-of-area capability in this White Paper. Surely that is the real lesson of the Falklands war.

Will the Secretary of State therefore answer the following questions? First, will he give the real number—not the phoney one—of surface ships that he expects there to be in April 1985? Secondly, how many of those ships will be mothballed—in the standby squadron? Thirdly, does he really believe that the dockyards of Portsmouth, Rosyth and Devonport will be

adequate for a proper maritime policy? Finally, when will he come clean with the House and admit that all of his maritime policy is put at risk by Trident?

**Mr. Nott:** The right hon. Gentleman says that we still have no maritime out-of-area capability. I thought that the Royal Navy did rather well in the Falklands, which is about as out-of-area an operation as one can possibly imagine. I completely fail to understand what he is suggesting.

I said in my statement that in 1985 we would have about 55 escort ships—destroyers and frigates. That is exactly the same number as we proposed in Cmnd. 8288. There will be none in the standby squadron in 1985 because the four that would otherwise have been in the standby squadron will be involved with the garrisoning of the Falkland Islands.

The dockyards at Rosyth and Devonport are fully sufficient to meet the size of the new fleet. We have gone out of mid-life modernisations and dockyard capacity will be sufficient. I have issued a consultative paper today proposing expansion of the naval base at Portsmouth. It will be used for the care, maintenance, weapon updating and other things that are needed for the fleet, as will Devonport and Rosyth.

The right hon. Gentleman criticises the Government and especially me on our policy towards the Royal Navy. In real terms, we are today spending £700 million more on the conventional Navy than the previous Labour Government were spending. Last year, naval shipbuilding—new ships and their weapon systems—was at a record level for the past 19 years. I cannot see how the right hon. Gentleman can criticise our policy when the party to which he belongs is proposing a massive cutback in defence spending.

**Mr. Churchill** (Stretford): I congratulate my right hon. Friend on his statement, especially on the enhancement that he is making for our air defence at home and for the fleet, and for the strengthening of the Royal Navy. Will he confirm that all the items to which he referred will represent a fundamental enhancement to the overall capability of our Armed Forces here in Europe as well as for the Falklands operation?

Will my right hon. Friend expose the right hon. Member for Deptford (Mr. Silkin) when he tries to masquerade as defender of our Armed Forces while representing a party that is committed to chop by one-third outlays on defence?

**Mr. Nott:** With regard to my hon. Friend's latter point, the right hon. Member for Deptford (Mr. Silkin) and especially the Labour Party are proposing to cut our defence expenditure by one third, yet they qualify that proposal by saying that jobs will not be shed. That is typical of the ambivalence in everything that the Labour Party says about defence. It would destroy our defences. That is becoming increasingly clear to the British people.

I can confirm that the majority of the proposals that I am making today will enhance our general defence capability for use in NATO, for use out-of-area and for the garrisoning tasks that we still retain in the Falkland Islands.

**Mr. A. J. Beith** (Berwick-upon-Tweed): Is the Secretary of State now convinced that our ships will not again be exposed to airborne attack without early warning?

Is not one of the principal lessons of the affair that we are at our most vulnerable if an enemy thinks that we have neither the will nor the means to respond to attack? Does he agree that the withdrawal of HMS "Endurance" created that impression, and that the same impression could be created if NATO does not appear to have the means to respond by conventional strength to conventional attack?

**Mr. Nott:** I hope that what I have announced will strengthen our conventional defences. I remind the hon. Gentleman that HMS "Endurance" was in the Falkland Islands when she was attacked. Apparently, the deterrent value of HMS "Endurance" was inadequate. The ships that we deployed in the Falkland Islands were necessarily placed within range of land-based aircraft from Argentina. Normally, in a NATO context, we would not place our ships in that position and they would have the protection of land-based NATO aircraft. They would also have the airborne early warning of NATO, which in the Falklands they did not possess. That is why we want to add an airborne early warning facility to our three carriers.

**Mr. Neville Trotter** (Tynemouth): Will my right hon. Friend accept my congratulations upon the increase in the naval strength that will result from the orders? Will he accept also that Tynemouth will be especially grateful for the fact that they were won by competitive tender, with all that that means for the future? Can he assure us that there will be a strengthening of the Navy's back-up by increasing the number of people employed in the dockyards and the bases and the number of sailors remaining in the Navy?

**Mr. Nott:** Not entirely. It has been my objective to reduce the support side and to put more of the total resources available to the Royal Navy into the front line. The greater the number of support bases and training bases and other such establishments, the less money there is to put into the front line. The pressure, which has not been entirely welcome to my hon. Friends or to the Royal Navy, which has been exerted during the past two years has created a slimmer and, I believe, a better front line. My hon. Friend is right in saying that we went out for competitive tenders. Swan Hunter put in an extremely competitive and attractive bid and, therefore, it won the order.

**Dr. David Owen** (Plymouth, Devonport): Is the right hon. Gentleman aware that many Members on both sides of the House who are friends of the Navy will be glad to see the readjustment of the balance and will only regret that it required the Falklands campaign to bring it about? Will he make it clear whether he intends more than 42 surface ships to be running in 1989 with fewer than eight in the standby squadron? Will he give some assurance to those of us who remain very worried that we shall be building insufficient numbers of hunter-killer submarines, especially because of the Trident building programme at Vickers?

**Mr. Nott:** I think that the priority is to move ahead as fast as possible with the new conventional submarine. The right hon. Gentleman is correct: while Trident is being built, we shall have a pause in the SSN programme. However, our principal requirement is for a new class of conventional submarine, which will be an extremely valuable addition to our force level.

The number of 42 has been much bandied about. It was an estimate of what might have been the number of ships

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in the running fleet in 1989 had we placed eight ships in the standby squadron. Cmnd. 8288 made it clear that we were looking to a force level of 50 in the late 1980s, of which we said up to eight might be in the standby squadron. I cannot say what the resources will be beyond the mid-1980s. Therefore, the number of ships in the standby squadron in the late 1980s will be for the decision of my successor. We are adhering to the figure of 55 destroyers and frigates, and they will all be in the running fleet over the next two years.

**Mr. Tam Dalyell** (West Lothian): Does the right hon. Gentleman recollect the only public utterance of Lord Carrington since he left office, which appeared in a letter to *The Times* of 18 June, which was headed "Mr. Nott and Submarines", in which he denied that he had prevented the Secretary of State from sending submarines to the South Atlantic on the ground that it might be provocative? Lord Carrington cuttingly ended his letter to the effect that Mr. Nott could testify that what he was saying was true. How does the right hon. Gentleman reply to Lord Carrington's rebuke?

**Mr. Nott:** Lord Carrington did not prevent me from sending any submarines to the South Atlantic. His letter was perfectly correct.

**Mr. John Peyton** (Yeovil): Is my right hon. Friend aware that his announcement of the extra six Sea King helicopters that are to be ordered is extremely welcome and will be taken as a further and proper acknowledgment of the way in which the aeroplane performed in the South Atlantic?

**Mr. Nott:** The Sea Kings performed extremely well. They were operating for very long hours and they were a great success. I hope that the Sea King replacement programme will come on to follow the present generation of Sea Kings.

**Mr. Dick Douglas** (Dunfermline): Will the Secretary of State give us some more information than he gave to the right hon. Member for Plymouth, Devonport (Dr. Owen) about submarines? Surely it is not good enough for him now to say that we shall crowd out SSN building because of the Trident programme when we still await a conventional design. In paragraph 314, reference is made to the inter-relationship of the merchant navy and the merchant marine with the naval capacity overall. Can the right hon. Gentleman be more forthcoming about his ideas on that score?

The right hon. Gentleman referred earlier to the issuing of a discussion paper between his Department and trade unions on the future of the dockyards. May the contents of that paper be made available to the House so that we can have a proper discussion about the yards?

**Mr. Nott:** Yes, I can place the consultative paper in the Library; that can be quite easily done. There are many functions which conventional submarines can perform better than hunter-killer nuclear submarines. The need now is to build up the number of conventional submarines. We are moving forward as fast as we can with the new SSK programme. We shall put as much money into that programme as is necessary to bring it forward. That is the submarine priority and not more SSNs. The relationship between the merchant marine and the Royal Navy was

proved during the Falklands campaign. It worked admirably, and I should like to consider every means of developing it further.

**Sir David Price** (Eastleigh): I welcome my right hon. Friend's announcement that he intends to order four new type 22 frigates. Will he explain why, after the successful launch of HMS "Gloucester", a type 42, at Woolston, no orders have gone to Vosper Thornycroft, which is one of the two designated warship builders in British Shipbuilders? Are we to take it that the Carrington arrangements no longer hold?

**Mr. Nott:** Vosper Thornycroft would have been given some orders if it had come in with a competitive bid. We must put these orders out to competitive tender. Swan Hunter came in with a price which was far lower than that which was arrived at by Vosper Thornycroft and Cammell Laird. If Vosper Thornycroft had come in with an attractive price, the order would have gone to it. We have placed two orders with Vosper Thornycroft today for the Hunt class, which is a significant order for Vospers. I hope that it will come in with a more attractive offer when the last replacement ship is put up for tender in the spring. The Ministry of Defence will not spend more money on placing orders with uncompetitive tenderers. It will go to the yard which offers it the best price.

**Mr. Tony Benn** (Bristol, South-East): Is the right hon. Gentleman aware that the main lesson of the Falklands conflict is that, after 1,000 casualties and probably £2 billion or £3 billion of expenditure, the future of the Falkland Islands is far from settled? France and Germany have resumed arms supplies to Argentina and the United States has voted against us in the United Nations. Almost everyone except the Prime Minister realises that the exclusive sovereignty of Britain over the Falkland Islands cannot survive much beyond this decade. Will the right hon. Gentleman say something about the Cabinet's discussion about its political failure, which it is trying to obscure behind a military success?

**Mr. Nott:** The right hon. Gentleman has made his point. I am not aware of any of those matters. The Falkland Islands are British, and so they will remain.

**Mr. Antony Buck** (Colchester): Does my right hon. Friend agree that the main lesson of the Falkland Islands is not that suggested by the right hon. Member for Bristol, South-East (Mr. Benn), but the conclusion in his White Paper that what we did there has given credibility to the entire Western defence posture? We shall take arms to assist those who wish to remain living in freedom, even if they are on the other side of the world.

**Mr. Nott:** I agree entirely with my hon. and learned Friend. Our action to recover the Falkland Islands has been an example to the entire West.

**Mr. Frank Allaun** (Salford, East): Does the Secretary of State deny the fact that the total bill for the Falklands war and its aftermath is £2½ billion, or £5 million per family on the Falkland Islands? Does it save the taxpayer a single pound if this colossal waste comes from his budget rather than that of the Chancellor of the Exchequer?

**Mr. Nott:** I do not have in front of me the exact figure for the cost of repossessing the Falkland Islands, but it was about £700 million to £800 million this year. The hon. Gentleman is correct to say that the cost of replacing all

the equipment that we lost will be substantial. Clearly I would be the first to say that this incident should never have happened. However, it did happen and it was a remarkable achievement by our Armed Forces. It showed that Britain was resolute in the way in which she recovered the Falklands. That has strengthened the deterrence of the West, which should please the hon. Gentleman, because it has made war less likely.

**Mr. Peter Viggers** (Gosport): I thank my right hon. Friend for his statement and for the increased flexibility and enhanced maritime commitment that it implies. As to the number of men employed in the Royal Navy, there remains on the record a signal from the First Sea Lord showing that the number of men in the Royal Navy would run down from 70,000 to 62,000, or possibly 60,000, by 1986 and that the diminution would continue at about that level. Does my right hon. Friend agree that the increase in the number of ships requires a larger number of Navy personnel?

**Mr. Nott:** The White Paper does not give details of the revised manpower requirements of the Royal Navy because that will take some time to work out. A signal has been sent to the fleet today by the Second Sea Lord explaining that we cannot give firmer figures for a few months. The reductions in shore establishments and the undertaking of more training afloat will reduce the numbers necessary to man the front line. The type 23 frigate will have a much smaller complement of men. Therefore, although the 4,000 redundancies that were originally contemplated will now be less than they might otherwise have been, there are likely to be some redundancies in the Royal Navy and the size of the Navy will decline, probably much in line with the figure given in Cmnd 8288.

The only way that we can stop the decline is by cancelling some naval programmes. We have a choice between equipment and manpower. With the funds available, we believe that the right balance has been struck, but we can keep more people in the Royal Navy only if we cut the programme.

**Mr. Jack Ashley** (Stoke-on-Trent, South): If we leave aside the earlier differences about the operation of the task force, will the Secretary of State now recognise that Britain has become bogged down in a military, economic and political morass in the Falkland Islands that is damaging rather than helping the national interest?

**Mr. Nott:** I am sorry, I did not understand who was becoming bogged down—[HON. MEMBERS: "You."] What I announced today will substantially increase our Armed Forces' capability generally for operations in NATO and elsewhere. The right hon. Gentleman will welcome that.

**Sir Philip Goodhart** (Beckenham): As my right hon. Friend this afternoon and on earlier occasions has paid eloquent tribute to the excellent work of our helicopters, can he tell us now whether he is carrying out a review of the projected helicopter strength in the British Army of the Rhine as in earlier plans there was to be only a comparatively small increase in years to come?

**Mr. Nott:** Yes. There are some interesting thoughts about that matter. As my hon. Friend knows, we are considering the possibility of using some older Wessex helicopters for the 2nd Division based in York. I would

wish to see more helicopters in the reserve elements of the BAOR and in the BAOR itself. The new Chinook squadrons that are now coming into service will enhance enormously the helicopter lift of the BAOR.

**Mr. A. E. P. Duffy** (Sheffield, Attercliffe): Is not the main lesson of the Falkland Islands that the Secretary of State for Defence could not have deployed so quickly or effectively but for the naval assets that he inherited from the Labour Government? His statement this afternoon is a justification not only of the Labour Party's perception of the size and shape of the fleet, but of the main priority areas that he verified this afternoon. It had taken him three and a half years to endorse the type 22 frigates, the MCMVs and the modern point defence for high value assets. Will he say something about the dual use and adaptation of merchant units such as the Arapaho project?

**Mr. Nott:** I hope that, after many years of delay, we can move ahead with the Arapaho project during the next year or so. I wish to include that project in the programme. The fact that the Government have put up money for the "Atlantic Conveyor" replacement is evidence of our interest in this area. I wish to put more money into the Arapaho project.

The hon. Gentleman inherited naval assets from the Conservative Government, so his argument is non-productive. The Royal Navy will continue to perform a valuable function under all Governments. Last year, before the Falkland Islands incident, we spent more in real terms on naval shipbuilding and weapons systems than had been spent for 19 years. There is nothing of which the hon. Gentleman can accuse this Government.

**Several Hon. Members rose—**

**Mr. Speaker:** Order. I propose to call four more hon. Members from either side and then to move to the second statement.

**Mr. Julian Critchley** (Aldershot): I welcome my right hon. Friend's statement, but he will be aware that it is calculated that, by fiscal year 1985-86, there will be under-funding in defence spending of about 15 to 20 per cent., due in part to Trident, in part to the Falkland Islands and largely to the rising costs of men and equipment. What advice does he have for his successor?

**Mr. Nott:** I have no idea from where my hon. Friend gets that figure. I am not sure to which under-funding he refers. We have planned for the next decade in accordance with the normal long-term costings of the Ministry of Defence. The programme is fully funded, well known and set out in the annual White Paper. I know of no under-funding.

**Mr. Bruce George** (Walsall, South): The White Paper and the Secretary of State's statement do not argue conclusively that it is possible to pay for the improvements of our maritime contribution to NATO, the air defence of the United Kingdom, our out-of-area capability and the replacement of Polaris. Will the Secretary of State come to the House in future with more detail than he has provided so far about how the Government propose to carry out two-thirds of what is contained in this document?

**Mr. Nott:** The hon. Gentleman knows that we tackle all those matters annually in the defence White Paper. We shall again next year give a full description of what we are doing. We are meeting all the main NATO roles. Of

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course, I would wish to do more in all roles, but with a 3 per cent. real increase a year there is a strain on the economy. We are improving all four roles and our allies believe that we are doing a good job.

**Miss Janet Fookes** (Plymouth, Drake): In welcoming the replacement of surface vessels, may I remind my right hon. Friend of the fire hazards revealed during the Falklands campaign about which the Royal Navy had previously warned? Will my right hon. Friend give assurances as to the type of electrical wiring to be used in the new designs, about the use of aluminium in the superstructures and about the use of materials for bedding and clothing?

**Mr. Nott:** Aluminium and PVC wiring have not been used in the construction of modern ships. My hon. Friend is right to say that they caused problems in older ships during the Falklands campaign. Much work has been carried out on the survivability of ships, and all such lessons shall be incorporated in the new ships that we are ordering.

**Mr. Gavin Strang** (Edinburgh, East): The defence of the Falkland Islands has been estimated at £3 billion over four years. Does the Secretary of State recognise that the best contribution the Government could make to our defence would be to secure a negotiated settlement with Argentina on the future of the islands, thus ending the haemorrhage of resources and the risk of further human losses on the islands?

**Mr. Nott:** I have always taken the view—I did during the time of the Falklands conflict—that we want a long-term accommodation with Argentina. The Falkland Islands must be secure so that the Falkland Islands may exist in peace with their neighbours.

**Mr. Keith Speed** (Ashford): I welcome some of the positive statements that my right hon. Friend has made this afternoon. Can he assure the House that new and existing ships will have their weapons, sensors and communications modernised from time to time, even if mid-life modernisation is no longer foreseen?

**Mr. Nott:** I entirely agree with my hon. Friend that we must be able to update those systems. We already have a substantial modernisation programme for the items that my hon. Friend mentioned, but he is right in saying that, as far as possible, we must be able to replace such items in ships in the running fleet—[HON. MEMBERS: "Why was the hon. Gentleman sacked?"] It is not within my power to sack my hon. Friends. My hon. Friend was a most valuable member of the Ministry of Defence. I can give my hon. Friend the assurance he seeks.

**Mr. R. C. Mitchell** (Southampton, Itchen): Is the right hon. Gentleman aware that the specialist warship building yards, such as Vosper Thornycroft in my constituency, maintain expensive design teams that increase their overhead costs, thereby placing them at a distinct disadvantage when competitively tendering for type 22s and other ships with yards such as Swan Hunter which do not have such expensive overheads? Does he want to see the specialist warship building yards break up their design teams?

**Mr. Nott:** I am unable to get involved in a debate on whether the design teams of Vosper Thornycroft are too

large. I am a customer. I put out tenders and receive bids. It is for British shipbuilders, not for me, to decide how they organise themselves so that they offer the lowest possible price.

**Sir Frederick Burden** (Gillingham): Is my right hon. Friend still of the view that the SSN submarine is our most important naval weapon, as stated in the 1981 White Paper? Was the delay in refitting and refuelling "Swiftsure" due to the fact that it is a new type of SSN? How different is it from "Churchill", which is being refitted and repaired at Chatham within two and a half years while it is taking more than three and a half years to refit "Swiftsure"?

**Mr. Nott:** I have already answered that question. It would not be right to take up the time of the House by answering it again.

**Mr. Frank Field** (Birkenhead): Does not today's statement indicate a further cut in the size of the Royal Navy? Is it not true that long before the Falklands campaign, the Government made a commitment to place two major orders for type 22s? With four ships sunk during the Falklands campaign, that makes a total of six. Today the right hon. Gentleman has announced orders for five. What about the other order? Although the Minister and his colleagues often make complimentary remarks about the performance and workers of Cammell Laird, does he realise that words, however complimentary, are no substitute for orders and jobs?

**Mr. Nott:** I realise that Cammell Laird will be disappointed that it has not secured any of these ship orders. There is one more to come and I hope that Cammell Laird tenders successfully for it. One type 22 frigate was in the programme, and I have today confirmed that order, which I announced previously. I have also mentioned four replacement ships. No other type 22 frigate is in the naval programme at present, nor has there ever been.

**Mr. Denzil Davies** (Llanelli): Does the right hon. Gentleman recollect that when, on becoming Secretary of State for Defence, he announced the naval cuts he said—I think that I quote him properly—that defence policy was over-extended and unbalanced? In view of the extra costs he has announced today, the other costs of the Falklands operation and the decision to buy the Trident II missile, does he agree that the defence policy is now even more unbalanced and over-extended? All that he has done today is to hand over the problems to his successor, and there will have to be another fundamental review of defence policy. In view of that, is he not relieved that he had the prescience about 15 years ago to tell his wife that he would leave active politics at the end of this year?

**Mr. Nott:** I do not think that that has much to do with the Falklands White Paper. When I became Secretary of State for Defence, I said that the budget was over-extended. We had far greater plans within the programme than we had resources to meet them. It was therefore necessary to hold the review that I conducted. The right hon. Gentleman would naturally expect me to believe that the programme is now in better order and better balanced than it was. I expect him, as Opposition spokesman, to take the opposite view. Unfortunately, I am unable to agree with anything that he has said.



**Mr. John Maxton** (Glasgow, Cathcart): On a point of order, Mr. Speaker. I appreciate that you have limited the time for questions on statements, and that some of us have inevitably not been called, but you have called the spokesman for the Liberal Party and the spokesman for the Social Democratic Party even though they fight every by-election and local election as one party and have made it quite clear that they intend to fight the next general election as one party.

**Mr. Speaker:** Order. I did exactly the same in the last Parliament when there was an understanding between the Liberal Party and the Government of the day.

**Sir Frederick Burden:** On a point of order, Mr. Speaker. My right hon. Friend, in replying to my question, made a terminological inexactitude, as will be shown in *Hansard* tomorrow. He did not make an accurate statement regarding submarines.

**Mr. Speaker:** That is a matter of opinion; it is not a point of order.

## Foreign Affairs Council

4.28 pm

**The Secretary of State for Foreign and Commonwealth Affairs (Mr. Francis Pym):** With permission, Mr. Speaker, I will make a statement on the Foreign Affairs Council which met in Brussels yesterday. This was the last Foreign Affairs Council of the Danish Presidency, and I should like to express my appreciation of the chairmanship of the Danish Foreign Minister.

The Council agreed that the Community should continue to participate in the multi-fibre arrangement on the basis of satisfactory new bilateral agreements. A separate statement is being made in another place by my right hon. and noble Friend the Secretary of State for Trade which my hon. and learned Friend the Minister for Trade will shortly repeat to the House.

The Commission reported on its talks on 10 December with the American Secretary of State and a number of his Cabinet colleagues on a wide range of trade matters. Both sides agreed on the importance of avoiding disruption of world markets for agricultural products. There will now be a programme of bilateral discussions on specific problems.

The Council agreed on the steps to be taken in trade relations with Japan. The full text is being deposited in the Library of the House. The main features are a decision to take the case submitted by the Community in the GATT to the second stage of the dispute procedure, to extend import surveillance and to reinforce pressure both for an increase in imports into Japan and for effective and clearly defined restraint of Japanese exports in certain sensitive sectors. There will be a report before the Council at its next meeting.

These measures represent a clear signal by the Community to the new Japanese Government that more action on their part is now urgently required to redress the trade imbalance.

The Commission gave a detailed statement on the problems of the 1970 EC-Spain agreement, which we requested at the November Foreign Affairs Council. It stated its intention of approaching Spain to seek better implementation of the agreement, and undertook to discuss the tariff imbalance with the car industry. We made it clear that we expected early and effective action to remedy the unbalanced trade relationship, and asked the Commission to report again to the January Council.

Ministers discussed the negotiations for a new trade regime between the Community and Cyprus in 1983. We, in common with a majority of our partners, pressed for an improvement in the arrangements being offered to Cyprus. No agreement was reached, and the existing regime will be extended automatically for a further six months.

The Council also discussed the internal market and identified the initial priority areas for work. It was agreed to hold special sessions in the new year to resolve outstanding problems. My hon. and learned Friend the Minister for Trade made clear the importance we attach to early progress towards the completion of the internal market for both services and goods.

It was agreed that a committee of three scientists should urgently review the cost effectiveness of the Super Sara project and produce a report for a final decision early in the new year.

[Mr. Francis Pym]

There was further discussion of measures to restore stability to the steel market. Support was given to the Commission's actions to strengthen the price regime.

Discussion of the European Parliament's proposals for a common electoral system showed that a number of difficult problems remained. The Council agreed to look at the question again at its next meeting in January.

The Council agreed a duty-free tariff quota for newsprint for 1983, but to our regret was unable to agree to a small supplement in the 1982 quota.

In the margins of the Council, Ministers met in political co-operation to discuss recent developments in Poland. They concluded that it would be premature to form conclusions now on the implications of the measures announced by the Polish Government. We will keep in close touch and continue to follow the situation closely.

**Mr. Eric S. Heffer** (Liverpool, Walton): I thank the right hon. Gentleman for that statement, but as it is wide-ranging I hope he will forgive me if I do not follow exactly all the subjects that he raised.

I should like to put four major points. Does he not agree that the Community's position is extremely hypocritical in the sense that, while it is protectionist on agriculture through the CAP, it demands free trade for industrial goods? If import penetration by the Japanese is so damaging—and we all agree that it is—will the Government follow the logic of that and accept that import penetration from Community countries into Britain is equally damaging, especially in such key sectors as steel and motor vehicles, and particularly bearing in mind that production in manufacturing industry is at its lowest level for 15 years?

I am sure that the whole House will congratulate the new Spanish Government led by Felipe Gonzalez, the leader of the Spanish Socialist party. As France seems certain to block Spanish entry until the problem of Mediterranean agriculture is sorted out, what is the Government's attitude? Does the Secretary of State believe that in its present form the CAP could survive the entry of Spain and Portugal? Has he any projections of the budgetary implications of Spanish accession? In other words, how much will it cost?

Did the right hon. Gentleman see this week's *Sunday Times* magazine, which included photographs of the destruction of fruit and vegetables because of CAP policy? Is he aware that many people in Britain cannot afford to buy those fruit and vegetables and that there is starvation in the Third world? Is it not disgraceful that such a thing should happen?

It is clear that a decision is needed by the end of December on the re-scheduling of Polish debt. What position do the Government adopt, especially as Lloyd's Bank, with the support of the Bank of England, is prepared to grant a loan to the Fascist junta in Argentina? What implications will the "wait and see" policy have for the Polish economy and the world banking system?

**Mr. Pym:** The hon. Gentleman drew a contrast between agricultural policy in the Community and the attitude to other trade. There is no doubt that that was the main subject discussed between the Commission and the United States. The United States Government also give much support to their farming industry. The conclusion

was that they must examine this problem in great detail, and that not much progress will be achieved by criticising each other across the Atlantic.

As the hon. Gentleman knows, we have criticised many features of the CAP. The most significant is the way in which it contrives to create surpluses. That is a great problem within the CAP. Although we have not yet been successful in altering that policy, it remains our first objective—as it was with the previous Government—to put that matter right. That will no doubt be a major problem in the future.

We want Spain to accede to the treaty, and France has made it quite clear that she also wants Spain to accede. However, there will be problems, particularly over Mediterranean agriculture, which are in the process of being sorted out in the discussions on accession. Similarly, discussions are at present taking place on the budgetary implications. The Community members feel that we should examine all these issues before accession is achieved.

The Spanish Foreign Minister made a statement on the Spanish Government's position at the Foreign Affairs Council to the effect that they gave a high priority to Community accession.

I share the hon. Gentleman's view about fruit and vegetables. It is unfortunate when events such as the one he described take place. This is another aspect of the CAP that we are constantly trying to reform.

We are in touch with our partners about Polish debt. That is one aspect of the Polish situation, and it is at present being considered with the United States and with other Community countries.

**Mr. Michael Latham** (Melton): Are we not proceeding at an absolute snail's pace regarding Japan, with more consultations and discussions? Is it not time for some action? How much longer will we put up with the French internal protection campaign without doing something about it?

**Mr. Pym:** On my hon. Friend's first question, the Council took the matter a stage further and agreed to go to the second stage of the disputes procedure. I do not think that that has been done before. It is a significant change, and it is much more effective because it has been done by the Community as a whole rather than by Britain on her own.

I assure my hon. Friend that some of the actions that have been taken inside France are now under review by the Commission, and the Government are watching the matter carefully.

**Mr. Russell Johnston** (Inverness): The right hon. Gentleman referred to a number of difficult problems over the common electoral system proposed by the European Parliament. Will he be more specific about the problems that the British Government perceive as important? Is it not a fact that the Government are using technical objections to mask their outright opposition in principle to a proportional solution even though everyone else agrees that that is the only fair outcome?

**Mr. Pym:** It is no secret that we have reservations about changing the basic system of elections in this country, but many other issues divide the other Community members who have already adopted a PR

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10 DOWNING STREET

From the Private Secretary

14 December, 1982.

Dear Richard,

Falklands White Paper: Ship Replacement Orders

The Prime Minister saw over the weekend your letter of 10 December and the accompanying draft announcement on ship orders which your Secretary of State proposes to make. You explained in the letter that Mr. Nott considered that the announcement should indicate an even-handed approach as between Cammell Laird and Vospers with regard to the order for the fourth replacement ship.

I also conveyed to the Prime Minister the view of the Secretary of State for the Environment that it would be preferable to indicate that this order would be placed with Cammell Laird subject to a satisfactory price being quoted.

After further enquiries about the prospect of the contract for the British gas rig going to Cammell Laird, the Prime Minister has taken the view that the announcement should adopt the even-handed approach suggested by Mr. Nott. Mrs. Thatcher believes that it is desirable to refer to Cammell Laird before Vosper Thorneycroft, and I note that the latest version of the text, enclosed with your letter of 13 December, does this.

I am sending copies of this letter to the Private Secretaries to the other Members of OD, the Secretaries of State for Industry, Employment, and the Environment, the Chief Secretary, Paymaster General, Chief Whip and Sir Robert Armstrong.

Yours ever  
John Goss.

Richard Mottram, Esq.,  
Ministry of Defence.

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PRIME MINISTER

Falklands White Paper: Ship Replacement Orders

A decision is needed tonight.

You asked (see attached minute) what the present position was on the possibility of Cammell Laird obtaining the contract for the British gas rig. I understand that Mr. Atkinson of British Shipbuilders considers that he has taken matters as far as he can. He is "utterly confident" that the rig contract will go to Cammell Laird but he does not want to apply further pressure to the British Gas Corporation, who are not yet willing to put anything in writing.

We will therefore have to decide whether, in his statement tomorrow, Mr. Nott should use the balanced wording: "The ship will be put out to competitive tender - Vosper Thornycroft and Cammell Laird will be strong contenders for this order". Or whether he should say, as Mr. Heseltine prefers: "An order for a further ship to complete the replacement of ships lost in the Falklands will in due course be placed with Cammell Laird, subject to a satisfactory price being quoted".

This is largely a political decision. But I am myself inclined to think that, in the absence of a firm decision that the work should go to Cammell Laird, it would be better to stick to Mr. Nott's wording.

Do you agree?

A.J.C.

13 December 1982

MR. COLES

FALKLANDS WHITE PAPER:  
SHIP REPLACEMENT ORDERS

The Secretary of State for the Environment has seen the reference to Cammell Laird's in the draft announcement on ship orders. He feels that the final sentence is less effective than the formulation used by the Defence Secretary at the meeting of OD on 7 December 1982. He would strongly urge the replacement of the final sentence with the words used by the Defence Secretary at OD: "An order for a further ship to complete the replacement of ships left in the Falklands would in due course be placed with Cammell Laird's subject to a satisfactory price being quoted."

The Secretary of State for the Environment feels that an announcement on these lines would be enormously helpful in political terms and would confirm the Government's confidence in the ability of the Merseyside shipbuilding industry to compete.

David Edmonds  
Department of the Environment  
10 December 1982

PRIME MINISTER

Falklands White Paper: Ship replacement orders

Please see the attached MOD letter.

The only sentence of Mr. Nott's proposed draft announcement which may be controversial is the last one stating that the fourth replacement ship will be put out to competitive tender and that Vosper Thornycroft and Cammell Laird will be strong contenders for the order.

Mr. Nott has chosen this wording to demonstrate that our approach is even-handed and to safeguard the Government from accusations of unfair treatment. His Private Secretary tells me, however, that he believes this is entirely a matter for political judgement and that if you wished the wording to be slanted towards Cammell Laird, he would not object.

Meanwhile Mr. Heseltine's office have told me that he would much prefer wording of the kind used by the Defence Secretary at OD, namely:

"An order for a further ship to complete the replacement of ships lost in the Falklands would in due course be placed with Cammell Laird, subject to a satisfactory price being quoted".

He believes this would be very helpful politically and would confirm the Government's confidence in the ability of the Merseyside shipbuilding industry to compete.

Do you prefer Mr. Nott's wording or Mr. Heseltine's?

A & C. What was the result of the enquiry about the 5 or 6? Patrick Senter was going to ask Mr. Atkinson

10 December 1982

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COMMERCIAL IN CONFIDENCE



MINISTRY OF DEFENCE

MAIN BUILDING WHITEHALL LONDON SW1

Telephone 01-~~230 7000~~ 218 2111/3

MO 5/21

10th December 1982

Dear Sir

FALKLANDS WHITE PAPER: SHIP REPLACEMENT ORDERS

Following the discussion in OD on Tuesday 7th December about ship replacement orders, there have been further consultations at official level with the Treasury and the Departments of Industry and the Environment and with Mr Robert Atkinson, the Chairman of British Shipbuilders. The Prime Minister may wish to know where matters stand.

Mr Atkinson warmly welcomed the Government's intention to announce orders next week for five Type 22 frigates and accepted without reservation that the first four of these ships, which can be ordered immediately, should be placed (as proposed in the Defence Secretary's minute of 6th December) with Swan Hunter (22-09 and 10) and Yarrow Shipbuilders (22-11 and 12). He considers that the order for the fifth ship should go out to competitive tender in which in his view the main contenders would be Cammell Laird and Vosper Thornycroft. Mr Atkinson expressed the hope that the order for the fifth ship would be placed as early as possible in 1983, recognising that the first step would be for Yarrow's to complete the drawings on which the tenders would be based.

Mr Atkinson confirmed that both Cammell Laird and Vosper Thornycroft needed additional steel warship orders. But the employment position in neither yard in the short term was critical to the point of threatening early closure. Cammell Laird had been successful in obtaining substantial sub-contracted steel work for offshore rigs from Scotts. In addition, he confidently expected very shortly a rig order for British Gas. (This has been confirmed by Department of Energy officials). With this order, he judged that the need to declare substantial early redundancies at the yard (which could have amounted to about 450) should not arise. He hoped that another prospect for an oil rig (Sun Oil) would arise in the summer and Cammell Laird would, of course, be a contender for the fifth frigate. At Vosper Thornycroft some 350 redundancies had been declared already this year and there would need to be a further trimming of the workforce

A J Coles Esq

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by about 200 to match the expected workload. But in general there was sufficient work at least until the end of 1983.

In the light of these developments particularly with regard to the position at Cammell Laird, there is a case for the public announcement on the fifth ship not indicating any Government preference for Cammell Laird over Vospers, the two main contenders for the order. An even-handed approach would not only preserve genuine competition but also safeguard us from criticism of unfair treatment. If this approach is adopted, it would be helpful if it could be arranged for the award of the British Gas rig to Cammells to be announced simultaneously - though we understand this may not be possible.

/ I attach draft paragraphs on ship orders which the Defence Secretary proposes to draw on in his statement to the House on Tuesday 14th December when the Falklands White Paper is published.

I am copying this letter to the Private Secretaries to the members of OD, the Secretaries of State for the Environment, Scotland, Industry and Energy, and Sir Robert Armstrong.

*Yours ever,*

*Richard Mottram*

(R C MOTTRAM)



DRAFT ANNOUNCEMENT ON SHIP ORDERS BY DEFENCE SECRETARY

The White Paper announces the Government's decision to replace the two Type 42 destroyers and the two Type 21 frigates lost in the South Atlantic with four Type 22 frigates. I announced earlier, on 1st July, a decision to seek tenders for another Type 22 frigate, not related to the Falklands losses.

Four of these five ships are to be ordered now. In the light of the tenders submitted, an order for two Type 22 frigates to Batch II design has today been placed with Swan Hunter Shipbuilders Ltd. An order for the third and fourth ships to the new Batch III design has today been placed with Yarrow Shipbuilders Ltd.

I am also able to announce today, although it is unconnected with the Falklands replacements programme, that an order for two further HUNT Class Mine Countermeasures vessels has been placed with Vosper Thornycroft (UK) Ltd.

The total value of these orders at today's prices is £585M. These sums will be met from within the announced defence budget for 1983-84 and the planning totals for later years.

We plan that the fourth replacement ship will be a further Batch III Type 22 frigate. It will be ordered as early as possible next year when Yarrow have completed the necessary re-design work. The ship will be put out to competitive tender <sup>between</sup> Vosper Thornycroft (UK) Ltd and Cammell Laird Shipbuilders Ltd will be strong contenders for this order.

10 DEC 1992

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Defence.

FILE

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10 DOWNING STREET

*From the Private Secretary*

9 December 1982

Falklands White Paper: Ship Replacement Orders

The Prime Minister has seen your Secretary of State's minute of 8 December.

She agrees that the Department of the Environment should be included in any further official and Ministerial discussions on this matter.

I am copying this letter to Richard Mottram (Ministry of Defence), Jonathan Spencer (Department of Industry) and Richard Hatfield (Cabinet Office).

A. J. COLES

David Edmonds, Esq.,  
Department of the Environment.

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SM



10 DOWNING STREET

Prime Minister

Mr. Heseltine wants to  
be included in the  
interdepartmental discussions about  
the ship replacement order in  
view of his Piersey's interest.  
If you agree, I shall ask the  
ROD to ensure that he is given  
the chance to put his case.

Amend

MS.

A.S.C.  $\frac{5}{12}$

2 pp

①



Prime Minister

8 December 1982

FALKLANDS WHITE PAPER: SHIP REPLACEMENT ORDERS

John Nott has copied to me his minute to you of 6 December about the ship replacement orders which the Ministry of Defence proposes to announce, which I understand was discussed at the meeting of OD yesterday.

I note from paragraph 6 of his minute that consideration has been given as to whether it would be possible to spread the orders to include the Cammell Laird shipyard on Merseyside. Given my responsibilities for Merseyside, and indeed given my interest in regional development matters generally, I believe it would have been proper to consult me before making a recommendation that in fact excludes Cammell Laird.

As the note attached to John Nott's minute shows, Cammell Laird have excellent shipbuilding facilities. The note also explains that there are no firm prospects of further off-shore work and that it is likely that there will be heavy redundancies in Cammell Laird from the middle of 1983. Unemployment on Merseyside is already running at over 20%.

I now understand that before final decisions are taken on the yards where the work is to be carried out, there are to be inter-departmental discussions. I should like to see the case for putting some of the work to Cammell Laird fully explored, and my Department to be included in any official and Ministerial discussions.

I am copying this minute to the Secretaries of State for Defence, for Industry, and to Sir Robert Armstrong.

*MH*

MH

Argentina

Relations:

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18 DEC 1982

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FORWARDED TO  
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MO 5/21/8

PRIME MINISTER

*ms*

FALKLANDS WHITE PAPER: SHIP REPLACEMENT ORDERS

In the Falklands White Paper which we shall be discussing in OD on Tuesday, I propose to announce immediate orders for four new Type 22 frigates. Of our existing ship designs, the Type 22 is a versatile ship with a strong anti-submarine warfare capability - the Royal Navy's principal task in the NATO area; the alternative - the Type 42 destroyer - is an older design and is optimised for air defence. The other option would be to wait for the new Type 23 frigate but this is still at the design stage and will not enter service until the 1990s - replacement ships are needed more quickly if naval force levels are to be maintained in the late 1980s.

2. Three of the new Type 22 ships will be replacements for Falklands losses and one part of the normal ship programme as already announced. The cost of these ships with their weapons is estimated at £471M. This, together with an imminent order for two minehunters worth £65M, will be the largest simultaneous warship order placed with British Shipbuilders by this Government.

3. In my consideration of the placing of these orders, my primary concern has been to restore the Royal Navy's front-line capability with all possible speed, as well as to enable industry to gain early benefit from new orders. At the same time we wish to incorporate as far as practicable in the design and fighting capability of new ships the lessons learned from the Falklands. Orders have yet to be placed for the last two ships of the Batch II design to be equipped with the OUTBOARD Communications intercept and direction



finding system. Thereafter, we propose a new Batch III version, within the hull dimensions of the Batch II, incorporating a 4.5" gun (all the losses were gunships) together with improved anti-submarine, anti-ship, air defence weaponry and communications.

4. In our tendering action we have sought the maximum benefit from competition between the yards opened up by the size of the prospective orders. We have, therefore, obtained tenders for two Batch II ships (22-09 and 22-10) (which will incorporate some "Falklands" improvement) from the five yards capable of building them (Yarrows, Vosper Thornycroft, Vickers, Cammell Laird and Swan Hunter). For the new Batch III ships we do not, however, have a similar choice because of the need to employ Yarrows, the parent yard for the Type 22 class of frigate, to make the design changes and, in the interests of speed and for other practical considerations, to build the first two ships (22-11 and 22-12) in the new version. I attach at Annex a note of the capacities of the various yards.

5. For ships 22-09 and 22-10 as a pair, Swan Hunter's bid is by far the lowest. For the first of the Batch III ships (22-11 and 22-12) we have negotiated a very tight price with Yarrows, again for a pair.

6. I have given much thought to whether it would be possible to spread the orders more widely to include Cammell Laird and/or Vosper Thornycroft. But this could be done in the case of the Batch II ships only at severe cost penalty (in the range of £14-23M), which I would not regard as an acceptable burden for the defence budget. As for the Batch III ships there is, for the reasons I have explained, no alternative to giving the first of these ships to Yarrows who are designing it. If we decided to put the second of these ships (22-12) to another yard there would be a delay of at least six months before the order could be placed and almost certainly an immediate price penalty for the loss of Yarrow's





offer for a pair of ships. However, Vosper Thornycroft are also likely to receive very soon, as a result of a keenly fought competition with Yarrow, an order for two new minehunters costing some £65M.

7. This leaves the question of a fourth replacement ship for the Falklands losses for which tenders cannot be invited before early next year since the drawings will not be available to put out to yards other than Yarrows until then. If we announced an order now for the fourth replacement, we could not specify a yard. I will explain the options surrounding the last replacement ship more fully at our meeting.

8. In summary, I propose to announce on the publication of the Falklands White Paper on December 14th the placing of orders as follows:

- a. two Type 22 Batch II frigates at a cost of £222M, at Swan Hunter;
- b. two Type 22 Batch III frigates at a cost of £249M, at Yarrow Shipbuilders;
- c. two minehunters at a cost of £65M at Vosper Thornycroft.

9. I invite my colleagues to note these proposals.

10. I am copying this to OD colleagues, the Secretaries of State for Industry, the Environment and Scotland, and Sir Robert Armstrong.

Ministry of Defence  
6th December 1982

*Rumston*  
Approved by Mr Nolt  
& signed in his absence

INDUSTRIAL CAPACITY OF BRITISH SHIPBUILDERSYARROWS (CLYDE)

5,400 on roll, all engaged on RN work.

Currently building four Type 22 frigates (05, 06 07 and 08) and two Minehunters (MCMVs) (04 and 06).

Yarrows need another two Type 22 orders to bridge the gap until production of the new Type 23 frigate. There are no redundancies in prospect at Yarrows - there will probably be a need for modest recruitment up to 1985.

A decision remains to be taken on whether Yarrows or Vosper Thornycroft will be the Lead Yard for the new design Single Role Minehunter. (SRMH).

VICKERS (BARROW)

8,000 on roll, all engaged on RN work.

Currently building:

Four nuclear-powered submarines (SSNs) (13, 14, 15 and 16)  
PWR 02 (Pressurised Water Reactor)

Planned to order:

Three SSNs (17, 18 and 19)  
New conventional submarine (SSK - 01)  
to be followed by the Trident submarine programme.

In the short term there will be a modest rundown of labour at Vickers. This level of redundancy is deemed to be containable. This will be followed by a steady state until about 1987 when there will have to be substantial recruitment in order to meet the Trident programme.

Have been included in a tender programme for any replacement Type 22s but there are no over-riding industrial reasons why an order should be directed to Vickers.

VOSPER-THORNYCROFT (WOOLSTON)

3,600 on roll.

Currently building: Destroyer Type 42-09 and 42-12

MCMVs 05, 07, 09 and 11.

They have recently declared some redundancies and are faced with further redundancies in the short term although these will be offset to some extent by overseas sales orders in that they are taking a sub-contract landing ship logistic from Brooke Marine and there are prospects for corvette orders from Trinidad and Indonesia.

Their current performance on RN work is not good and they were the only Yard which was unable to accelerate Acceptance Dates of existing orders required in the Falklands emergency. Whether this was labour obduracy, inefficient management or recognition that the order book was running dry was not clear.

There are no current plans to place further steel surface warships in Vospers but they have successfully tendered for MCMVs 08 and 10 in competition with Yarrows.

Placing one or more of any additional Type 22 orders at Vospers would have a marked effect on the redundancy position in the short term. However, on current performance Vosper-Thornycroft would not be the choice of builder for the fastest or most cost-effecting build.

The outcome of the current MCMV exercise could be a pointer to the future for the SRMH programme. If the Yard were to be engaged in glass reinforced plastic construction only it would need dramatic restructuring and a significant reduction in total labour force.

SWAN HUNTER (TYNE)

9,000 on roll, of whom about 5,800 are engaged on RN work.

Remaining RN orders are the carrier (CAH-03) and the destroyer Type 42-14 (YORK).

Planned orders for Swan Hunter are the new support ship (AOR) programme starting in the mid-1980s. They are also likely to be one of the follow-on Type 23 builders.

There is a substantial gap between the completion of the current programme and the start of the AOR and Type 23 programme. If this is not filled by merchant ship work then there will be very heavy redundancies at Swan Hunter. The addition of one or two replacement Type 22s would go a long way to bridge this gap and would be most welcome at this yard. Their past record on both man-hours and cost has been excellent.

CAMMELL LAIRD (MERSEYSIDE)

3,600 on roll, of whom 1,100 are currently employed on RN work.

They have recently finished the destroyer Type 42-10 (LIVERPOOL) and the only orders in the Yard at present are Type 42-13 (EDINBURGH) and a Drilling Rig for Dome Petroleum. This rig is due to complete in June 1983 and at present there are no firm prospects of further offshore work - although they do have some tenders out. It is thus likely that there will be heavy redundancies in Cammell Laird from the middle of 1983 and if Type 42-13 is the sole order left in the Yard its completion by 9/84 becomes problematical.

There are no orders envisaged for Cammell Laird in the planned programme although there remains the prospect of their becoming the follow-on builder in 1985 for the new conventional submarine (SSK). They have excellent shipbuilding facilities and could rapidly divert into conventional submarine building at very little capital cost.

The cessation of surface RN work at Cammell Laird and their switch into the offshore division was agreed policy with BS. However the future prospects for offshore work are not good and a swing back to surface warship building would be welcomed by BS.

SCOTTS (CARTSBURN)

2,100 on roll, about 1,000 employed are on the SOV (Seabed Operations Vessel) which is due to complete about mid 1983. The future of the Carlsburn Yard beyond this date will be entirely dependent on their gaining commercial orders but the prospects do not seem good.

There are no MOD orders currently envisaged to be placed at Scotts but should they still be in existence in 1985 they could be considered for the build of the follow-on SSKs. However a large capital investment would be required to provide the necessary facilities.

The situation is such that all 2,100 could become redundant in 1983 - other than those who would transfer to the Lithgow Yard.

CONFIDENTIAL

Scotts do not have the facilities or the skills to build modern surface warships such as replacement Type 22s.

CONFIDENTIAL

17 November 1982

MEMORANDUM BY CAPTAIN MOORE

The Prime Minister has seen your Secretary of State's letter of 12 November (and the short manuscript letter which accompanied).

Mrs. Thatcher is most grateful to Mr. Nott for this very thorough examination of the points made in Captain Moore's memorandum. She has asked me to say that she entirely agrees with the comments in the last paragraph of Mr. Nott's letter of 12 November.

ASZ

Richard Mottram, Esq.,  
Ministry of Defence.



10 DOWNING STREET

Prime Minister

Would you like me to pass your  
thanks to Mr. Nott for the  
very thorough examination of the  
points in Captain Moore's  
memorandum and say that  
you entirely agree with the  
last paragraph of his (typewritten)  
letter?

Yes please  
A.F.C.  $\frac{15}{4}$   
ms



12th Nov.

Dear Prime Minister.

Capt. Moore's memorandum was put round the Department without his name being mentioned.

You should know that nobody who saw the memorandum had any doubts that it came from Moore. The arguments have been put by him many times - and are rather unique to him.

Yours ever - John.



VIG



## MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000  
DIRECT DIALLING 01-218 6169

MO 36

12th November 1982

Jean Prime Minister.

You asked for my comments on a memorandum you had received which is critical of the Defence Ministry in general and the naval programme in particular. I do not think anything is to be gained from responding to the personal criticism of politicians, civil servants and Service officers contained in the memorandum; there is no answer to general rebukes. I am sure that Lord Mountbatten was a very successful officer but he was grappling with very different problems to those we face today, not least a less pressing demand on resources and a much less intensive technological challenge.

Let me then leave the rhetoric and answer the specific points in the memorandum. We do not have the resources to explore the potential offered by every new development and area of technology, and common prudence dictates caution in the too ready abandonment of tested parts. Thus, although I sometimes get frustrated in the field of naval procurement, it is still true that we were among the first to adopt nuclear propulsion, in the use of glass reinforced plastic for larger hulls and, as was so well demonstrated in the Falklands, with the Sea Harrier and the only effective anti-missile missile system in the world, SEA WOLF. More recently, the STING RAY

The Rt Hon Margaret Thatcher MP



lightweight and the new heavyweight torpedoes now under development will employ technology several years ahead of their competitors. This is no bad record - and does not really support the charge that the Ministry of Defence is unreceptive to new ideas. As with any large organisation, the Department needs pushing from the top but it takes up realistic new concepts with enthusiasm.

On the design of the new Type 23 frigate, the Royal Navy are broadly content with the latest proposals - and I think they are right. An important objective in this ship has been to enhance the ratio of weapons to ship "platform", all within a strict unit cost budget. Yarrow Shipbuilders, who have the design contract, are being encouraged to come up with their own ideas for achieving the required performance at lower costs. We have commissioned an independent agency (Y-ARD) to carry an objective and critical examination of the design. Thornycroft Giles and Associates, sponsors of the S90 proposal, are also being given the opportunity to validate their claims that our requirements for this frigate could be met and more cheaply with a wide-bodied ship design built by a private consortium and their proposals have already been discussed at some length with my staff. Geoffrey Pattie is strongly representing the merits of S90 but, having listened to the arguments in its favour, I find myself in agreement with the scepticism of all my expert advisers on the suitability of this design.

On submarines, the German IKL 2000 design, which we have examined, does not meet the operational requirement against which our own Type 2400 submarine is being developed. Again, Geoffrey Pattie has represented the arguments in favour of the German submarine but I found the naval arguments against it quite overriding. Its sensor fit is not considered adequate for effective surveillance in a highly hostile environment such as the North East Atlantic; it has a very simple "swim out" torpedo discharge system with elementary storage and handling, making salvo fire difficult;



and the crew would be hard put to maintain the surveillance role effectively and maintain equipment throughout a long patrol. On the basis of cost information available to us on the German boat, there is little difference in first-of-class costs compared with the 2400. In the case of follow-on orders the German boat would be about one-third cheaper - but mainly as a result of the limitations of its weapon systems. The claims of higher performance for it are, therefore, misleading.

Turning to torpedoes, the lightweight STING RAY has just completed its final deep water contract acceptance trials with production warshot torpedoes. Both the Royal Navy and the Royal Air Forces asked to have early weapons made available for the Falklands and all available stock was deployed some six months before the planned in-service date. There are some minor delays to the programme principally as a result of this diversion of equipment but STING RAY was on a war footing ahead of schedule and no doubt played its part as a deterrent to submarine operations. Our confidence in STING RAY's capability against the assessed threat was endorsed by the House of Commons Defence Committee in June 1981 (House of Commons Paper 218) when its development potential, to which my official quoted in the memorandum was clearly referring, was also recognised.

As the source of the memorandum's cost figures for the heavy-weight torpedo are not given, it is difficult to evaluate them. You will recall the decision taken by OD in September last year in favour of the Marconi option for this torpedo (since named SPEARFISH) after a hard fought competition with the US contender. The figure of £460 million mentioned in the memorandum approximates to that included for the United States weapon in the cost comparisons examined by OD which, over a 20-year life and on the cash flow over the early years of the programme, gave a small edge to the United States proposal. OD decided on all the factors that had to be



considered in favour of a British buy and we were able subsequently to negotiate with Marconi to eliminate the cash flow differential. We obtained a good fixed price contract from Marconi for the development and initial production of STING RAY and SPEARFISH and so will be protected under the contract from real price increases. I have grave doubts whether we would have achieved similar protection in the case of the Gould proposals. We shall be seeking in due course similarly keen prices for follow-on production orders to meet our long term training and warstock needs.

With regard to the HAP/OTTO motor developed by Sundstrand, we acknowledge that the fuels have their attendant hazards, but these will be taken fully into account in stringent design requirements to ensure safety. The new subsidiary company, Marconi Underwater Systems Ltd, was formed from those elements of Marconi which produced STING RAY. MUSL will also develop and produce SPEARFISH and its management structure will strengthen the technological base and allow experience on STING RAY to be applied directly to SPEARFISH. The new company has incidentally recently achieved a major export order of the older TIGERFISH torpedo to Brazil.

Finally, let me comment on the criticism of our procedures. We have been making a sustained effort to improve the effectiveness of management in defence. Major improvements are in hand in particular in the area of financial management and control. In our equipment plans, it is always difficult to strike the right balance between quantity and quality when we are dealing with a very sophisticated threat and of course we are not perfect. Changes are needed to some of the ways in which we do our business - and these changes are being made, for example, in the role of the Chief of the Defence Staff, and the central military staffs and the streamlining of equipment requirement procedures. The major reforms proposed in our procurement procedures by the Fisher Report which are now in train may be relevant to some of the criticisms



in the memorandum. But the truth is that most programmes take a long time to bring to fruition because of their complexity and the need to get value for money - not because of unavoidable delay in the system.

I am not complacent, but I would certainly not share the memorandum's blanket condemnation of the Ministry of Defence - and I think that the support provided by the staffs both Service and Civilian during the Falklands crisis, when innovation was very much to the fore, should not be overlooked in any assessment of the Department's performance.

*Cons ever  
John.*

John Nott

File

dfg

3 November 1982

The Prime Minister has noted the contents of your letter of 2 November about service oil stocks.

**A. L. COLES**

Miss Jane Ridley,  
Ministry of Defence.

SECRET

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MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1  
Telephone 01-9307622 218 2111/3

MO 26/17/1

2nd November 1982

Prime Minister  
you expressed interest in this.

Dear John,

A. J. C.  $\frac{2}{11}$

In your letter of 20th October you asked for a note about the state of Service oil stocks.

Oil supplies held by the MOD, have in fact increased and will continue to rise over the course of this year. The increases will build up stocks of aviation, ground and motor fuels depleted by earlier financial restraints to a level which will be at least sufficient to meet national and NATO requirements which call for a minimum of 30 days war reserve with a longer term objective of a 45 day reserve.

The Navy Department is increasing its main propulsion fuel purchases by an estimated additional £35M, and this will allow war reserves to be raised to a minimum of 45 days or significantly higher where storage facilities permit. Similarly the Army Department is enlarging fuel stocks by an additional £10M, either as forward purchases against next year's consumption or to bolster war reserves. £5M will be spent on raising war reserves which will be up to 45 days within the next few months. Air Force Department stocks now fill available tankage and provide a 30 days reserve. A works programme is in hand to increase storage capacity and should allow fuel holdings to rise to provide a 45 day reserve by the mid 1980s.

Finally the Prime Minister should be aware that although favourable market conditions have undoubtedly helped create opportunities for increasing stocks and these have been taken, our scope for further purchases has been limited to some extent because of the fact that the depressed state of the crude oil market has not as yet been fully reflected in the price of the refined products which are suitable for MOD use. However, the MOD will continue to watch the market closely.

Yours ever,

(J E RIDLEY)(MISS)

A J Coles Esq

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cc Master

10 DOWNING STREET

From the Private Secretary

21 October 1982

Dear Richard,

DEFENCE EXPENDITURE

The Prime Minister had a discussion on 18 October with the Chancellor of the Exchequer, your Secretary of State and the Chief Secretary (HM Treasury) about the defence programme. The annotated agenda which was sent to me under cover of John Gieve's letter of 14 October served as the basis for the discussion.

Your Secretary of State said that he had originally bid for additions of £215 million in 1983/84, £566 million in 1984/85 and £606 million in 1985/86 in order to restore the NATO 3% growth commitment to the defence budget. In the light of the Treasury's latest inflation forecasts and the public sector pay factor for 1983/84, he had revised this bid downwards to a reduction of £43.5 million in 1983/84, together with additions of £46.7 million in 1984/85 and £50.2 million in 1985/86. He had reduced his bid in this way notwithstanding the Treasury's earlier position that the cash defence budget planning figures were inviolate and he gave notice that the adequacy of the cash provision should be reviewed next year if the inflation forecasts proved over optimistic.

As to the financing of the 1982 Armed Forces Pay Review Body and other Review Body awards, it was essential for both political and purely defence reasons that the cost of these awards should be added to the defence budget totals: it was both a matter of principle that the defence budget should be compensated in this way as it had been over the past three years, and as a matter of practice the Services were anxious that there should be no question of their equipment programmes being cut to find room for the cost of their pay awards. Your Secretary of State said that he recognised that the principle of thus compensating the defence budget for the Review Body awards might need to be given up after the General Election; but for the present there could be no question of requiring the defence budget to accommodate these sums.

The Chief Secretary said that he could agree to the adjustments to the defence budget sought by the Defence Secretary with a view to restoring the NATO 3% growth commitment (i.e. the line of figures in paragraph 2 of the annotated agenda). He did not accept, however, the Defence Secretary's reasoning for making these adjustments; but, since he could agree the figures, he saw no point in attempting to reach agreement on what the proper basis for any such adjustments could be. On the Review Body awards, it had, in fact, never been a principle that the defence budget should be compensated. Mr. Nott had accepted that the cost of £33.4 million in 1982/83 could be accommodated within the existing defence budget total. The figures for future years could, in practice, and should, be similarly accommodated.

SECRET

/ After



After discussion, the Prime Minister said it was agreed that the costs of the Review Bodies awards from 1983/84 to 1985/86 should be added to the agreed defence budget totals. The Defence Secretary would, however, withdraw his bid for an allowance totalling some £1½ billion over the three years (i.e. line (iii) in paragraph 1 of the annotated agenda) for defence non-pay relative price effect on the understanding that the adequacy of the cash provision was open to review, as last year, in the light of the movement in defence prices. The adjustments set out in paragraph 2 of the annotated agenda should also be made.

There followed discussion of Falklands expenditure. Your Secretary of State recalled that the Government had announced that all the equipment lost in the Falklands conflict would be replaced - not necessarily on a like for like basis - and that these costs, together with the cost of the Falklands campaign and of any future garrison, would be met out of monies in addition to the 3% annual rate of real growth. The best available assessment of the full additional cost of the campaign and of replacing lost equipment in cash terms was £725 million in 1982/83, £223 million in 1983/84, £334 million in 1984/85 and £313 million in 1985/86; a further £365 million (at 1982/83 prices) would be required for the later years. The Chief Secretary proposed that these costs should be re-phased as between the three years 1983/84 to 1985/86 as follows:-

1983/84:	£200 million
1984/85:	£345 million
1985/86:	£325 million

Your Secretary of State said that he would prefer that the 1983/84 figure should be £213 million: he would consider whether this could be further reduced. Subsequently you have confirmed that your Secretary of State and the Chief Secretary have agreed that firm additions to the defence budget should be made of £200 million in 1983/84, £350 million in 1984/85 and £320 million in 1985/86.

On the costs of the Falklands garrison the Secretary of State proposed that the interests of control would be best served by allocating fixed sums and including them in the defence budget. If that was accepted, he would be prepared to argue at OD(FAF) that any additional costs should be met from the defence budget. After discussion it was agreed that the sums to be added to the defence budget, at 1982/83 prices, should be 1983/84: £400 million; 1984/85: £300 million; and 1985/86: £200 million. This estimate rested on the assumption of an airfield costing around £220 million and of a configuration of forces on the following lines:

1 SSN	5 other helicopters
2 Frigates	8 Rapier fire units -
3 Patrol Craft	with a total onshore
1 Ice Patrol Ship	strength not exceeding
1 Oiler	2,000
1 Battalion	
6 Phantoms	
2 Hercules	
3 Chinooks	

SECRET

At the end of the meeting the Defence Secretary mentioned his plan to purchase four second-hand wide-bodied jets (DC 10 freighters) for mid-air refuelling. He would be obliged to purchase these from the USA, and his intention would be to find as much as possible of the cost of purchase of these aircraft within this year's defence budget total. The costs of conversion were included within the provision of £400 million for the Falklands garrison next year. The Prime Minister noted the considerable operational advantages that this purchase would confer, and agreed that it would be important to bring forward as much of the cost as possible to within this year's expenditure.

I am sending copies of this letter to John Kerr and John Gieve (Treasury) and to Richard Hatfield (Cabinet Office).

*Yours sincerely,*

*Michael Scholar*

→

Richard Mottram, Esq.,  
Ministry of Defence.

SECRET

COVERING SECRET



MINISTRY OF DEFENCE

MAIN BUILDING WHITEHALL LONDON SW1A 2HB

Telephone 01-218 2111/3 (Direct Dialling)

01-218 9000 (Switchboard)

MO 8

21st October 1982

*Richard  
Mettram*

*Dear Michael,* PA

/ We spoke and I now attach a copy of the amendments to your draft record which my Secretary of State would wish to have made.

A copy of this letter goes to John Gieve.

*Your ever*

*Mich Evans.*

(N H R EVANS)

M C Scholar Esq

COVERING SECRET

*No instructions required*DEFENCE EXPENDITURE

The Prime Minister had a discussion this afternoon with the Chancellor of the Exchequer, your Secretary of State, and the Chief Secretary (HM Treasury) about the defence programme. The annotated agenda which was sent to me under cover of John Gieve's letter of 14th October served as the basis for the discussion.

Your Secretary of State said that he had originally bid for additions of £215 million in 1983/84, £566 million in 1984/85, and £606 million in 1985/86 in order to restore the NATO 3% growth commitment to the defence budget. In the light of the Treasury's latest inflation forecasts and the public sector pay factor for 1983/84 he had revised this bid downwards to a reduction of £43.5 million in 1983/84, together with additions of £46.7 million in 1984/85 and £50.2 million in 1985/86. He had reduced his bid in this way notwithstanding the Treasury's earlier position that the cash defence budget planning figures were inviolate and on the understanding *and the* that the adequacy of the cash provision should be reviewed next year if the inflation forecasts proved over optimistic. *gave where that*

As to the financing of the 1982 Armed Forces Pay Review Body and other Review Body awards, it was essential for both political and purely defence reasons that the cost of these awards should be added to defence budget totals: it was both a matter of principle that the defence budget should be compensated in this way as it had been over the past three years, and as a matter of practice the Services were anxious that there should be no question of their equipment programmes being cut to find room for the cost of their pay awards. Your Secretary of State said that he recognised that the principle of thus compensating the defence budget for the Review Body awards might need to be reviewed after the General Election; but for the present there could be no question of requiring the defence budget to accommodate these sums.

\*  
would  
need to be  
given up  
after

The Chief Secretary said that he could agree to the adjustments to the defence budget sought by the Defence Secretary with a view to restoring the NATO 3% growth commitment (i.e. the line of figures in paragraph 2 of the annotated agenda). He did not accept, however, the Defence Secretary's reasoning for making these adjustments; but, since he could agree the figures, he saw no point in attempting to reach agreement on what the proper basis for any such adjustments could be. On the Review Body awards, it had, in fact, never been a principle that the defence budget should be compensated. Mr Nott had accepted that the cost of £33.4 million in 1982/83 could be accommodated within the existing defence budget total. The figures for future years could, in practice, and should, be similarly accommodated.

After discussion, the Prime Minister said it was agreed that the costs of the Review Bodies awards from 1983/84 to 1985/86 should be added to the agreed defence budget totals. The Defence Secretary would, however, withdraw his bid for an allowance totalling some £1 $\frac{3}{4}$  billion over the three years (i.e. line (iii) in paragraph 1 of the annotated agenda) for defence non-pay relative price effect on the understanding that the adequacy of the cash provision was open to review, as last year, in the light of the movement in defence prices. The adjustments set out in paragraph 2 of the annotated agenda should also be made.

There followed discussion of Falklands expenditure. Your Secretary of State recalled that the Government had announced that all the equipment lost in the Falklands conflict would be replaced - not necessarily on a like for like basis - and that these costs, together with the cost of the Falklands campaign and of any future garrison, would be met out of monies in addition to the 3% annual rate of real growth. The best available assessment of the full additional cost of the campaign and of replacing lost equipment in cash terms was £725 million in 1982/83, £223 million in 1983/84, £334 million in 1984/85 and £313 million in 1985/86; a further £365 million (at 1982/83 prices) would be required for the later years. The Chief Secretary proposed that these costs should be re-phased as between the three years 1983/84 to 1985/86 as follows:-

1983/84:	£200 million
1984/85:	£345 million
1985/86:	£325 million

*No intention*

Your Secretary of State said that he would prefer that the 1983/84 figure should be £213 million: he would consider whether this could be further reduced. ~~W/Note~~ Subsequently you have confirmed that your secretary of State and the Chief Secretary have agreed that firm additions to the defence budget should be made of £200 million in 1983/84, £350 million in 1984/85 and £320 million in 1985/86".

*X*

On the costs of the Falklands garrison the Secretary of State proposed that the interests of control would be best served by allocating fixed sums and including them in the defence budget. If that was accepted, he would be prepared to argue at OD(FAF) that any additional costs should ~~as far as possible~~ be met from the defence budget. After discussion it was agreed that the sums to be added to the defence budget, at 1982/83 prices, should be 1983/84: £400 million; 1984/85: £300 million; and 1985/86: £200 million. This estimate rested on the assumption of an airfield costing around £220 million and of a configuration of forces on the following lines:

1 SSN  
2 Frigates  
3 Patrol Craft  
1 Ice Patrol Ship  
1 Oiler  
1 Battalion  
6 Phantoms  
2 Hercules  
3 Chinooks

5 other helicopters  
8 Rapier fire units -

*with a total onshore strength not exceeding 2,000.*

I attach a table summarising the changes to the PESC baseline as a result of these decisions.

At the end of the meeting the Defence Secretary mentioned his plan to purchase four second-hand wide-bodied jets (DC 10 freighters) for mid-air refuelling. He would be obliged to purchase these from the USA, and his intention would be to find as much as possible of the cost of purchase of these aircraft within this year's defence budget total. The costs of conversion were included within the provision of £400 million for the Falklands garrison next year. The Prime Minister noted the considerable operational advantages that this purchase would confer, and agreed that it would be important to bring forward as much of the cost as possible to within this year's expenditure.

~~Last sentence of record deleted~~

I am sending copies of this letter to John Kerr and John Gieve (HM Treasury) and to Richard Hatfield (Cabinet Office).

## CONFIDENTIAL

DEFENCE PROGRAMME

	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>
Survey baseline	15277.8	16424.2	17596.3
"Restoration of 3%"	-43.5	46.7	50.2
1982 AFPRB etc awards	42.0	44.1	45.9
Falklands non-garrison	200	350	320
Falklands garrison	424	334	232
Baseline for PEWP	<u>15900.3</u>	<u>17199</u>	<u>18244.4</u>
Change	+622.5	+774.8	+648.1
of which Falklands	+624	+684	+552

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76  
JL

BF

20 October 1982

When the Chief of the Defence Staff called on the Prime Minister yesterday, Mrs. Thatcher expressed the hope that we were taking advantage of the comparatively low price of oil to build up considerably the stocks available to the Armed Forces. I should be grateful to know what the position is.

AJC

Richard Mottram, Esq.,  
Ministry of Defence.





FWS

EM

10 DOWNING STREET

*From the Private Secretary*

20 October, 1982

Following your meeting with the Prime Minister yesterday, I enclose, as promised, a copy of the letter which the Prime Minister has received from Captain John Moore, Editor of Jane's Fighting Ships.

The Prime Minister sent this on a personal basis to the Defence Secretary a few days ago.



Field Marshal Sir Edwin Bramall, G.C.B., O.B.E.,  
M.C., A.D.C. Gen.,

EM

SUBJECT

FIVE

cc Master  
of's



cc: IG

10 DOWNING STREET

THE PRIME MINISTER

Personal Minute

No. M7/82

PERSONAL

SECRETARY OF STATE FOR DEFENCE

Dear John

I enclose a note which I have received from Captain John Moore, Editor of Jane's Fighting Ships, who is a neighbour of Ian Gow. I think that these comments, coming from such an expert source, have to be taken seriously; and you will see that John Moore has been in touch with Geoffrey Pattie. May I leave it to you to follow up these points in whatever way you think most effective, protecting the source.

If there are any comments you want to let me have in due course on the points made by John Moore, I should be very interested to see them.

Yours ever

Margaret

19 October, 1982

RM



HLB

BM

cc: IG  
MO

10 DOWNING STREET

THE PRIME MINISTER

19 October, 1982

Dear Captain Moore.

Thank you for your letter of 1 October about potential economies in naval procurement.

As you know, this is a subject in which I am closely interested and I found our earlier conversation on this subject most valuable.

I am very grateful for these further comments, and also for your offer of help at any time.

Yours sincerely

Captain John E. Moore, R.N.

Raymond Storer

RM

cc: Mr. Gow

PRIME MINISTER

LETTER FROM THE EDITOR OF  
JANE'S FIGHTING SHIPS

I gather that there was not an opportunity for you to hand Captain Moore's letter to Mr. Nott when you met him the other evening.

I now attach a reply to Captain Moore and a personal letter under which you could send Captain Moore's letter, if you think fit, to the Secretary of State for Defence.

F.R.B.

15 October 1982



10 DOWNING STREET

THE PRIME MINISTER

Thank you for your letter of 1 October about potential economies in naval procurement.

As you know, this is a subject in which I am closely interested and I found our earlier conversation on this subject most valuable.

I am very grateful for these further comments, and also for your offer of help at any time.

Captain John E. Moore, R.N.



10 DOWNING STREET

THE PRIME MINISTER

Personal Minute

No.

PERSONAL

SECRETARY OF STATE FOR DEFENCE

I enclose a note which I have received from Captain John Moore, Editor of Jane's Fighting Ships, who is a neighbour of Ian Gow. I think that these comments, coming from such an expert source, have to be taken seriously; and you will see that John Moore has been in touch with Geoffrey Pattie. May I leave it to you to follow up these points in whatever way you think most effective, protecting the source.

If there are any comments you want to let me have in due course on the points made by John Moore, I should be very interested to see them.

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG

Michael Scholar Esq  
Private Secretary  
No.10 Downing Street  
London SW1

*ms*  
14 October 1982

*Dear Michael*

DEFENCE SPENDING: NATO COMPARISONS

I understand that at yesterday's meeting with the Prime Minister, the Chief Secretary offered to comment on the table attached to Richard Mottram's letter to me of 8 October. *TPM*

As the Chief Secretary explained at the meeting, he sees good prospects of an amicable settlement to this year's defence PES bids and to avoid further controversy he had not intended to send an early response to Mr Nott. But he has asked me to send you the attached tables to demonstrate that there are different ways of comparing defence expenditure which are not nearly so unfavourable as the one chosen by Mr Nott.

*Yours sincerely*

*J. Gieve*

JOHN GIEVE  
Private Secretary

CONFIDENTIAL

## COMPARISONS OF DEFENCE EXPENDITURE IN NATO

1. There are differing ways of measuring real growth. The Annex to the letter from the Ministry of Defence of 8 October is based on figures calculated by MOD's internal price methodology. This has been found by the Unwin report to overestimate inflation and to understate "volume". Calculations based on the CSO defence procurement deflator show the UK's growth performance to be equal second to the US and are as follows:

	1979	1980	1981 (provisional)	average
US	3.7	5.0	5.7	4.8
*UK	4.7	4.1	1.1	3.3
France	2.5	3.9	3.5	3.3
Germany	1.8	1.9	3.4	2.4
Italy	2.6	4.9	1.5	3.0
** (UK	2.1	2.9	1.7	2.2)

\* CSO defence procurement deflator: financial year figures

\*\* MOD price methodology: calendar year figures

2. In assessing our defence effort there are, however, factors other than the growth rate that should be considered. In absolute terms, UK defence spend is second only to the US. As a percentage of GDP, the UK is second; in per capita terms third:

	total expenditure 1981		per capita expenditure
	US\$ million	% GDP	US\$
US	167,800	5.8	730
UK	25,200	4.9	439
France	23,800	4.2	442
Germany	23,100	3.4	377
Italy	8,700	2.5	151



3. The 1977 NATO Resource Guidance (which formally recorded the 3% aim) recognised that what countries could achieve would depend on their economic circumstances. GDP growth of the principal NATO nations has been as follows:

---

	1979	1980	1981	average
United States	2.8	-0.4	1.9	1.4
France	3.3	1.2	0.3	1.6
Italy	4.9	3.9	-0.2	2.8
Germany	4.4	1.8	-0.3	1.9
United Kingdom	1.9	-2.1	-2.2	-0.8

Source: OECD

4. In 1982-83, the defence budget provided for real growth of 3.7%. Lower inflation than expected should mean that the actual growth achievement could exceed that figure.

5. The calculations of course take no account of the defence expenditure incurred in connection with the South Atlantic which we have agreed should be additional to other expenditure. But anything spent there does increase the total claim of defence on our national resources.

LONDON

covering CONFIDENTIAL

Z PPS



Treasury Chambers, Parliament Street, SW1P 3AG

M Scholar Esq  
Private Secretary  
No.10 Downing Street  
London SW1

14 October 1982

Dear Michael

DEFENCE PROGRAMME

... The Chief Secretary has asked me to send you the attached annotated agenda for the meeting with the Prime Minister on Monday afternoon.

The agenda has been agreed with the Defence Secretary, who I understand shares the Chief Secretary's view that following their discussion and subsequent consultation between officials the differences between our Departments are now much reduced and should be capable of resolution on Monday.

I am copying this letter to John Kerr, Richard Mottram and Richard Hatfield.

Yours sincerely

J.S. Gieve

JOHN GIEVE

Private Secretary

covering

CONFIDENTIAL

ANNOTATED AGENDA  
THE DEFENCE PROGRAMME

The following table shows the baseline and bids which were the basis for the figures reported to Cabinet in the Chief Secretary's paper (C(82)28).

	£ million cash			
	<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>
Survey baseline	14072.5	15277.8	16424.2	17596.3
Additional bids in PESC Report:				
(i) Cost of 1982 AFPRB TSRB and DDRB awards	33.4	42.0	44.1	45.9
(ii) Restoration of 3% commitment		215.0	566.0	606.0
(iii) Allowance for defence non-pay relative price effect		264.0	584.0	956.0
Sub-total	33.4	521.0	1194.1	1607.9
(iv) Cost of Falklands operation and consequential				Unquantified bid

2. The Defence Secretary's bids at (ii) were based on the 1982 Budget forecasts of general inflation; on the basis of the Cabinet decision to apply a 3½% factor for public service pay, of Treasury advice that the forecast of general inflation in 1983-84 is 6%, and on the assumption that in future years the existing cash planning factors remain appropriate for the present, the changes required to secure 3% growth would become:

-43.5      46.7      50.2

NON-FALKLANDS EXPENDITURE

1982 Pay Awards

3. The cost of the 1982 Armed Forces, Service top salaries and Service doctors and dentists pay awards exceeded the provision of 4% made in Estimates 1982-83. In accordance with past practice the Defence Secretary seeks an increase in cash provision for 1982-83 and in subsequent years to meet the excess. The Chief Secretary is opposed to this on the basis that extra provision is unnecessary.

/ 4.

4. It is for consideration:

- (a) whether the 1982-83 cash limit should be increased for the extra costs of the 1982 Armed Forces, etc pay awards;
- (b) whether additional provision should be made for the extra costs of the awards in later years.

Restoration of 3% commitment

5. The Defence Secretary considers that the baseline provision in 1984-85 and 1985-86 will not enable the NATO target of 3% annual real growth to be met; the figures shown in paragraph 2 represent the changes to Survey baseline provision needed to secure 3% growth on the basis of the latest Treasury forecast of general inflation in 1983-84, the 3½% public service pay factor in 1983-84 and the cash factors of 5% in 1984-85 and 4% in 1985-86.

6. The Chief Secretary agrees that a reduction is necessary in 1983-84 but believes that existing provision in 1984-85 and 1985-86 is more than sufficient to meet the NATO target since the path of 3% real growth underlies the additions made at the end of the 1981 Survey.

7. It remains for consideration what changes to the baseline provision are required to enable the Government to meet its commitment to plan to implement in full the NATO 3% target.

Defence non-pay relative price effect

8. MOD predict that prices on defence non-pay expenditure will, on average, increase faster than overall prices by 2.8% each year over the Survey period. In the Defence Secretary's view, additional provision is needed to avoid jeopardising the NATO real growth commitment.

9. In the absence of evidence of the inevitability of a future RPE and given the dangers to cash control and counter-inflation strategy of over-provision, the Chief Secretary sees no reason to make advance provision for it. He accepts that the public expenditure system allows for the adequacy of cash provision to be considered in the course of each year in the light of the movement in defence prices.

10. The Defence Secretary's bid remains for consideration.

FALKLANDS EXPENDITURE

11. The Government has announced that all the equipment lost in the Falklands conflict will be replaced - not necessarily on a like for like basis - and that these costs, together with the cost of the Falklands campaign and of any future garrison, will be met out of monies in addition to the 3% annual rate of real growth.

The Campaign and Replacement Equipment

12. Officials have agreed that the best available assessment of the full additional cost of the campaign and of replacing lost equipment is as follows:

	£m 1982-83 prices				
	<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>Later Years</u>
Cost of campaign	700	115	70	40	} 365
Replacement of lost equipment	25	95	230	230	
Total	725	210	300	270	365

(These costs are at 1982-83 prices and for future years will need to be converted to cash on the same basis as the non-Falklands programme.)

13. It has been agreed that a once for all settlement of the funds to be added to the Defence Budget on account of the campaign and the replacement of lost equipment should be reached; that these amounts should be separately identified in the text of the 1983 PEWP; that they should be managed as an integral part of the defence programme; and that in future decisions on public expenditure after 1985-86 the Defence Budget should make full allowance for continuing costs associated with the Falklands in accordance with the Government's commitment.

14. It was left unresolved at the bilateral whether the Falklands additions for equipment lost should cover the full additional cost of the replacement equipment (eg the 4 Type 22s planned to replace the lost Type 21s and 42s). It has been argued that the additions to the Defence Budget should be only the value of the equipment lost, ie should exclude an amount corresponding to the "betterment", that is, the degree of improved capability resulting from the replacements. This "betterment"

/ amount

amount would then be a charge on the main Defence Budget. On the other hand it is argued that this would be contrary to the sense of the Ministerial agreement. Moreover no claim has been made for "worsenment" arising from the loss of capability pending delivery of replacement assets and from damage to assets not lost. Rough estimates have been made by MOD of the value of worsenment and these largely cancel out the Treasury's estimates of betterment.

### The Garrison

15. MOD have estimated that the cost of the garrison described in the attachment to the Defence Secretary's minute of 2 September to OD(FAF), including the cost of the air base, will be of the order of:

<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>
<u>140</u>	<u>500</u>	500	400

with continuing significant costs in later years. OD(FAF) are to have a further discussion in November about the future garrison and this may lead to changes in the estimated costs.

16. There are two alternative ways of handling the costs of whatever garrison is agreed by Ministers. First, specific figures could be agreed and added to the Defence Budget in exactly the same way as has been agreed for the costs of the campaign and of replacing equipment lost. Secondly, no figures could be published at this stage but the Government's commitment to fund the costs of the garrison in addition to 3% growth could be reaffirmed in the PEWP and they could be met as required from the Contingency Reserve.

17. The advantage of the first course is that it demonstrates more clearly the Government's determination to guarantee the security of the Falklands; it gives the MOD a firmer basis for planning its 1983-84 programme; it would be politically difficult to resist publishing such information once Cabinet has determined the garrison size; and it should help to clarify the implications of decisions now before Ministers as to the size of the garrison if the costs have to be specifically added to future defence expenditure totals. Moreover provision will have to be taken in Estimates for costs associated with the garrison. This course is preferred by the Defence Secretary, who is reviewing the minimum garrison and air base requirements for consideration by OD(FAF) at the beginning of November.

18. In the Chief Secretary's view the second course would be more practical, at least at this stage. Cabinet will consider public expenditure on 28 October. OD(FAF) are unlikely to consider proposals for the garrison before the first week of November, and may not be in a position to take firm decisions immediately for all the Survey years. The Chief Secretary therefore proposes that in the Public Expenditure White Paper provision for garrison costs should be made in the Contingency Reserve rather than on the Defence Budget; this need not be inconsistent with defence planning, a public announcement, or the presentation of Estimates once firm decisions are taken for 1983-84. But he would see presentational problems meanwhile in putting to Cabinet or announcing garrison costs of £500m per annum.

19. It is for consideration which course should be adopted.

Rle

PRIME MINISTER

cc Mr Gow

LETTER FROM CAPTAIN JOHN MOORE

Ian Gow has handed me the attached letter to you from Captain John Moore, Editor of Jane's Fighting Ships, and has told me the background.

I suggest that we might handle this most tactfully and at the same time try to ensure that something happens, in the following way.

I suggest that you might hand the letter to the Secretary of State for Defence when you see him this afternoon. Ian tells me that he mentioned to Mr Nott last week that he had heard from John Moore, and that Mr Nott is sympathetic. You could ask Mr Nott to handle the letter in such a way that it does not get in the hands of those in the Ministry of Defence who would suppress it and may-be try to create trouble for Captain Moore.

If you wish, I could then send a personal copy of the letter to Clive Whitmore: if you would like me to do so, perhaps you would mention this also to Mr Nott. A spare copy of Captain Moore's letter is attached for you to hand to Mr Nott: I will be putting a reply to Captain Moore in your box.

R.R.B.

14 October 1982





FERB

10 DOWNING STREET

13th October 1982

Thank you very much for your letter of 3rd October, with which you enclosed a letter dated 1st October addressed to the Prime Minister.

I apologise for not having written earlier, but I was away in Brighton for the whole of last week.

I have handed your letter to the Prime Minister and she will be replying to you separately.

I am very glad to see that you have sent a copy to Geoffrey Pattie direct.

Thank you so much for all the trouble which you have taken about this.

IAN GOW

Captain John Moore RN



MO 8

May I have a word with the Treasury first. MS.

✓  
Prime Minister ①

You would also wish the Chief Secretary to be present?

MS 8/10

PRIME MINISTER

DEFENCE EXPENDITURE

Leon Brittan and I have now had a bilateral meeting about defence expenditure and he has no doubt made a report to you on it. Although we were able to establish the framework of the points which need resolution, I do not believe there is any scope for taking the issues further bilaterally. Instead I think that the best way forward would be to have a small political meeting to look at all the outstanding issues as a single package and to settle them. I do not believe that the issues are of such intrinsic difficulty that it will prove impossible to do this at a single meeting.

2. Could I therefore ask you to consider convening a meeting with the Chancellor of the Exchequer and myself to sort out on a political basis how we are to handle defence expenditure. I think that the timing that would make most sense from everyone's point of view would be for this to be done before my departure for the Falkland Islands on 21st October.

SW

Ministry of Defence  
8th October 1982

CONFIDENTIAL

Prime Minister (2)



MINISTRY OF DEFENCE *ms 8/10*  
MAIN BUILDING WHITEHALL LONDON SW1  
Telephone 01-~~3307822~~ 218 2111/3

MO 8

8th October 1982

*ms*

*Dear John,*

DEFENCE EXPENDITURE TO 1985/86

On his return from his overseas tour, the Defence Secretary has now seen your predecessor's letter to me of 9th September. Although defence expenditure is now under active discussion and Mr Nott is hopeful that a satisfactory settlement can be reached, he has asked me to place on record the following points.

The Chief Secretary is critical of the fact that MOD were unable to spend the enhanced cash limit in 1981/82 except by bringing forward expenditure from 1982/83. Mr Nott's view is that this reflects the very tight control exercised over defence expenditure earlier in the year when an enhancement to the cash limit could not be guaranteed. He points out that the Treasury forecasts changed much more dramatically during this period than the cash flow forecasts of the MOD - precise estimating in difficult economic conditions down to the last 1% of Defence expenditure on a £6 bn procurement budget is a mammoth task, obviously subject to variations within the year. He has also observed that if the addition to the cash limit had not been secured and spent, real growth over 1980/81 would not have been 1.2% but minus 1.2%. That would have been a serious embarrassment, quite apart from the loss of military capability. He reminds the Chief Secretary that our defence spending has been growing less fast than that of any of the other principal NATO nations (see the attached table).

The Chief Secretary refers to possible underspending this year against the defence cash limit. Mr Nott agrees that the indications point to some underspend. He intends to ensure that the defence programme continues to be managed sensibly and that the best possible use is made of the resources available. As part of this, he will be advancing a pay day to bring it into the present financial year. In so far as there is any unavoidable underspend this will enable the extent of supplementary provision for Falklands costs to be reduced. But Mr Nott's view is that to encourage an underspend on the main programme would be highly damaging to our defence capability (we can now pay for some absolutely vital elements which have been deferred for years) and would be contrary to

J Gieve Esq



declared Government policy to fund the Falklands costs in addition to 3% growth. He has commented that we have a country to defend - and there are other important parts of Government policy as well as the PSBR.

Mr Nott has been informed that the reference in your predecessor's letter to MOD calculations of price rises in 1981/82 justifying a cash increment of only £100 million is based on a misunderstanding which has been explained to Treasury officials and he hopes has been brought to the Chief Secretary's attention.

Finally, Mr Nott has observed that the Chief Secretary's reading of the Unwin Report (on which I shall be writing separately) must have been highly selective. The Report found 'no major systematic errors' in the MOD's pricing methodology and recognised the objections to using general non-defence specific indices such as the CSO index on which the Treasury's calculation of real growth is based. Mr Nott has asked me to confirm that the real growth figures he has quoted both internally and publicly are the most accurate available and should be regarded as the only authoritative figures that there are.

I am copying this to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and Sir Robert Armstrong.

Yours etc,

Richard Mottram

(R C MOTTRAM)

## ANNEX

Real Increases in Defence Expenditure by NATO Countries 1979-81

<u>Country</u>	<u>1979</u>	<u>1980</u>	<u>1981</u> (provisional)	<u>Average</u> <u>1979-81</u>	<u>Ranking</u>
United States	3.7	5.0	5.7	4.8	1
France	2.5	3.9	3.5	3.3	2
Italy	2.6	4.9	1.5	3.0	3
Germany	1.8	1.9	3.4	2.4	4
United Kingdom	2.1	2.9	1.7	2.2	5

DEFENCE: TIME PREFERENCE BUDGET

PART 9

-8 OCT 1982

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5 6 7 8 9

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ANNOTATED AGENDA  
THE DEFENCE PROGRAMME

The following table shows the baseline and bids which were the basis for the figures reported to Cabinet in the Chief Secretary's paper (C(82) 28 ).

	£ million cash			
	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>
Survey baseline	14072.5	15277.8	16424.2	17596.3
Additional bids in PESC Report:				
(i) Cost of 1982 AFPRB TSRB and DDRB awards	33.4	42.0	44.1	45.9
(ii) Restoration of 3% commitment		215.0	566.0	606.0
(iii) Allowance for defence non-pay relative price effect		264.0	584.0	956.0
Sub-total	33.4	521.0	1194.1	1607.9
(iv) Cost of Falklands operation and consequentials				
			Unquantified bid	

2. The bids at (ii) were based on the 1982 Budget forecasts of general inflation. In the light of the Cabinet decision to apply a  $3\frac{1}{2}\%$  factor for public service pay; of Treasury advice that the forecast of general inflation in 1983/84 is 6%; and on the assumption that in future years the existing cash planning factors remain appropriate for the present, the Defence Secretary is willing to reduce his bid to:

-43.5            46.7            50.2

FALKLANDS EXPENDITURE

3. The Government has announced that all the equipment lost in the Falklands conflict will be replaced - not necessarily on a like for like basis - and that these costs, together with the cost of the Falklands campaign and of any future garrison, will be met out of monies in addition to the 3% annual rate of real growth.

The Campaign and Replacement Equipment

4. Officials have agreed that the best available assessment of the full additional cost of the campaign and of replacing lost equipment is as follows:

	£M 1982/83 Prices				
	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>	<u>Later Years</u>
∟ Cost of campaign	705	125	55	25	} 400
Replacement of lost equipment	25	145	225	230	
Total	730	270	280	255	400 ∟

(These costs are at 1982/83 prices and for future years will need to be converted to cash on the same basis as the non-Falklands programme).

5. It has been agreed that a once for all settlement of the funds to be added to the Defence Budget on account of the campaign and the replacement of lost equipment should be reached; that these amounts should be separately identified in the text of the 1983 PEWP; that they should be managed as an integral part of the defence programme; and that in future decisions on public expenditure after 1985/86 the defence budget should make full allowance for continuing costs associated with the Falklands in accordance with the Government's commitment.



6. It was left unresolved at the bilateral whether the Falklands additions for equipment lost should cover the full additional cost of the replacement equipment (eg the 4 Type 22s planned to replace the lost type 21s and 42s). It has been argued that the additions to the Defence Budget should be only the value of the equipment lost, ie should exclude an amount corresponding to the "betterment", that is, the degree of improved capability resulting from the replacements. This "betterment" amount would then be a charge on the main defence budget. On the other hand it is argued that this would be contrary to the sense of the Ministerial agreement. Moreover no claim has been made for "worsenment" arising from the loss of capability pending delivery of replacement assets and from damage to assets not lost. Rough estimates have been made <sup>by MOD</sup> of the value of worsenment and these have been found largely to cancel out the Treasury's estimates of betterment.

#### The Garrison

7. MOD have estimated that the cost of the garrison described in the attachment to the Defence Secretary's minute of 2 September to OD(FAF), including the cost of the air base, will be:

<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>
[ 140	500	500	400 ]

with continuing significant costs in later years. OD(FAF) are to have a further discussion in November about the future garrison and this may lead to changes in the estimated costs.

8. There are two alternative ways of handling the costs of whatever garrison is agreed by Ministers. First, specific figures could be agreed and added to the defence budget in exactly the same way as has been agreed for the costs of the campaign and of replacing equipment lost. Secondly, no figures could be published at this stage but the Government's commitment to fund the costs of the garrison in addition to 3% growth could be reaffirmed in the PEWP and should be met as required from the Contingency Reserve.

9. The advantage of the first course is that it demonstrates more clearly the Government's determination to guarantee the security of the Falklands; it gives the MOD a firmer basis for planning its 1983/84 programme; it would be politically difficult to resist publishing such information once Cabinet has determined the garrison size; and it should help to clarify the implications of decisions now before Ministers as to the size of the garrison if

he costs have to be specifically added to future defence expenditure totals. Moreover provision will have to be taken in Estimates for costs associated with the garrison. This course is preferred by the Defence Secretary.

10. In the Chief Secretary's view the second course would be more practical, at least at this stage, Cabinet will consider public expenditure on 28 October. OD(FAF) are unlikely to consider proposals for the garrison before the first week of November, and may not be in a position to take firm decisions immediately for all the Survey years. The Chief Secretary therefore proposes that in the Public Expenditure White Paper provision for garrison costs should be made in the Contingency Reserve rather than on the Defence Budget; this need not be inconsistent with defence planning, a public announcement, or the presentation of Estimates once firm decisions are taken for 1983-84. But he would see presentational problems meanwhile in putting to Cabinet or announcing garrison costs of £500m per annum.

11. *It is for consideration which course should be adopted.*

#### NON-FALKLANDS EXPENDITURE

##### 1982 Pay Awards

12. The cost of the 1982 Armed Forces, Service top salaries and Service doctors and dentists pay awards exceeded the provision of 4% made in Estimates 1982/83. In accordance with past practice the Defence Secretary seeks an increase in cash provision for 1982/83 and in subsequent years to meet the excess. The Chief Secretary is opposed to this on the basis that extra provision is unnecessary.

13. It is for consideration:

- a. whether the 1982/83 cash limit should be increased for the extra costs of the 1982 Armed Forces, etc pay awards;
- b. whether additional provision should be made for the extra costs of the awards in later years.

Restoration of 3% commitment

14. The Defence Secretary considers that the baseline provision in 1984/85 and 1985/86 will not enable the NATO target of 3% annual real growth to be met, although the figure for 1983/84 is more than sufficient. The revised bid in paragraph 2 represents the changes to Survey baseline provision needed to secure 3% growth on the basis of the latest Treasury forecast of general inflation in 1983/84, the 3 $\frac{1}{2}$ % public service pay factor in 1983/84 and the cash factors of 5% in 1984/85 and 4% in 1985/86.

15. The Chief Secretary agrees that a reduction is necessary in 1983/84 but believes that existing provision in 1984/85 and 1985/86 is more than sufficient to meet the NATO target since the path of 3% real growth underlies the additions made at the end of the 1981 Survey.

16. It remains for consideration what changes to the baseline provision are required to enable the Government to meet its commitment to plan to implement in full the NATO 3% target.

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Defence non-pay relative price effect

17. MOD predict that prices on defence non-pay expenditure will, on average, increase faster than overall prices by 2.8% each year over the Survey period. In the Defence Secretary's view, additional provision is needed to avoid jeopardising the NATO real growth commitment.

18. In the absence of evidence of the inevitability of a future RPE and given the dangers to cash control and counter-inflation strategy of over-provision, the Chief Secretary sees no reason to make advance provision for it. He accepts that the public expenditure system allows for the adequacy of cash provision to be considered in the course of each year in the light of the movement in defence prices.

19. The Defence Secretary's bid remains for consideration.

2 PPs



Prime Minister

MINISTRY OF DEFENCE  
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MO 8

This work was  
commissioned after last year's sterile and  
inconclusive argument about the defence RPE. MOD  
have been rather coy about circulating it - I can see why:  
it implies that no-one really knows what defence price movements,  
properly defined, are ; and x is rather uncomfortable, too.

8th October 1982

Dear Michael,

DEFENCE EXPENDITURE

MUS 11/10

I understand that you asked to see a copy of the "Unwin Report" - the joint review by the Treasury and Ministry of Defence of the methodology of calculating movements in defence prices which it was agreed should be set in hand last December.

I enclose a joint note by the Treasury and Ministry of Defence which records progress in the review so far, and indicates the direction which further work is taking. The work done so far covers the MOD procurement Vote (Vote 2) which is the part of the defence budget where the task of price measurement is most complex. The report points out that no major systematic errors of methodology have been found although a number of small errors and grey areas have been discovered which generally tend to inflate pay and price calculations. Guidance has been issued within the Department with the object of correcting these deficiencies.

For the longer term work is proceeding, in consultation with the Treasury as appropriate, towards the introduction of centrally calculated defence-specific price indices; paragraph 8 of the covering note describes other follow-up action. The need for external assistance is being kept under consideration.

The Defence Secretary has asked me to emphasise that this study, and the proposed new indices, take no account of the continuing growth of the costs of defence equipment which arise from increasing sophistication. This is a separate and most important problem on which this year's Defence White Paper contained a major discussion.

I am sending copies of this letter to the Private Secretaries to the Chancellor of the Exchequer, the Chief Secretary and to Sir Robert Armstrong.

Yours etc,

Richard Mottram

(R C MOTTRAM)

M C Scholar Esq

## STUDY OF PAY AND PRICE METHODOLOGY

(Joint note by HM Treasury and Ministry of Defence)

### Introduction

1. At the end of the 1981 Public Expenditure Survey, it was agreed that a joint study by the Treasury and the Ministry of Defence should examine the methodology of calculating movements in defence prices.
2. A report of progress to date is annexed. This note summarises that report, and indicates the directions further work is taking.

### Present system

3. MOD finance branches are required to split their expenditure forecasts into "volume" (the cost of the work at an earlier price base) and "pay and price" (inflation since that price base). The precise calculation of "pay and price" (P&P) is extremely complex, if not impossible, because of a number of factors: the difficulty in establishing the price base; the nature of the defence programme; and the manner in which prices are agreed and payments made.
4. For their calculation of P&P, finance branches use either direct data (eg wage and overhead rates etc) or price indices. Great skill and expertise is needed to translate "direct data" to an accurate price assessment; and the scope for subjectivity and misinterpretation among non-specialist finance staff is considerable. Many of the existing indices are not defence-specific, and are not acceptable to finance branches. Moreover, the extrapolation of indices or direct data by individual branches is again open to subjectivity which can lead to inconsistency and makes it difficult to determine centrally whether P&P has been overestimated or underestimated because of forecasting error.
5. The diversity of methodologies employed makes it impossible to verify or disprove P&P estimates from the current system. No major systematic errors common to all branches have been found. A number of small errors and grey areas have been discovered, which generally tend to inflate the P&P element.

### Proposed system

6. Although it would be possible to strive for individual improvements, the only way of producing an agreed measure of defence inflation acceptable to both the Treasury and Ministry of Defence is the introduction of centrally calculated defence-specific price indices. Initial investigation shows that this would be practicable; a family of indices could be produced using information held within MOD for the major defence contractors.
7. Construction of the indices will take time (the first year of full use would be 1984-85) but limited manpower resources (about 3 to 4 man years). The longer term effect will be to save staff effort.

### The Way Forward

8. Further exploration is being made, notably with PE finance branches of the practical implications of an index-based system. Other future work will address overheads (which present rather special problems) and the other MOD Votes (where the difficulties should be less intractable). Meanwhile internal instructions will be issued with the aim of improving the standard of the present system.

9. All the work so far has been undertaken from in-house resources; and the immediate way forward continues to be internal in emphasis. The possible need for external assistance however will be kept under continuing review.

J E HANSFORD  
Assistant Under Secretary of State  
Defence and Materiel Division  
HM Treasury

J D BRYARS  
DUS(Finance and Budget)  
Ministry of Defence

June 1982

## JOINT TREASURY/MOD STUDY OF PAY AND PRICE METHODOLOGY

1. At the conclusion of the 1981 Public Expenditure Survey, it was agreed and recorded in Sir Robert Armstrong's minute of 2 December 1981:

"there will be a joint review by the Treasury and the Ministry of Defence, with the assistance of suitable external advice, of the methodology of calculating movements in defence prices, on the lines proposed in the Defence Secretary's letter of 24 November to the Chancellor of the Exchequer; this review should also cover the possibility of devising arrangements which will enable the Ministry of Defence to live within cash limits without unacceptable consequences for the defence industries."

2. This paper reports on the way in which finance branches currently calculate their pay and price (P&P) estimates and puts forward proposals for a new system of P&P calculation.

3. Because of time constraints work to date has been confined to Vote 2. The fact-finding part of the study has been based on a questionnaire sent to all finance branches responsible for Vote 2 expenditure, and on visits to about twenty of them. DGDC, AS(PE) and TC have also been visited. The visits has been conducted by the Central Analytical Unit in GF4 and a Department of Industry statistician nominated by the Treasury, with help from Stats(G) and Technical Costs (TC).

### Objective of pay and price work

4. Finance branches are required, when compiling internal forecasts of outturn, to split their expenditure into "volume" and "pay and price", where "volume" relates to the cost of the work at an earlier price base. There are 2 main purposes of this exercise. Firstly it provides an estimate of the overall effect of inflation on the Defence budget; this can be used to measure real growth and in negotiations with the Treasury. Secondly the P&P figures provide a potential management tool for measuring and attempting to control inflation at a project or finance branch level; they may also in the future form the basis for differential allocation of the cash uplift to Estimates.

### The present system

5. The calculation of precise P&P figures is in most cases an extremely complex if not impossible exercise. There are 2 main complicating factors. Firstly the defence equipment programme does not in general consist of homogeneous articles bought on long production runs. In many cases MOD is buying sophisticated non-standard equipment which is subject to changes during both the development and production stages. This makes it difficult to separate quality changes and inflation in a nominal price movement.

6. The second complicating factor is the manner in which prices are agreed and payments are made. Prices are often not finalised until a production run is well under way. A large proportion of expenditure is incurred in the form of progress payments, the arrangements for which deliberately provide for retention of some part of the payment until satisfactory completion of the contract. In summary, MOD is not dealing with expenditure where each payment can be related to a known quantity of specific goods at a known price.



7. In the face of these difficulties, finance branches have 2 main methods by which they can calculate their P&P. They can either use the most appropriate price index available to them or they can attempt to estimate their own inflation by the use of what we shall call 'direct data' eg wage and overhead rates, unit price costings, development cost plans.

8. The price indices available are mostly calculated by Stats(G) with the exception of Air Systems where DPTCAn are the main supplier. They are usually based on indices provided by other government departments, mostly the Departments of Industry and Trade. They relate to the industries with which defence expenditure is incurred but they are not 'defence specific' in that they reflect cost movements in those industries as a whole and not specifically in the defence subsectors of them. The use of indices for P&P calculations is most common in branches which deal with a mass of relatively small projects, since in these cases the collection of 'direct data' would be very time consuming. It is also for this sort of expenditure that indices are usually most appropriate, particularly if the goods concerned are not specifically for defence purposes and are subject to market pressures. Examples of such goods are general stores, machinery and commercial vehicles.

9. 'Direct data' is more commonly used in branches dealing with a small number of large projects or at least with a small number of contractors. The actual information used is collected either from the contractors or from one of the costing branches within MOD such as contracts branches, AS(PE), TC, DPTCAn, DEng Costs, DAP Costs and naval technical cost branches. The most common method of using direct data is to calculate the movement in the charging rate is a combination of wage and overhead rates. Other methods include monitoring changes in unit price costings or development cost plans.

#### Defects in the present system

10. The first difficulties in pay and price work concern the establishment of a price base. Estimates for years up to and including 1981/82 were required to be submitted at a price base relating to 'quoted' prices in the previous September. For 1982/83 and future years the price base is 'forecast average outturn prices' for the previous financial year eg Estimates 1982/83 and LTC 82 were costed at 1981/82 forecast average outturn prices.

11. We have found that some branches have had difficulty in establishing a price base with any degree of accuracy, mostly because of the complications outlined in paragraphs 5 and 6 above. In particular we found that the term 'quoted' prices caused some confusion. A 'quoted' September price is a theoretical price which would be charged if a good was ordered, manufactured and paid for instantaneously in September, ie it relates to the costs of manufacture in September. If, for example, there were in reality a 3 month lag between work being done and payment being made then a September 'quoted' price would equate to a December 'paid' price. This distinction was not always understood in finance branches and some Estimates were submitted at a September 'paid' price base. The effect of this error was not always as serious as it might seem, since overhead rates, which govern a substantial proportion of expenditure, are normally only changed once a year and hence the difference between a September 'quoted' and a September 'paid' price would not always be a full 3 months inflation. However under the old, survey price, system it would in general cause Sketch Estimates figures to be lower than they should be and to require a greater allowance for inflation than the cash limits factor gave.

12. The 'quoted' price problem no longer exists with the introduction of cash planning and the compilation of sketch estimates at forecast average outturn prices. However there is still some confusion over how the new price base should be compiled and further guidance to branches would be helpful. DS1 have recently issued some instructions and these will be followed by a General Finance Memorandum (see paragraph 30). Nevertheless, however much guidance is given, the calculation of a price base will in some cases always be a difficult and imprecise exercise.

13. One final problem concerning the price base is the treatment of firm prices, by which we mean prices which have been agreed and which will not be increased to allow for inflation. If these are included at face value in the Estimates, then obviously no pay and price allowance is necessary. However we have found cases where such double counting takes place. Guidance will have to be given to finance branches to ensure that in future an adjustment to allow for firm prices is made to either the Estimates or the P&P claim.

14. Moving on to the way in which P&P claims are calculated, we have found great divergence in both the standard and methodology of P&P estimation from branch to branch. Several disadvantages arise from this, two of which stand out. Firstly, there is considerable duplication of effort in the gathering of cost information; DPTCA, TC, individual finance branches and others are often all trying to derive cost data relating to the same contractors. Secondly the overall P&P figure which emerges from the exercise cannot be verified without checking in detail most of the individual components that make it up. This is not feasible since it would mean virtually redoing the whole job.

15. Hence we have found it very difficult to verify or disprove beyond doubt the overall 1981/82 P&P estimate. We have found no major systematic errors common to all branches but we have come across many small errors and areas of extreme uncertainty which, rather than cancelling each other out, tend almost always to increase the amount allocated to P&P. Examples of such errors are:-

- a. the inclusion of estimating changes as P&P;
- b. the inclusion of design changes as P&P;
- c. under the old 'quoted' price system, the inclusion of 12 months inflation with no allowance for lags;
- d. the inclusion of the increase in maintenance time as equipment ages as pay and price; and
- e. some finance branches which claim they rely entirely on indices produce P&P estimates higher than the rise in the index they use.

16. But there are 2 fundamental deficiencies of the present hybrid system of indices and direct data which are probably more important than any of the above. Firstly, there will inevitably be a greater incentive for those branches experiencing higher than average inflation to investigate 'direct data' sources and use them. Indices are by definition averages and if they are correct overall, some branches will experience higher inflation than the indices suggest and others lower. If the former tend to use 'direct data' and the latter indices then there will be an upward bias in the total P&P estimate. Secondly, because of the difficulties outlined in paragraphs 5 and 6, there will inevitably be both an element of subjective judgement and scope for misinterpretation in the use of direct data.

Further subjectivity and inconsistency between branches is caused by the fact that most P&P calculations have to be made on the basis of extrapolated indices or direct data. Each branch makes their own judgements when extrapolating. During the year some revise them and others do not. Branches are probably as well placed as anybody to forecast inflation in their area, but the result of the present system is that it is difficult to determine centrally whether there has been overprovision or under provision for inflation because of forecasting error.

#### Possible improvements

18. When considering how the present system could be improved, we have borne in mind that if the first objective of P&P work stated in paragraph 4 (namely the provision of an agreed measure of defence inflation) is to be met, then it will be necessary to devise a methodology which is more susceptible to central validation than the present one. We have considered whether this could be done by issuing improved central guidance on P&P work and in particular on the use of direct data. Our opinion is firstly that the correct identification and interpretation of direct data is too complex a task to be carried out properly in most finance branches without devoting a wasteful level of resources to it; and secondly that even in the few areas where this is not the case, it is extremely difficult to ensure consistency of methodology under a system similar to the present one.

19. We therefore feel that the only way of overcoming the problem is to extend the use of price indices. If P&P estimates were based on centrally calculated indices, then it would be relatively easy for the methodology of constructing the indices to be investigated and agreed with a central source. But the price indices, as well as being agreed with the Treasury, need to be seen as generally satisfactory by MOD finance branches. At present many branches claim that the current Stats(G) indices do not reflect their price rises accurately because they are too general and are not defence specific. However there is a wealth of information available within the department which could be used to make the indices more specific. TC, DFng, DAP Costs, DPTCAN, PDAS and naval technical costs officers all collect cost information from contractors. In addition price lists for spare parts for many Air Systems projects are held on magnetic tape.

20. We therefore recommend that resources should be devoted to using such information to construct new defence-specific indices. We have investigated with TC and AS(PE) what data are available or could be provided. The information collected by these 2 organisations is all on a contractor basis and so we feel that the basic building blocks of the new indices should be contractor indices or, if necessary, further sub-divisions of these into factory site indices. It would then be possible to create indices for projects, finance branches, ledgerheadings or defence equipment as a whole by taking weighted averages of these building blocks. The building block indices could theoretically be calculated for all contractors for which AS(PE) collect information but it would probably be sensible to restrict them to the largest 40 or so.

21. Although AS(PE) and TC collect a considerable amount of data from contractors it is not assimilated in a way which makes the calculation of price indices straightforward. Given the difficulties, we feel it would be best to calculate indices which aimed solely to measure the inflation in contractors' costs. The indices would therefore mostly be 'input' indices ie based on input costs rather than output prices. They would be calculated by breaking down a contractor's costs in a base year into items such as direct salaries, indirect salaries, bought out items, fuel, rates, materials etc and then creating an index which reflected the inflation in each of these items weighted by their relative importance to the contractor's total costs.

Where appropriate and possible, different weightings of the components of the contractor costs could be used to produce separate indices for development and production work. For some items, such as salaries, the inflation would be measured using information specific to the contractor. In other cases, such as bought-out items, if no such information were readily available within the Department, the most appropriate external index for the industry concerned would be used (although it may be possible to obtain some contractor-specific information from the Department of Industry). The indices would reflect overhead increases due to inflation in the constituent parts of overheads. But they would not reflect rises or falls in overheads due to changes in capacity utilisation. This point is discussed further in paragraphs 26 to 28.

#### Resource implications

22. We have had preliminary discussions with AUS(Stats) and with Stats(G), who would seem the logical branch to be charged with establishing the new indices, about the resources that would be required to do so. They feel that to create indices for the top 30 or 40 defence contractors would require approximately a Statistician (Principal level) and an SAS (HEO level) for about 18 months and an EO (ADP) for about 6 months. Once the indices were established only the EO (ADP) would be required on a permanent basis to help the present Stats(G) organisation maintain them. These estimates are obviously extremely tentative and will remain so until work on the indices is well under way.

23. There would of course be some extra work for staff in AS(PE), TC and finance branches in providing data for the indices. However two points need to be made. Firstly, we do not envisage any extra data being collected for the indices; it will merely be a case of assimilating what is at present available in an appropriate way. By doing this it would be possible to produce indices which, although not perfect, would enable considerable improvements in P&P work to be made. If the team constructing the indices felt that further potential improvement warranted the collection of new data, a case would have to be made for the extra resources required. The second point is that the central calculation of indices would save considerable effort in finance branches and elsewhere. At present there seems to be duplication of effort in the collection and analysis of cost information from industry. In the long term the resources saved should easily outweigh the effort required to set up the indices.

24. As well as the short term resource implications, two other possible disadvantages of the proposed index system have been put to us. Firstly would they be accepted by finance branches, especially if they were made the "official" measure of P&P? Although they would be defence specific, it is inevitable that in certain areas they would be too general, and, as with any indices, they would be averages and would not therefore reflect inflation exactly for every individual contract. Secondly, it could be argued that by taking P&P calculations out of finance branches we were weakening the second objective outlined in paragraph 4, namely the control of inflation at project or finance branch level. We would argue that these disadvantages were not serious. Although the indices would not be ideal in every case, it has to be remembered that the system they would replace is far from perfect. If a finance branch really felt its index was inappropriate it should be reasonably easy to identify the reason for this by examination of the data which had been used to construct it. This could in some cases lead to the indices being revised because of information supplied by the finance branch. If, however, the difference reflected unusual circumstances relating to one particular project and not the contractor as a whole, then of course when figures for that project were being considered the finance branch could point it out as a special case

and explain the circumstances. As for the second point on the control of inflation, accurate assessments of inflation on a contractor basis could lead to better, rather than worse, control. And finally one further advantage of the proposal is that the indices could also be extrapolated centrally; although this would give no guarantee of improved forecasting, it would solve the difficulty of monitoring the effect of forecasting error mentioned in paragraph 17.

25. In summary we argue strongly that the establishment of the indices would be worthwhile. It would provide an agreed measure of defence inflation for expenditure of some £7 billion at a relatively low and mostly temporary cost and at the same time would release resources in finance branches from P&P work to more constructive tasks.

#### Overheads

26. The treatment of overheads is a major cause of the discrepancy between finance branches P&P estimates and evidence provided by indices. At present they are treated inconsistently, with some finance branches ignoring overheads information and others including all overhead rises as P&P.

27. The major reasons for changes in overhead costs are:

- a. changes in the price of the components of overheads, eg indirect labour, fuel, rates etc;
- b. changes in quantities ordered by MOD;
- c. changes in capacity utilisation caused by non-MOD work;
- d. maintenance of spare capacity for use on future projects; and
- e. changes in companies' costing structures.

28. Of the above, only (a) would be reflected in the proposed indices; (e) would in many cases have no effect on MOD expenditure but may merely reflect a shift from direct costs to overheads or vice versa. The other 3 reasons are the most difficult to estimate and cause the most controversy over whether they should be treated as P&P or not. Ideally we feel they should be identified separately from both volume and P&P. It would be possible to obtain a crude measure of the effect of (b) to (e) in aggregate by comparing the movement in the charging rate, which includes all overhead changes, with the movement in the proposed indices, which would only include those due to (a). In cases where this difference was substantial, we feel that further work would be justified to identify precisely where the cause lay; and, indeed, it would seem to be good management to aim to have a system where the effects of (b), (c), (d) and (e) could be identified individually as a matter of course. The question of the scope and extent of further work in this area will be separately addressed as a matter of priority.

#### Further work

29. This study has only considered Vote 2. Further consideration will have to be given to Votes 1, 4 and 5. Our impression is that the problems of P&P work on those votes will be less intractable than those on Vote 2.

If it were agreed to proceed with the establishment of the new indices, they would not be available for at least 18 months and the first year in which they were likely to be in full use would be 1984/85. We therefore recommend that instructions should be circulated as soon as possible to attempt to improve and standardise the present methodology of constructing the price base for Estimates and calculating P&P. GF4 are drafting a General Finance Memorandum to do this.

Difference: The Difference Budget

Part 9.

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11/12

Refence



Treasury Chambers, Parliament Street, SW1P 3AG

PA

Dear Michael

I attach a copy of the "Unwin Report" as requested. I have not told Mod - no doubt you will let them know if the PM does see it since it is more a report to Mr. NSH than to the CST.

Yours sincerely

J. Gieve

5/19/82



## STUDY OF PAY AND PRICE METHODOLOGY

(Joint note by HM Treasury and Ministry of Defence)

### Introduction

1. At the end of the 1981 Public Expenditure Survey, it was agreed that a joint study by the Treasury and the Ministry of Defence should examine the methodology of calculating movements in defence prices.
2. A report of progress to date is annexed. This note summarises that report, and indicates the directions further work is taking.

### Present system

3. MOD finance branches are required to split their expenditure forecasts into "volume" (the cost of the work at an earlier price base) and "pay and price" (inflation since that price base). The precise calculation of "pay and price" (P&P) is extremely complex, if not impossible, because of a number of factors: the difficulty in establishing the price base; the nature of the defence programme; and the manner in which prices are agreed and payments made.
4. For their calculation of P&P, finance branches use either direct data (eg wage and overhead rates etc) or price indices. Great skill and expertise is needed to translate "direct data" to an accurate price assessment; and the scope for subjectivity and misinterpretation among non-specialist finance staff is considerable. Many of the existing indices are not defence-specific, and are not acceptable to finance branches. Moreover, the extrapolation of indices or direct data by individual branches is again open to subjectivity which can lead to inconsistency and makes it difficult to determine centrally whether P&P has been overestimated or underestimated because of forecasting error.
5. The diversity of methodologies employed makes it impossible to verify or disprove P&P estimates from the current system. No major systematic errors common to all branches have been found. A number of small errors and grey areas have been discovered, which generally tend to inflate the P&P element.

### Proposed system

6. Although it would be possible to strive for individual improvements, the only way of producing an agreed measure of defence inflation acceptable to both the Treasury and Ministry of Defence is the introduction of centrally calculated defence-specific price indices. Initial investigation shows that this would be practicable; a family of indices could be produced using information held within MOD for the major defence contractors.
7. Construction of the indices will take time (the first year of full use would be 1984-85) but limited manpower resources (about 3 to 4 man years). The longer term effect will be to save staff effort.

### The Way Forward

8. Further exploration is being made, notably with PE finance branches of the practical implications of an index-based system. Other future work will address overheads (which present rather special problems) and the other MOD Votes (where the difficulties should be less intractable). Meanwhile internal instructions will be issued with the aim of improving the standard of the present system.

9. All the work so far has been undertaken from in-house resources; and the immediate way forward continues to be internal in emphasis. The possible need for external assistance however will be kept under continuing review.

J E HANSFORD  
Assistant Under Secretary of State  
Defence and Materiel Division  
HM Treasury

J D BRYARS  
DUS(Finance and Budget)  
Ministry of Defence

June 1982

## JOINT TREASURY/MOD STUDY OF PAY AND PRICE METHODOLOGY

1. At the conclusion of the 1981 Public Expenditure Survey, it was agreed and recorded in Sir Robert Armstrong's minute of 2 December 1981:

"there will be a joint review by the Treasury and the Ministry of Defence, with the assistance of suitable external advice, of the methodology of calculating movements in defence prices, on the lines proposed in the Defence Secretary's letter of 24 November to the Chancellor of the Exchequer; this review should also cover the possibility of devising arrangements which will enable the Ministry of Defence to live within cash limits without unacceptable consequences for the defence industries."

2. This paper reports on the way in which finance branches currently calculate their pay and price (P&P) estimates and puts forward proposals for a new system of P&P calculation.

3. Because of time constraints work to date has been confined to Vote 2. The fact-finding part of the study has been based on a questionnaire sent to all finance branches responsible for Vote 2 expenditure, and on visits to about twenty of them. DGDC, AS(PE) and TC have also been visited. The visits have been conducted by the Central Analytical Unit in GF4 and a Department of Industry statistician nominated by the Treasury, with help from Stats(G) and Technical Costs (TC).

### Objective of pay and price work

4. Finance branches are required, when compiling internal forecasts of outturn, to split their expenditure into "volume" and "pay and price", where "volume" relates to the cost of the work at an earlier price base. There are 2 main purposes of this exercise. Firstly it provides an estimate of the overall effect of inflation on the Defence budget; this can be used to measure real growth and in negotiations with the Treasury. Secondly the P&P figures provide a potential management tool for measuring and attempting to control inflation at a project or finance branch level; they may also in the future form the basis for differential allocation of the cash uplift to Estimates.

### The present system

5. The calculation of precise P&P figures is in most cases an extremely complex if not impossible exercise. There are 2 main complicating factors. Firstly the defence equipment programme does not in general consist of homogeneous articles bought on long production runs. In many cases MOD is buying sophisticated non-standard equipment which is subject to changes during both the development and production stages. This makes it difficult to separate quality changes and inflation in a nominal price movement.

6. The second complicating factor is the manner in which prices are agreed and payments are made. Prices are often not finalised until a production run is well under way. A large proportion of expenditure is incurred in the form of progress payments, the arrangements for which deliberately provide for retention of some part of the payment until satisfactory completion of the contract. In summary, MOD is not dealing with expenditure where each payment can be related to a known quantity of specific goods at a known price.

7. In the face of these difficulties, finance branches have 2 main methods by which they can calculate their P&P. They can either use the most appropriate price index available to them or they can attempt to estimate their own inflation by the use of what we shall call 'direct data' eg wage and overhead rates, unit price costings, development cost plans.

8. The price indices available are mostly calculated by Stats(G) with the exception of Air Systems where DPTCAN are the main supplier. They are usually based on indices provided by other government departments, mostly the Departments of Industry and Trade. They relate to the industries with which defence expenditure is incurred but they are not 'defence specific' in that they reflect cost movements in those industries as a whole and not specifically in the defence subsectors of them. The use of indices for P&P calculations is most common in branches which deal with a mass of relatively small projects, since in these cases the collection of 'direct data' would be very time consuming. It is also for this sort of expenditure that indices are usually most appropriate, particularly if the goods concerned are not specifically for defence purposes and are subject to market pressures. Examples of such goods are general stores, machinery and commercial vehicles.

9. 'Direct data' is more commonly used in branches dealing with a small number of large projects or at least with a small number of contractors. The actual information used is collected either from the contractors or from one of the costing branches within MOD such as contracts branches, AS(PE), TC, DPTCAN, DEng Costs, DAP Costs and naval technical cost branches. The most common method of using direct data is to calculate the movement in the charging rate is a combination of wage and overhead rates. Other methods include monitoring changes in unit price costings or development cost plans.

#### Defects in the present system

10. The first difficulties in pay and price work concern the establishment of a price base. Estimates for years up to and including 1981/82 were required to be submitted at a price base relating to 'quoted' prices in the previous September. For 1982/83 and future years the price base is 'forecast average outturn prices' for the previous financial year eg Estimates 1982/83 and LTC 82 were costed at 1981/82 forecast average outturn prices.

11. We have found that some branches have had difficulty in establishing a price base with any degree of accuracy, mostly because of the complications outlined in paragraphs 5 and 6 above. In particular we found that the term 'quoted' prices caused some confusion. A 'quoted' September price is a theoretical price which would be charged if a good was ordered, manufactured and paid for instantaneously in September, ie it relates to the costs of manufacture in September. If, for example, there were in reality a 3 month lag between work being done and payment being made then a September 'quoted' price would equate to a December 'paid' price. This distinction was not always understood in finance branches and some Estimates were submitted at a September 'paid' price base. The effect of this error was not always as serious as it might seem, since overhead rates, which govern a substantial proportion of expenditure, are normally only changed once a year and hence the difference between a September 'quoted' and a September 'paid' price would not always be a full 3 months inflation. However under the old, survey price, system it would in general cause Sketch Estimates figures to be lower than they should be and to require a greater allowance for inflation than the cash limits factor gave.

12. The 'quoted' price problem no longer exists with the introduction of cash planning and the compilation of sketch estimates at forecast average outturn prices. However there is still some confusion over how the new price base should be compiled and further guidance to branches would be helpful. DSI have recently issued some instructions and these will be followed by a General Finance Memorandum (see paragraph 30). Nevertheless, however much guidance is given, the calculation of a price base will in some cases always be a difficult and imprecise exercise.

13. One final problem concerning the price base is the treatment of firm prices, by which we mean prices which have been agreed and which will not be increased to allow for inflation. If these are included at face value in the Estimates, then obviously no pay and price allowance is necessary. However we have found cases where such double counting takes place. Guidance will have to be given to finance branches to ensure that in future an adjustment to allow for firm prices is made to either the Estimates or the P&P claim.

14. Moving on to the way in which P&P claims are calculated, we have found great divergence in both the standard and methodology of P&P estimation from branch to branch. Several disadvantages arise from this, two of which stand out. Firstly, there is considerable duplication of effort in the gathering of cost information; DPTCAN, TC, individual finance branches and others are often all trying to derive cost data relating to the same contractors. Secondly the overall P&P figure which emerges from the exercise cannot be verified without checking in detail most of the individual components that make it up. This is not feasible since it would mean virtually redoing the whole job.

15. Hence we have found it very difficult to verify or disprove beyond doubt the overall 1981/82 P&P estimate. We have found no major systematic errors common to all branches but we have come across many small errors and areas of extreme uncertainty which, rather than cancelling each other out, tend almost always to increase the amount allocated to P&P. Examples of such errors are:-

- a. the inclusion of estimating changes as P&P;
- b. the inclusion of design changes as P&P;
- c. under the old 'quoted' price system, the inclusion of 12 months inflation with no allowance for lags;
- d. the inclusion of the increase in maintenance time as equipment ages as pay and price; and
- e. some finance branches which claim they rely entirely on indices produce P&P estimates higher than the rise in the index they use.

16. But there are 2 fundamental deficiencies of the present hybrid system of indices and direct data which are probably more important than any of the above. Firstly, there will inevitably be a greater incentive for those branches experiencing higher than average inflation to investigate 'direct data' sources and use them. Indices are by definition averages and if they are correct overall, some branches will experience higher inflation than the indices suggest and others lower. If the former tend to use 'direct data' and the latter indices then there will be an upward bias in the total P&P estimate. Secondly, because of the difficulties outlined in paragraphs 5 and 6, there will inevitably be both an element of subjective judgement and scope for misinterpretation in the use of direct data.

17. Further subjectivity and inconsistency between branches is caused by the fact that most P&P calculations have to be made on the basis of extrapolated indices or direct data. Each branch makes their own judgements when extrapolating. During the year some revise them and others do not. Branches are probalby as well placed as anybody to forecast inflation in their area, but the result of the present system is that it is difficult to determine centrally whether there has been overprovision or under provision for inflation because of forecasting error.

#### Possible improvements

18. When considering how the present system could be improved, we have borne in mind that if the first objective of P&P work stated in paragraph 4 (namely the provision of an agreed measure of defence inflation) is to be met, then it will be necessary to devise a methodology which is more susceptible to central validation than the present one. We have considered whether this could be done by issuing improved central guidance on P&P work and in particular on the use of direct data. Our opinion is firstly that the correct identification and interpretation of direct data is too complex a task to be carried out properly in most finance branches without devoting a wasteful level of resources to it; and secondly that even in the few areas where this is not the case, it is extremely difficult to ensure consistency of methodology under a system similar to the present one.

19. We therefore feel that the only way of overcoming the problem is to extend the use of price indices. If P&P estimates were based on centrally calculated indices, then it would be relatively easy for the methodology of constructing the indices to be investigated and agreed with a central source. But the price indices, as well as being agreed with the Treasury, need to be seen as generally satisfactory by MOD finance branches. At present many branches claim that the current Stats(G) indices do not reflect their price rises accurately because they are too general and are not defence specific. However there is a wealth of information available within the department which could be used to make the indices more specific. TC, DFng, DAP Costs, DPTCAN, PDAS and naval technical costs officers all collect cost information from contractors. In addition price lists for spare parts for many Air Systems projects are held on magnetic tape.

20. We therefore recommend that resources should be devoted to using such information to construct new defence-specific indices. We have investigated with TC and AS(PE) what data are available or could be provided. The information collected by these 2 organisations is all on a contractor basis and so we feel that the basic building blocks of the new indices should be contractor indices or, if necessary, further sub-divisions of these into factory site indices. It would then be possible to create indices for projects, finance branches, ledgerheadings or defence equipment as a whole by taking weighted averages of these building blocks. The building block indices could theoretically be calculated for all contractors for which AS(PE) collect information but it would probably be sensible to restrict them to the largest 40 or so

21. Although AS(PE) and TC collect a considerable amount of data from contractors  $\phi$  it is not assimilated in a way which makes the calculation of price indices straightforward. Given the difficulties, we feel it would be best to calculate indices which aimed solely to measure the inflation in contractors' costs. The indices would therefore mostly be 'input' indices ie based on input costs rather than output prices. They would be calculated by breaking down a contractor's costs in a base year into items such as direct salaries, indirect salaries, bought out items, fuel, rates, materials etc and then creating an index which reflected the inflation in each of these items weighted by their relative importance to the contractor's total costs.

Where appropriate and possible, different weightings of the components of the contract costs could be used to produce separate indices for development and production work. For some items, such as salaries, the inflation would be measured using information specific to the contractor. In other cases, such as bought-out items, if no such information were readily available within the Department, the most appropriate external index for the industry concerned would be used (although it may be possible to obtain some contractor-specific information from the Department of Industry). The indices would reflect overhead increases due to inflation in the constituent parts of overheads. But they would not reflect rises or falls in overheads due to changes in capacity utilisation. This point is discussed further in paragraphs 26 to 28.

#### Resource implications

22. We have had preliminary discussions with AUS(Stats) and with Stats(G), who would seem the logical branch to be charged with establishing the new indices, about the resources that would be required to do so. They feel that to create indices for the top 30 or 40 defence contractors would require approximately a Statistician (Principal level) and an SAS (HEO level) for about 18 months and an EO (ADP) for about 6 months. Once the indices were established only the EO (ADP) would be required on a permanent basis to help the present Stats(G) organisation maintain them. These estimates are obviously extremely tentative and will remain so until work on the indices is well under way.
23. There would of course be some extra work for staff in AS(PE), TC and finance branches in providing data for the indices. However two points need to be made. Firstly, we do not envisage any extra data being collected for the indices; it will merely be a case of assimilating what is at present available in an appropriate way. By doing this it would be possible to produce indices which, although not perfect, would enable considerable improvements in P&P work to be made. If the team constructing the indices felt that further potential improvement warranted the collection of new data, a case would have to be made for the extra resources required. The second point is that the central calculation of indices would save considerable effort in finance branches and elsewhere. At present there seems to be duplication of effort in the collection and analysis of cost information from industry. In the long term the resources saved should easily outweigh the effort required to set up the indices.
24. As well as the short term resource implications, two other possible disadvantages of the proposed index system have been put to us. Firstly would they be accepted by finance branches, especially if they were made the "official" measure of P&P? Although they would be defence specific, it is inevitable that in certain areas they would be too general, and, as with any indices, they would be averages and would not therefore reflect inflation exactly for every individual contract. Secondly, it could be argued that by taking P&P calculations out of finance branches we were weakening the second objective outlined in paragraph 4, namely the control of inflation at project or finance branch level. We would argue that these disadvantages were not serious. Although the indices would not be ideal in every case, it has to be remembered that the system they would replace is far from perfect. If a finance branch really felt its index was inappropriate it should be reasonably easy to identify the reason for this by examination of the data which had been used to construct it. This could in some cases lead to the indices being revised because of information supplied by the finance branch. If, however, the difference reflected unusual circumstances relating to one particular project and not the contractor as a whole, then of course when figures for that project were being considered the finance branch could point it out as a special case

and explain the circumstances. As for the second point on the control of inflation, accurate assessments of inflation on a contractor basis could lead to better, rather than worse, control. And finally one further advantage of the proposal is that the indices could also be extrapolated centrally; although this would give no guarantee of improved forecasting, it would solve the difficulty of monitoring the effect of forecasting error mentioned in paragraph 17.

25. In summary we argue strongly that the establishment of the indices would be worthwhile. It would provide an agreed measure of defence inflation for expenditure of some £7 billion at a relatively low and mostly temporary cost and at the same time would release resources in finance branches from P&P work to more constructive tasks.

#### Overheads

26. The treatment of overheads is a major cause of the discrepancy between finance branches P&P estimates and evidence provided by indices. At present they are treated inconsistently, with some finance branches ignoring overheads information and others including all overhead rises as P&P.

27. The major reasons for changes in overhead costs are:

- a. changes in the price of the components of overheads, eg indirect labour, fuel, rates etc;
- b. changes in quantities ordered by MOD;
- c. changes in capacity utilisation caused by non-MOD work;
- d. maintenance of spare capacity for use on future projects; and
- e. changes in companies' costing structures.

28. Of the above, only (a) would be reflected in the proposed indices; (e) would in many cases have no effect on MOD expenditure but may merely reflect a shift from direct costs to overheads or vice versa. The other 3 reasons are the most difficult to estimate and cause the most controversy over whether they should be treated as P&P or not. Ideally we feel they should be identified separately from both volume and P&P. It would be possible to obtain a crude measure of the effect of (b) to (e) in aggregate by comparing the movement in the charging rate, which includes all overhead changes, with the movement in the proposed indices, which would only include those due to (a). In cases where this difference was substantial, we feel that further work would be justified to identify precisely where the cause lay; and, indeed, it would seem to be good management to aim to have a system where the effects of (b), (c), (d) and (e) could be identified individually as a matter of course. The question of the scope and extent of further work in this area will be separately addressed as a matter of priority.

#### Further work

29. This study has only considered Vote 2. Further consideration will have to be given to Votes 1, 4 and 5. Our impression is that the problems of P&P work on those votes will be less intractable than those on Vote 2.



30. If it were agreed to proceed with the establishment of the new indices, they would not be available for at least 18 months and the first year in which they were likely to be in full use would be 1984/85. We therefore recommend that instructions should be circulated as soon as possible to attempt to improve and standardise the present methodology of constructing the price base for Estimates and calculating P&P. GF4 are drafting a General Finance Memorandum to do this.

# JANE'S YEARBOOKS

## JANE'S FIGHTING SHIPS

from the Editor  
Captain John E. Moore, R.N.

Elmhurst  
Rickney  
Nr. Hailsham  
Sussex BN27 1SF, England

Telephone 0323 763 294

Your reference

our reference

date 3<sup>rd</sup> October 1982

My dear Ian,  
On Jane's advice I am sending this to No. 10 as it seems unlikely that you are going to see much of Hankham in the next week or so. It is the result of whittling away at a whole stack of briefs which I had prepared - the result really, I'm afraid, contains more questions than answers but that is inevitable in such a condensation.

The outcome of this is no more than an indication of the scale of the problem with which Geoffrey is struggling, with, if the Naval Staff are to be believed, precious little help from T.T. I realise how very difficult it must be for someone with so little experience of such a vast field of technicalities to hoist in the implications of what is being done. At the same time, being strictly parochial, the Navy is in a situation of the gravest danger at the moment and conservative attitudes, entrenched interests and plain pig ignorance

are merely compounding the problem. I think Beaffrey is probably the only one of the five ministers who sees this with total clarity.

I mention "a number of like-minded people" in my letter to the P.M. Between us we have built up a formidable dossier of waste and extravagance running into hundreds of millions of pounds - this is why the "quantity versus quality" cry has become such anathema to me. At the moment I am working on a paper for the Americans on future technological trends in the Soviet navy. I appreciate the vast difference between their budget and ours; what fills me is their continuing capacity for innovation, born of mental activity and acuity. Similar ability is available in many parts of our own country but is tramped down by official opposition and apathy. ~~As a~~ A small example is the matter of providing adequate equipment for the Special Boat Service of the Royal Marines. The so-called "new" diving set devised by the Experimental Diving Unit costs about <sup>£1,000</sup> a third more than a more efficient set available from a small Hexham firm. Also from this firm is a riding submersible which is causing considerable interest abroad - unfortunately the men of Hexham are not allowed to discuss this vehicle with the possible users in the SBS because they are not "approved" by the E.D.U. Heaven knows how much has been spent on official development over the last twenty years.

# JANE'S YEARBOOKS

## JANE'S FIGHTING SHIPS

from the Editor  
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3.

Your reference

our reference

date 3 October 1982

but the likely outcome is a vehicle running into millions of pounds. The absurd thing is that in 1966 when I needed such a vehicle for GBS raids from submarines in my Singapore squadron I found the Royal Engineers, the Admiralty materials laboratory, the Admiralty Underwater Weapons Establishment and the E.D.U. showing varying degrees of interest. But nothing was available so we went back to the depot ship, took a couple of out-dated torpedoes, changed the gearing and batteries, fitted some navigational kit and had what we needed - rudimentary but operational. Total cost - two old torpedoes plus about £800. Today a small raid, if it used what may eventually be produced from official sources, would be operating what has become little less than a mini-submarine and would be putting at risk millions of pounds. However if

• The Hexham machine, were it adopted, would cost £65,000 plus £3,000 for frills such as satellite navigation. As you know the better firms of yacht fitters provide remarkably inexpensive navigational equipment - I bet there has been little effort by the official establishments to find out what is available from such sources. Finally, so far as the Hexham firm is concerned, all the development costs have been from their own funds.

Thank you, Ian, if you've got this far. There are so many areas where the same objections are, I believe, valid - sonar, towed arrays, radar, fuel, mine-countermeasures, aircraft support to mention only some. "We can't afford them" they say. Of course we could if those concerned got off their backsides, forgot their pride and used the very great capabilities of our country to the full. We could again have not only the best but the biggest navy in Europe.

P's ever

John

P.S. I'm sending a copy of the brief to Geoffrey  
P.P.S. The Hexham diving set is selling like hot cakes.

# JANE'S YEARBOOKS

*Robin Butler*

## JANE'S FIGHTING SHIPS

from the Editor  
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Telephone 0323 763 294

Rt. Hon. M. Thatcher MP  
10 Downing Street  
LONDON  
SW1

Your reference

our reference

date 1 October 1982

*Dear Prime Minister,*

At the suggestion of Ian Gow I am enclosing a note on the present state of affairs regarding the navy. This covers only a few points but does, I hope, demonstrate that there are considerable savings to be made without any loss of efficiency. There are many other areas in which equivalent, and frequently better, equipment could be obtained at less cost than current or planned contracts. One of the main problems in this respect is that the existence of such equipment is often not known in the Ministry and manufacturers, both large and small, find it difficult to discover a point of entry. Even when they succeed in giving an explanation of their products, too often they find themselves pre-empted by one of the large monopolies whose alternative equipment may well be obsolescent or even obsolete. A lead time of ten to twelve years from the inception to completion of a class of ship or type of weapon system (a period which the Ministry expects to increase in the future) results in built-in obsolescence as the speed of technological advance accelerates. I am confident that Geoffrey Pattie is aware of all these problems and great comfort comes from knowing of his most refreshing approach despite the opposition, apathy and ignorance which delay his projects.

I do have a number of like-minded people who are very ready to help at any time and if I can be of any service in the future it would be a great privilege.

*Yours sincerely,*

*John Moore*

J.E. Moore,  
Captain, RN.

The Ministry of Defence is a mess. It has been so since Mountbatten left it in 1965. It was designed by him and the position of CDS fitted him perfectly. He dictated the Ministry's operation and none has been able to do that since. In the confusion of committees, registries and ad hoc working parties which today are responsible for our security the politicians have to cope with a mass of unexpected technicalities but are aware of financial stringencies, the uniformed members know of some of the technicalities but little of finance while the majority of civil servants (except for the special few) have no professional knowledge of defence matters, are sometimes expert in a small band of technicalities and have a varying knowledge of financial affairs. The actual Headquarter's figures, although at first sight absurd, demonstrate in some measure the problems of assimilation of what is probably the most complex welter of technicalities faced anywhere in the Government -

5 Government ministers, 2800 uniformed people and 12500 civil servants.

One of the results of this situation is that all processes are slowed down, obsolescence is up-dated and new ideas are unwelcome. Unfortunately the speed of decision making compares unfavourably not only with commercial organisations but also with the two largest navies in the world. One of the great dangers in our present system is that, due to the comparatively short tenure of office of both politicians and service people, various adages become accepted doctrine - "2500 tons is the least warship displacement to carry a helicopter", "anti-submarine attacks will be made from ahead", "speed needs length". Perhaps the most insidious is the "quality versus quantity" chant. None of the first three has any factual basis but the last is not only misleading

but undermines any attempts to achieve modernisation in the fleet at an acceptable cost. In all current major naval requirements there are considerable savings to be made if modern ideas were adopted - at the same time, with no reduction of quality more ships, submarines and equipment could be made available. For example:-

Frigates The S90 design, a private venture, has currently received grudging acceptance as a competitor against the British Shipbuilder's/Bath Type 23 design. The claims for the S90 - greater payload, longer range, possibly higher speed, equal if not better sea-keeping qualities than the Type 23 - are based on sea trials of smaller, similar ships. It has taken several years and considerable ministerial support to get this far. Two, and possibly two and a half, S90s for the price of a Type 23 appear attractive, particularly as the S90 consortium wants to build at Chatham.

Submarines The last Controller visited West Germany to investigate the claims of the I.K.L./Howaldtswerke submarine designs. On the basis of a sea trial in a Type 209 boat his advisers recommended no further interest. The 209 is a smaller design than that required by the R.N. However, the I.K.L./H.D.W. Type 1500 ordered by India and their Type 2000 being considered by Australia both meet the requirements to which the British Type 2400 is being designed. The significant facts are that both the German designs are of higher performance than the Type 2400, require two thirds the crew of that design and would cost less than half the price of Type 2400. An agreement exists for the German designs to be built in the UK under licence.



Torpedoes Stingray is now running its preliminary deep range trials and, even in its present format, is probably still a long way from Fleet acceptance. On 17 March 1981 Mr Mumford (AUS Mat (Navy)) remarked in evidence to the Defence Committee "If we decide to move towards a faster and deeper diving torpedo than Stingray which we may need ourselves in the 1990." With new designs of Soviet submarines likely in the near future maybe we need those attributes now.

As the American Gould package of £460 million for the Mark 48 mod 5 heavyweight torpedo was turned down in favour of the Marconi proposition it now appears that we have a bill of £1.2 thousand million for this new weapon. There is evidence to suggest that there is no proven Otto/HAP propulsion system currently available for this torpedo and if the Sundstrand turbine proposed for it is produced a number of chemists on both sides of the Atlantic have expressed doubts about the safety of the proposed fuel, a mixture of Otto fuel and HAP (Hydroxylamine and Perchloric acid). At the same time there is some confusion in certain areas as to why the heavyweight torpedo computer and software is apparently being produced by a different subsidiary of Marconi than that which produced the Stingray package. One of the advertised advantages of the Marconi offer was that Stingray experience would be utilised in the heavyweight.

Capt. J.E. Moore, RN  
September 1982



Deference  
 Prime Minister

MUS 10/9

Should we ask

Treasury Chambers, Parliament Street, SW1P 3AG

R C Mottram Esq  
 Private Secretary to the  
 Secretary of State  
 Ministry of Defence  
 Main Building  
 Whitehall  
 London SW1A 2HB

Wait - until we return

for the Unwin  
 at X  
 Report - or that  
 it be circulated?

9 September 1982 MUS 10/9

Dear Richard,

DEFENCE EXPENDITURE TO 1985-86

The Chief Secretary has seen your letter of 6 September.

He has asked me to say that he regrets that there still appears to be disagreement about the basis of the £1,200 million cash additions made to the defence programme at the end of the 1981 Survey. He agreed the cash additions last November because of the severe difficulties that were then perceived by Mr Nott to be facing the defence programme. It was said then that another MOD overspend was inevitable in 1981-82, if the cash limit uplift was less than £300 million.

In the event MOD had to take special action to avert a massive underspend in 1981-82, notably by advancing a bill-paying date from 1982-83, so that some £300 million of extra payments could be made to contractors in 1981-82.

The Treasury understand that, Falklands apart, there are similar underspending problems on the defence budget in the current year. The Ministry of Defence is apparently contemplating yet again action to counter this, including advancement of a bill-paying date from 1983-84. The Chief Secretary's preference would be that the underspend on "normal" expenditure be used to accommodate some of the South Atlantic costs, thus reducing the charge on this year's Contingency Reserve. And in so far as action is taken to advance payments from next year into this, it certainly reduces any case for additions to next year's cash programmes.

One of the arguments for a cash limit increase in 1981-82 was that the allowance for defence prices was thought inadequate. The Treasury never accepted the MOD forecasts of defence inflation. In the event subsequent analyses by MOD officials showed that defence non-pay prices rose only 12.3% in 1981-82. This was slightly more than the original cash limit allowance. It might have merited an increase of up to £100 million. In the event the increase made was £300 million.

X | The report of the joint review of the MOD methodology of calculating movements in defence prices - the Unwin report - found widespread shortcomings in the MOD system; and concluded that MOD price methodology tended to overstate defence inflation, and to understate "volume" and real growth. It is understood that Mr Nott has endorsed the Unwin recommendations to implement reforms in the MOD system of price calculation. Meanwhile the findings of the Unwin report raise doubts about MOD's figures for real growth in defence spending - quoted for example in your memorandum C(82)33 as well as in your Private Secretary's letter. Calculations based on the CSO's defence procurement deflator suggest that the 1981-82 level of defence spending was in fact 11% higher, in real terms, than in 1978-79. This would be well in excess of the NATO target and of the aim announced in Cmnd 8288.

In absolute terms, the UK defence budget, even leaving aside Falklands expenditure, is higher than any of our European allies and second only to the US. The UK's record on defence spending - despite our economic difficulties - is excellent; and deserves proper credit, not least in NATO.

I am copying this letter to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, and to Sir Robert Armstrong.

*Yours sincerely*

*Terry Matthews*

T F MATHEWS

Private Secretary

PERSONAL AND CONFIDENTIAL

Prime Minister  
Agree to have a word  
with Mr. Nott - perhaps after  
OD on Wednesday?  
FERB  
6.9.

Prime Minister

You discussed with  
Mr. Nott today - but  
may like to see the  
attachments.

MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1  
Telephone 01-930 7022 218 2111/3



MO 22/7

6th September 1982

A.F.C. 9

Dear Robin,

mf mb

MR 10/9

INTERVIEWS GIVEN BY SIR HENRY LEACH

The Defence Secretary would welcome a brief word with the Prime Minister at a suitable opportunity about the interviews which Admiral Sir Henry Leach gave at the weekend to the Sunday Times and to the BBC.

There was difficulty in June over Admiral Leach's address to the RUSI and a subsequent dinner which he gave to Mr Callaghan to speak to him about the naval programme. As a result, Sir Frank Cooper spoke to Admiral Leach and subsequently minuted the Chiefs of Staff about the general issue of relations with the media. As this is relevant to recent events I am attaching copies of these papers.

Also attached is a transcript of Admiral Leach's interview with the BBC yesterday.

Yours sincerely,

Richard Mottram

(R C MOTTRAM)

Robin Butler Esq

PERSONAL AND CONFIDENTIAL

NOTE FOR THE RECORD

Admiral Sir Henry Leach, Chief of the Naval Staff, came to see me - at my request - on Monday 12 July.

2. I told him that Ministers, including the Prime Minister, were aware that he had given dinner in his flat to Mr James Callaghan, that he had not sought permission, and that he had not reported it subsequently. I said that this information had come from Parliamentary sources and not from within the MOD.

3. I went on to say that he knew full well that this was quite wrong, was a major breach in the rules, and was disloyal. I was speaking to him at Ministerial direction, including that of the Prime Minister, and, though Ministers were conscious of the very considerable services he had performed, they were deeply distressed by what had happened. Indeed, this was putting it mildly.

4. I asked him why he acted as he had done, because he must have known that it was wrong. He said first that he was being loyal to the Royal Navy and that he did not think his case had had a fair hearing. In particular, during the Defence Review last year, the alternative of withdrawing Forces from Germany and going further towards a maritime/air strategy had not been properly considered. He went on to say that what had incensed him recently was that the Secretary of State had been making selective use of statistics about the money available for the Royal Navy and the number of ships that would be available over the next few years. The Secretary of State had used these arguments in giving advice to the Prime Minister and in answering Members of Parliament. The facts had got to be known and it was for this reason that he had seen Mr Callaghan. I told him that none of his arguments were tenable. He knew full well that if everyone in official life was allowed to brief Members of Parliament and the Press indiscriminately, then there would be no loyalty or discipline left. How would he feel if his subordinates went around arguing against his policies?

5. I concluded by saying that as far as Ministers were concerned this was the end of the matter, but clearly it was wrong to have behaved in this kind of way, particularly just before a debate in the House of Commons on Naval matters, and we could not have such a situation occurring again. I would be sending a note round almost at once to all the Chiefs of Staff reminding them of the rules and requiring them and their staffs to follow them.



FRANK COOPER  
14 July 1982

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PUS/82/846

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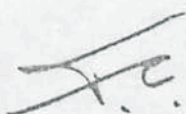
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We have been suffering again recently from a good deal of heavy briefing, some of which has been in direct conflict with the Government's defence policy. This has included private meetings with Members of Parliament - including the Opposition; encouragement of lobbies; and addresses being given by senior officers with politically controversial content. All this is damaging to the Government, Ministers, and ultimately Defence as a whole.

2. It has been long established that the Services keep quiet about politically controversial issues, that relations between Service personnel and Ministers or the advice given should not be disclosed, and that the Services and the MOD should not be brought into disrepute.

3. After the Falkland Islands, Defence is a subject of great public interest. But I would ask you to ensure that senior officers and others do not indulge in lobbying or unauthorised briefings and speeches. In particular, Members of Parliament, of whatever party, should not be lobbied or entertained with the aim of influencing them against the known or published policies of the Government.

4. I would be glad if you would remind your senior people - both inside the MOD and outside - of the need to behave properly. I will make sure my own staff are reminded. The fact is that it is not possible for any organisation to perform properly if internal policy debates become a matter for external lobbying.



FRANK COOPER  
13 July 1982

BBC RADIO WORLD "THIS WEEKEND - FIRST SEA LORD - SUNDAY 5 SEPTEMBER

Gordon  
Clough

It is not often that serving officers are so openly dismissive of the Government's they serve particularly not First Sea Lord's and there has been much fluttering among the Whitehall doves. When William Horsley telephoned Admiral Sir Henry Leach this morning he found the First Sea Lord in no mood to retract one jot or tittle of what he had said:

1SL

"Naturally I wish to put the position of my Service straight forwardly before the audience, factually, correctly, accurately and honestly because there have been a number of implications that all is a good deal better than in fact was the case and you'll be as aware as I of the really savage cutting of the Navy that resulted from last year's Defence Review."

William  
Horsley

You are quoted as saying that the idea that the Navy would be capable of mounting an operation similar to the Falklands in several years time, is a pack of lies; why do you say that?

"If the decisions of the Defence Review were implemented in full then at a point in time a few years hence, it would not have been a practical proposition for the Navy to have undertaken the Falkland Islands campaign successfully".

And what is the prospect now?

"The prospect now is of the three major errors of the Defence Review - one has been corrected, that is the salvage of INVINCIBLE, the other two remain to be considered and corrected and action has not yet been taken on that: one is the decision of the Defence Review totally to abandon the so called modernisation of ships and unless some improvement, however modest, is done to update weapon systems then we shall be on a steady slope to obsolescence, for example, we have launched a new Type 42 Destroyer THE YORK about a couple months ago fitted with the Sea Dart System, which is a good system and showed up well in the Falkland Islands campaign albeit with the shortcomings that were known to exist in it. All the improvements to that system were cancelled as part of last year's Defence Review. There is a ship which will not be in service, operational service for another two years, to me its ludicrous to suppose that that system which already has known shortcomings is not going to be touched, is

not going to be updated, is not going to be improved for what must be a minimum of fifteen years of useful life of that ship."

What is the other main area of your concern?

"The other one is the actual number of the bulk of the Fleet which is the destroyer-frigate force, stemmed from this ignorance that surface ships are intolerably vulnerable, they have a useful role to play so we had better do without them and I put it to you that if it had not been for surface ships we would have had very little chance of any success whatsoever in the Falkland Islands campaign, for a start we wouldn't have even got there."

How much more money are you saying would be necessary to make the kind of improvements that you want?

"Well I would prefer not to go into detailed figures about this but what I would like to make quite clear is that no way would I wish to claw this off the backs of either the Army or the Air Force, I'm doing the thing in a responsible light as defence overall and there is plenty of money there to do these modest things if it is allocated in the right direction."

Your remarks       Admiral represent something of an unprecedented attack by the senior naval officer against policies of the Government power, do you think you speak for a very wide range of opinion within the Service?

"My remarks are not intended as attack on anybody, it is simply an exposure of the facts of the situation, an exposure if you like of the truth and I stop well short of telling even the whole truth which would be even more embarrassing in some circles. It is not in any way personal, it is nothing whatsoever to do with any attack on the Government, on the other hand there are various methods of expressing your views which have been the norm until recent times. One has appeared as a Chief of Staff before the House of Commons Defence Committee, one has communicated in a variety of ways, one has had a Service Minister who was at some pains to find out the facts as a politician of the problems concerning that Service and represent them with whatever degree of success might have been judged to be necessary and all those lines of communication if you can call them such have disappeared and therefore if you are in a position to get up in what is not at all public, it is very much a closed forum in a



well respected institution like the RUSI and talk about your Service and if you cannot then speak in perfectly normal balanced terms the truth of the situation there then I do not see very much hope for the future".





MINISTRY OF DEFENCE  
 MAIN BUILDING WHITEHALL LONDON SW1  
 Telephone 01-938X02X 218 2111/3

MO 8

6th September 1982

New John,

DEFENCE EXPENDITURE TO 1985/86

The Defence Secretary has seen the Chief Secretary's letter of 11th August, on which he has made the following observations.

First, he has noted that the Chief Secretary is 'reluctant to reopen the agreement' reached last year, with the implication that last year's figures should be allowed to stand in PES 1982. He has asked me to point out that it was part of last year's agreement that the figures for 1983/84 and 1984/85 were provisional and Cmnd 8494 made clear that they would be reviewed in the 1982 Survey.

Secondly, Mr Nott has asked me to point out that Mr Brittan's reference to the defence budget additions agreed in PES 1981 does not correctly reflect the basis on which the case for the increases was made. As my predecessor explained in his letter of 25th February this rested on the higher prices in the defence programme actually experienced in 1981/82, which had to be reflected in increased cash provision in PES 1981 if the 3% commitment was to be maintained. Mr Nott rejects absolutely the view that the PES 1981 additions were 'on top of 3% real growth provision' (together with the implication of the Chief Secretary's third paragraph that he was not justified in seeking a revision of the defence cash limit). If this were the case, real growth in 1981/82 (over 1978/79) would be significantly greater than the 8% for which Cmnd 8175 provided; and growth in 1982/83 would be correspondingly greater than the 11.3% provided in Cmnd 8175. In fact growth in 1981/82 - when the cash limit was spent in full - is calculated at less than 7½% and this figure has been quoted by Defence Ministers with the agreement of the Treasury. The growth implied by the cash provision for 1982/83 is in line with Cmnd 8175 (ie 11.3%). Indeed, Mr Brittan himself has said - and was the first Minister to do so (in his Oxford speech in April) - that the 1982/83 cash provision represents a real increase of about 11% over 1978/79. The Chief Secretary's assertion that the PES 1981 additions were on top of 3% growth is simply not

J Gieve Esq

CONFIDENTIAL



reconcilable with these statements and the facts which support them and Mr Nott is surprised that Mr Brittan should have reverted to a position which events have shown to be unsustainable.

Mr Nott therefore maintains his view that, for the reasons set out in his letter of 5th August, additional provision is required if we are to meet the 3% commitment. NATO have been informed, with Treasury agreement in the UK DPQ 82 response that existing cash provision in 1983/84 and 1984/85 allows less than 3% growth, if inflation is in line with the cash factors, and there is bound to be criticism within the Alliance if we fall short again.

Finally, as to the defence non-pay relative price effect which the UK - along with our major NATO allies - experiences, the Defence Secretary has indicated his willingness to discuss how provision should best be made for it. He does not, however, understand Mr Brittan's reference to paragraph 2(v) of Sir Robert Armstrong's minute of 2 December 1981. In his view that subparagraph was intended to close the books on PES 1981, not to rule out all future consideration of RPE; the remaining subparagraphs of Sir Robert's minute are consistent with this view.

I am copying this to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and Sir Robert Armstrong.

*Yours sincerely,*

*R. C. Mottram*

(R C MOTTRAM)

CONFIDENTIAL

8 SEP 1982

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6 7 8 9 10 11



PRIME MINISTER

SBAC FARNBOROUGH INTERNATIONAL 82 - EH101 and P110

I can understand why John Nott feels it essential to give a strong positive indication of support for the aerospace industry at Farnborough and while I do not object to his proposed statement it would have been helpful if we could have been given more time to consider the implications.

2. I welcome the fact that the statement falls short of full commitment to these two very expensive projects. But the expectations of Industry and others can only be raised and if there is some major hitch, for example over Italian participation in the EH101, our room for manoeuvre will have been further curtailed.

3. The EH101 will be a major commitment, with significant civil implications. Before any commitment to full development there should be collective discussion in OD, perhaps when the Italian position is clear and the Westlands/DOI discussions have made progress. It will also be necessary for formal Treasury approval to be sought before any new Government financial commitments are entered into on the research aircraft programme.

4. I am copying this minute to the Secretaries of State for Defence and Industry, to other members of OD and to Sir Robert Armstrong.

L. B.

LEON BRITTAN

3 September 1982



MO 17/3/9

PRIME MINISTER

Prime Minister

Mr Nott will be making  
this statement on Sunday.  
 The Chief Secretary's views  
 are at A: he does not object, but  
 puts down a marker that Treasury  
 approval will be needed before we  
 enter into financial commitments.  
 No other minister has commented.

SBAC FARNBOROUGH INTERNATIONAL 82 - EH101 AND P110

The SBAC Air Show at Farnborough will focus particular interest on the future prospects of the new Westland/Agusta EH101 helicopter and the industrial proposals made recently for the P110. BAe will be making a statement on Sunday on the P110 and we should make our position clear as Farnborough assembles.

2. Much progress on EH101 has been made towards Anglo/Italian collaboration at both the defence and commercial levels. A basic design has been agreed which meets both countries Naval requirements, (in our case linked closely with the Type 23 Frigate), and also provides an attractive springboard for exploiting a substantial civil market as well. I have discussed all this several times with Signor Lagorio the Italian Defence Minister and we have agreed that the right approach is to integrate these defence and civil prospects and involve the industry itself in a joint venture to which they also contribute risk capital. Our Department of Industry and the Italian equivalent MICA, have been fully involved. Patrick Jenkin is to meet Signor Marcora at Farnborough to discuss further their joint intent to pursue these objectives.

3. In Italy financial provision for the Naval helicopter is being made by a Parliamentary Law (which includes also the Air Force AMX project and an Army communications programme). The Law has gained approval through the necessary Committees and now requires only formal confirmation by the House and Senate. Lagorio is fully confident that this will happen, probably in October, not least because, if not, there would be a major defence crisis. Lagorio's re-appointment to Defence in the reformed Government has ensured



continuity. On the civil side, MICA claim to have already the necessary funds available and, you will recall, are anxious to use them for EH101 to pre-empt diversion to the A320. All the indications are that Italy will come up with its half share of EH101 costs in the next few months.

4. On our side, provision is being made in the defence budget for an appropriate Naval share of the development costs. The main outstanding financial issue is the Westland contribution to a joint venture for part of which they are looking for some DOI support in the form of launch aid. Detailed negotiations are in hand but will not be completed before the Farnborough show.

5. Neither we nor the Italians can make an immediate announcement about Full Development but there is the need to be helpful at Farnborough and not undermine the essential commercial exploitation of the EH101 in that special shop window. We do believe that the world commercial and military market, apart from the naval market, for the new medium helicopter could be very large; but if we are to capture it we must move ahead fast to be in the business before the Americans. I propose to reflect confidence that the EH101 programme ought to be underway early next year.

6. The P110 situation is more difficult. Considerable political pressure has been generated recently but there is little evidence yet on the prospects for collaboration or of an adequate commercial export market for the aircraft design being put forward by industry. Nor am I yet persuaded on the sort of aircraft needed for defence purposes or of its priority and affordability. It would be premature to give the sort of commitments being suggested by industry.

7. Equally it would be damaging to do nothing. Industry has taken the initiative as we have urged them to do and deserve support; we ourselves need to be better informed if future decisions are to be taken with confidence. I have proposed to industry that we should jointly undertake an experimental research aircraft programme





which would bring together current component elements of demonstrator work to further advance our knowledge of the new technologies which will be essential to meet the high performance requirements now foreseen. Work on such a research aircraft would help to sustain the nucleus of a design team in BAe and other parts of the aerospace industry which otherwise could rapidly erode to a point where there would be no longer an adequate national capability to undertake military aircraft development.

8. This would not certainly be a commitment to the P110 and major objectives of the research aircraft programme would be to explore technologies relating to high agility, composite materials, Stealth (i.e. minimum radar and other signatures), artificial stability and advanced cockpit and weapon system designs which would apply equally to any future aircraft project, including improvements to Tornado. To enhance this work and provide better confidence in future STOVL possibilities for the 1990s a smaller, parallel programme would investigate STOVL engine aspects and control in the hover.

9. It will take some three years to build this research aircraft and the total programme could extend to five years. Costs, including the parallel STOVL work, would be up to £30M per year and I am prepared to find this in the defence budget as a necessary investment to create a sounder base for later decisions and to reduce the risks of wasteful mistakes. It would also carry us over the difficult social, industrial and employment problems and for our long term military aircraft capability which would arise if we were to allow the design effort of British Aerospace to disappear. I hope that European partners, who face similar defence and industrial difficulties (the latter particularly as Tornado passes its peak) will be persuaded to join and share in this work. I shall discuss this with them when we meet later this year.

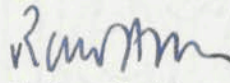
10. At Farnborough I propose to counter our inability to accept the industry's P110 proposals by this positive proposal to undertake



a research aircraft programme which will provide very practical, significant and technological assistance to any industrial initiative, whilst we gain better understanding of the many operational, international and political issues involved, including the essential market and collaboration prospects and the central questions of costs and affordability.

11. I am attaching for information the text of my statement to the Press.

12. I am sending copies of this minute to the Members of OD, to the Secretary of State for Industry, and to Sir Robert Armstrong.

*for*   
John Nott

*Approved by the Defence Secretary  
& signed in his absence*

Ministry of Defence  
31st August 1982



MOD PRESS RELEASE - FARNBOROUGH INTERNATIONAL 82

To be issued Sunday 5th September 1982.

Statement by The Rt Hon John Nott - Secretary of State for Defence

I The EH101 Medium Helicopter

1. Very heartening progress is being made in establishing collaborative and joint venture arrangements for the new EH101 helicopter.
2. This helicopter with its good endurance, high agility essential for adverse weather deck landing, substantial payload and advanced avionics capability will provide the new Royal Navy Type 23 Frigates with an organic air capability for hunting submarines and destroying them at long range with Stingray torpedoes and other weapons. The helicopter will not only operate from the Type 23s but also from the Invincible class carriers, Royal Fleet Auxiliaries and other ships and from land for the crucial role of shallow water anti-submarine defence around our coasts.
3. Similar Italian Navy operational requirements have led to collaboration. In addition, Westland and Agusta have identified substantial commercial market opportunities for such a helicopter and they have formed a joint company EHI to exploit together the full naval, civil and utility potential of this new helicopter. We are thus uniquely bringing together two nations, two Governments, two companies, two kinds of investment, public and private, directed towards a total market giving attractive prospects of a sound commercial return and an affordable defence capability.
4. Joint Anglo-Italian project definition studies for the naval helicopters were completed this summer and there is joint agreement also that the design provides the right springboard for commercial exploitation. Recently, I have had two most helpful personal discussions with Signor Lagorio, the Italian Defence Minister, and we reached full agreement about the importance of and our approach to this EH101 programme. The Department of Industry and their



counterparts in the Italian MICA have made excellent progress also in their intention to pursue the civil and utility aspects of this Anglo-Italian co-operative project.

5. Current activity involves those detailed administrative processes in both countries, such as completing a further Memorandum of Understanding, writing the Development Cost Plan, negotiating contract terms, agreeing the appropriate levels of cost sharing and obtaining the necessary authorities for expenditure which will enable the formal start of full development. This should be possible by early next year. Meanwhile it is important to sustain the momentum which has been built up (MOD have spent already some £60M and Westland have contributed their own money as well). As a measure of the confidence jointly shared in this programme, I have asked my officials to identify with industry further critical work on which it would be sensible to start now to ensure that full development can proceed as rapidly as possible once the necessary documentation has been agreed.

## II New Experimental Aircraft Programme

6. Farnborough International 1982 also gives me the opportunity of announcing that MOD and industry are jointly to undertake a research experimental aircraft programme which would bring together current component elements of demonstrator work and further advance our knowledge of the demanding technologies which will be essential to the high performance requirements now foreseen. This is essential work for future advanced fixed wing combat aircraft of either STOVL or conventional design. It will provide challenging work in the design offices and experimental workshops and create a sounder base for later decisions. Such a research aircraft could be flying in about three years time.

7. Major objectives will be to explore the many facets which contribute to high agility, the efficient use of composite materials, artificial stability, Stealth techniques and advanced cockpit and



system designs to give maximum operational capability. Interactions of weapons, ECM/ESM, defence suppression, target acquisition, aiming, communications and data exchange will need to be studied also. Whilst not directly incorporated in the experimental aircraft, other work will explore specific future STOVL engine and hovering control techniques. The intention is that this research programme will cover technologies with potential application to a variety of possible future advanced agility aircraft, including STOVL, as well as to further Tornado improvements. It will lead to greater confidence in future decisions and by reducing risks will smooth and accelerate progress in later development programmes. I hope that European partners, who face similar needs to resolve these future advanced technology issues, may feel able to join and share in this work, either nationally or industrially.

8. The research aircraft programme which I am proposing will provide very practical, significant and relevant technological assistance, particularly in the field of new agile combat aircraft, as proposed by British Aerospace, whilst we gain better understanding of the many operational, international and political issues involved, including the essential market and collaboration prospects and the central questions of costs and affordability.



11-55555555

1 2 3 4 5 6 7 8 9 10 11 12

CONFIDENTIAL

Prime Minister

2  
LW  
13/8



Defence

Mr Butler

To be aware

LW  
13/8

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Nott MP  
Secretary of State  
Ministry of Defence  
Whitehall  
London SW1A 2HB

*Handwritten initials*

11 August 1982

2 Jan.

DEFENCE EXPENDITURE TO 1985-86

I have seen a copy of your letter of 3 August to the Chancellor and our offices have now agreed that we should meet on 29 September to discuss your PES bids.

Geoffrey and I were glad to hear that the defence programme is now in better balance with the cash provision this year. This is particularly reassuring in view of the programme gap of £200 million that you foresaw last January - your memorandum OD(82)2.

No doubt one factor that helped to ease your 1982-83 problems was the advancement of the monthly bill-paying date planned for April, and the acceleration of over £300 million worth of expenditure into 1981-82. The manoeuvre did call into question however, whether it was necessary, as you claimed last November, to increase the 1981-82 defence cash limit by £300 million.

Defence, Budget, p17

I would be reluctant to reopen the agreement we reached last year. But that agreement - recorded in Sir Robert Armstrong's minute of 2 December - will of course form the essential background to our discussions this autumn. In recognition of the difficulties then perceived to be facing the defence programme, additions were made to defence provision as follows:

	1981-82	1982-83	1983-84	1984-85
£m	300	375	325	250

It was quite apparent at that time that the additions for 1983-84 and 1984-85 were not 3% higher than the £375 million increase agreed for 1982-83. But this was simply because the 1982-83 increase was disproportionately large, reflecting the pressure you then foresaw. It was never intended to be carried through, 3% higher each year, in perpetuity: a response to perceived difficulties in one year cannot be taken to imply further special treatment thereafter.

In short, the additions recorded on 2 December 1981 were on top of 3% real growth provision. They were not to be built into the baseline from which 3% growth is calculated. This is of course the very principle that will also apply to the Falklands additions we agree.

I was surprised, in view of the agreement recorded in paragraph 2(v) of Sir Robert's minute, to see a renewed bid for a defence relative price effect - claimed now to be 3 percentage points extra on defence prices in each of the next few years. This assertion - that MOD will be unable to prevent defence prices increasing at a rate some 50% faster than forecast general inflation - carries major implications, for the level of industrial wages as well as for our expenditure strategy. We will have to look very closely next month at the case supporting your rpe bid of over £1800 million.

Indeed there are a number of other issues that will need to be covered in the bilateral. By the autumn, more up-to-date information should be available - not least on Falklands costs and on forecast inflation. Inflation in the current year is rather lower than we expected last autumn; and I myself would hope that public sector cost increases, not least pay, can be held below the level of general inflation. I look forward to discussing these issues in September.

I am copying this letter to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and to Sir Robert Armstrong.



LEON BRITTAN





MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000  
DIRECT DIALLING 01-218 2111/3

MO 8

3rd August 1982

Dear Geoffrey,

DEFENCE EXPENDITURE TO 1985/86

At Cabinet on 15th July we agreed that our aim should be to adhere to the public expenditure planning totals published in Cmnd 8494; and that Departmental Ministers' bids for additional provision should be discussed bilaterally with the Chief Secretary. Before this process starts I should like to set down the issues to which I attach importance for defence.

First, the Falklands operation. We have agreed that the costs of the campaign, of replacing equipment lost and of the future garrison will be met out of monies which will be additional to the 3% annual rate of real growth. I shall be bringing a paper to colleagues setting out the proposed size of the Falklands garrison - and a first estimate of the costs involved - in September. It is already clear that we shall need to acquire additional aircraft and ships, if our home defences are not to suffer a severe detriment. My officials are discussing with yours the Falklands bill as a whole and I shall give my colleagues by October an estimate of the total cash required.

Second, our basic defence commitments. There should be no illusion that these can be met without additional provision, as set out in my bids. The Prime Minister, the Foreign and Commonwealth

The Rt Hon Sir Geoffrey Howe QC MP



and I received last month a briefing on recent Soviet exercises; they showed a huge and widening gap in capability. We are committed in the clearest possible terms to planning to implement in full until 1985/86 the NATO aim of real increases in defence expenditure of 3% a year. This commitment was set out in last year's White Paper "The UK Defence Programme: The Way Forward" (Cmnd 8288) and repeated in Cmnd 8494 and in my recent Statement on the Defence Estimates. The 3% increase needs to be met "in full". And I cannot regard the extra cost of meeting the Government's published commitment as "an additional bid".

The provision for 1983/84 and 1984/85 that was published in Cmnd 8494 and forms the baseline for this year's Review does not, on any reasonable forecast of inflation, allow for real growth of 3% a year. On the basis of the Budget forecast of general inflation, the figures allow for growth of no more than about 1% a year. Even if inflation were in line with the cash factors used in constructing the figures, growth would be limited to 2.4% a year. It would require inflation to fall to little more than 5% in 1983/84 and 4% in 1984/85 for 3% real growth to be provided by the baseline figures. If the Government is to meet its 3% commitment, therefore, additional provision must be agreed as indicated in the PESC Report. There is no way round this: either we provide more money, or we renege on our commitment. I regard the latter as politically impossible.

However, the question is not simply one of the rate of general inflation. The 1982 Armed Forces Pay Award exceeds the 4% provision in 1982/83 Estimates. The carry-through effect of this in later years will have to be met (as it was last year) by additional cash provision to protect the 3% commitment. Furthermore, defence non-pay costs rise faster than general inflation and, if we are not to fall short of 3% growth, additional provision is needed to offset this relative price effect. I acknowledge, however, that this is an area in which precise predictions are difficult and I should be glad to talk to you or the Chief Secretary about how best to make allowance for it in our future planning.



I should also like to emphasise that, following last year's defence review and other action which we have taken to improve financial management such as cash profiles for firms, the programme is in better balance with the available cash in the current year, although we still face potential problems in 1983/84 and 1984/85. The difficulty is that if the consequence of our efforts to achieve a better balance and of showing a prudent caution in our plans is an underspending, under the present rules we lose the shortfall. To avoid this, we should have to over-programme with the risk of damaging last-minute cutbacks. This is why I believe end-year flexibility to be so important as a means for more efficient management. I am grateful for the Prime Minister's agreement that this should be discussed in October. There can be no argument for adding to the resource costs of defence by the continuation of a system which is costly and inefficient.

I am copying this letter to the Prime Minister, the Foreign and Commonwealth Secretary, and the Chief Secretary, and to Sir Robert Armstrong.

*Yours ever*  
*John*

John Nott



6 AUG 1952



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*Deserub*

10 DOWNING STREET

THE PRIME MINISTER

30 July 1982

Dear Lord Hill-Norton,

Thank you for your letter of 23 July 1982.

I note that you now feel free to pursue publicly the point which you were making in your letter of 22 June.

I rather doubt whether there is much more to be gained by continuing to exchange letters about the matter.

Yours sincerely,

Margaret Thatcher

Admiral of the Fleet The Lord Hill-Norton, G.C.B.

LPO



MINISTRY OF DEFENCE

MAIN BUILDING WHITEHALL LONDON SW1A 2HS 42

Telephone 01-218 2193 (Direct Dialling)

01-218 9000 (Switchboard)

PERMANENT UNDER-SECRETARY OF STATE

SIR FRANK COOPER GCB CMG

PUS/82/942

20/16

*JP*  
*to see*

*GF4 - Mr. Gantner*

*17*  
*20/7*

J R Rose Esq  
Clerk to the Committee of Public Accounts  
House of Commons  
LONDON SW1

28 July 1982

*J R Rose*

PROJECT INFORMATION

When I appeared before the Public Accounts Committee to answer questions on Chevaline, I undertook to see whether it would be possible to provide the Committee on a regular basis with financial information on major defence projects.

2. Because of other preoccupations the assembling of information has taken much longer than I had hoped but I now attach 3 tables covering our largest sea, land and air conventional systems respectively.

3. The tables include 24 projects with authorised expenditure in excess of £200M. In each case the original cost estimates quoted are at the point in the project's life cycle at which they become firm government policy decisions (ie after project definition). Projects continue to be included as long as there is significant expenditure still to come in the current and future years.

4. In each project, production costs are separated from development and the following figures are given:

- a. estimated cost as originally approved (price base identified in brackets);
- b. (i) a. above revalued to present defence prices;
- (ii) a. above revalued by the GDP deflator;
- c. actual expenditure to 1.4.82;
- d. c. above revalued to present prices;
- e. estimated overall project cost at present prices for work currently authorised.

The figures in columns b., d. and e. are fully revalued. Column b(ii) has been included to show the difference between defence cost inflation and general inflation. This revaluation exercise is not yet complete but I thought it better to avoid further delay. We should let you have the missing figures as soon as possible.

5. As I mentioned in my letter of 4 March, these tables relate to expenditure formally approved rather than forecasts of the ultimate overall size of the project. The latter may fluctuate according to the exact quantities of the purchase assumed. Of course, even using approved expenditure, comparisons may sometimes be complicated by changes in the scale of the project.

6. Needless to say, much of this work involved breaking new ground. We hope to have substantially refined both the methodology and the coverage by next year. In particular I would hope to clarify the SEA EAGLE figures fairly soon. I hope nevertheless you will find this first attempt of significant value. We are assuming that with this new and more comprehensive information available you will not in future need the Ship Construction Accounts (the 'Blue Pages'). You may also like to consider whether the 'Pink Pages' relating to Dockyard work continue to fulfil any useful purpose.

7. I am writing separately about nuclear weapons projects.

*Yours sincerely  
Frank Cooper*

FRANK COOPER

PRIME MINISTER

I attach below (Flag A) a pretty arrogant and unpleasant letter from Admiral Hill-Norton in reply to your letter of 19 July to him (Flag B).

I really see little point in your continuing this correspondence with him: it is plainly going to get nowhere. I hope that you will feel able to send him the fairly stiff reply which I attach below.

*KW.*

28 July 1982



Admiral of the Fleet The Lord Hill-Norton G.C.B.

NUTFIELD RIDGE 3309

KING'S MILL HOUSE,  
SOUTH NUTFIELD,  
REDHILL,  
SURREY. RH1 5NG

cf?  
Red  
incf 207

The Rt.Hon. Mrs. Thatcher, M.P.,  
10 Downing Street,  
London,  
S.W.1.

23rd July, 1982

Dear Prime Minister,

R2617

Thank you for your letter of 19th July.

I am sorry that most of it was about Defence Policy, to which I was at pains not to refer in my letter of 22nd June. The arguments deployed by your Private Office have not improved with time, and are today no more convincing to those who understand Defence than they were when first adumbrated last year. They are, of course, entirely different to those which you (presumably) endorsed during the first eighteen months of your Administration, on the advice of Mr. Pym - who did understand the problem. What, one may well enquire, has since then changed in the Defence scene except the Secretary of State?

I am, to return to the gravamen of my previous letter, bound to be disappointed and, I must confess, surprised that you do not accept my contention, to put it quite bluntly, that Mr. Nott deliberately misled the House in a matter of fact, on 7th April. Following our exchange, which I initiated solely to save you personal embarrassment, I feel free now to say so, at what I consider to be the right time.

I am content to let Parliament and the public be the judges as they have been in the past, of what the words he used do actually mean, both in English and in context.

Yours sincerely,  
Hill-Norton



file

cc MoD

Defence

10 DOWNING STREET

THE PRIME MINISTER

19 July 1982

*Paper hand Hill-Norton.*

Thank you for your letter of 22 June.

Before I make any comment on some of the points you have raised, I must say that the Government's overall naval policy was very clearly set out in the White Paper the Secretary of State for Defence published last summer "The UK Defence Programme - The Way Forward" (Cmd. 8288). Decisions about our future defence policy had to be taken in response to changes in the technological environment and the rapid growth of defence equipment costs, and one decision was a reduction below the then current plans for the size of the surface Fleet. Others were mentioned in your critique. You are right to say that most of the major warships that have entered service since April 1979, or will enter service over the next five years, were ordered by the last Government but that is bound to be the case since the Labour Party were in power over most of the relevant period. But given their commitment drastically to reduce defence spending to the average of our NATO Allies it would have been impossible for them to pay for them - indeed the defence programme was too large prior to Command 8288 even to be accommodated by the 3 per cent growth target to which we are committed.

For our part we have explained our policy and defended it on many occasions in both Houses of Parliament. It has also been analysed in the press, and there has been wide support

/for its

BR

for its overall thrust although I realise that there are a significant number of people, like you, who find difficulty in accepting aspects of it. The note to which you refer must be seen as an attempt to highlight the favourable points in the naval programme in contrast to the criticism which has been one-sided and unbalanced. For instance, your critique makes no mention that the naval programme is higher today in real terms than when we took office and we have, as a matter of policy, made a switch in the programme to weapons as opposed to platforms.

You referred to a statement by John Nott in the House of Commons on 11 March on Trident. I cannot accept your assertion that the House was misled on that occasion. It is to my mind clear from the context in which John Nott made his remarks that he was seeking to refute the criticism that had been made on a number of occasions, and was implicit in Keith Speed's question, that Trident was funded at the sole expense of the Navy Programme, with the implication that if Trident had not gone ahead the associated funding would have been devoted to enhancing conventional naval forces.

You also mentioned what John Nott said in the House on 7 April. I have re-read the paragraph in which the quotation appears; and, bearing in mind that it is dealing principally with levels of expenditure and that our plans to reduce the surface Fleet are well known, I do not think that there can have been any doubt that John Nott was intending the specific remarks to which you draw attention to refer to increases in the naval budget rather than the size of the Fleet.

Yours sincerely  
Raymond Nott

Admiral of the Fleet The Lord Hill-Norton, G.C.B.

---

The attached  
letter has been  
copied to  
MOB



Manica

10 DOWNING STREET

PRIME MINISTER

I have retyped the second  
page of Lord Hill-Norton's  
letter, and marked it  
private and confidential  
as you requested.

Vanessa

18 July 1982

for its overall thrust although I realise that there are a significant number of people, like you, who find difficulty in accepting aspects of it. The note to which you refer must be seen as an attempt to highlight the favourable points in the naval programme in contrast to the criticism which has been one-sided and unbalanced. For instance, your critique makes no mention that the naval programme is higher today in real terms than when we took office and we have, as a matter of policy, made a switch in the programme to weapons as opposed to platforms.

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~~I realise how strongly you feel about some of the decisions contained in Cmnd. 8288. It is, however, a very serious charge to say that a Member of Parliament - and particularly a Minister - has deliberately misled the House of Commons and I hope that on reflection you will withdraw it.~~

~~Yours sincerely~~  
~~Harold Wilson~~

Admiral of the Fleet The Lord Hill-Norton, GCB.

CONFIDENTIAL



MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1  
Telephone 01-~~93817022~~ 218 6169

D/S of S/PS/10

13th July 1982

Prime Minister 3

Mr Nott would prefer you to send the short reply at A. There is a longer version at B, if you prefer. Wn 15/7

Thank you for your letter of 23rd June enclosing one from Lord Hill-Norton to the Prime Minister, complaining about certain aspects of the public presentation of defence policy.

On the first of Lord Hill-Norton's points, that the briefing note circulated recently to backbenchers was incomplete and hence misleading, my Secretary of State has asked me to say that it was not intended to be a full and balanced picture any more than is Lord Hill-Norton's critique which - not unexpectedly - seeks to discredit the Government's plans. Most of his criticisms are well known to us and have been answered before in replies to Parliamentary Questions and Members' letters (though this is the first time that Lord Hill-Norton has intervened); and my Secretary of State does not recommend that the Prime Minister should reply in detail. For your background information, however, I attach a commentary on the critique.

My Secretary of State believes, however, that the Prime Minister would wish to deal with the second of Lord Hill-Norton's points - the allegation that he misled the House on two occasions recently. On the first occasion the position is as follows. Lord Hill-Norton has taken out of context the remarks Mr Nott made in the House when he was seeking to deal with the criticism, implicit in Mr Keith Speed's remarks to which he was replying, that Trident was funded at the sole expense of the Navy programme. Mr Speed's intervention had implied that, if Trident had not gone ahead, the associated funding would have been devoted to enhancing conventional naval forces. Mr Nott pointed out (Hansard attached) that Trident was financed by the defence programme as a whole and had been placed in the Navy programme simply for reasons of management: it did not, therefore, follow that without Trident there would have been more funds available for the Navy. Obviously without Trident the SSN programme would have been different as Lord Hill-Norton suggests, but, as is clear from the context, Mr Nott was addressing a different point.

As to the suggestion that the House was misled on 7th April, (Hansard attached), two factors should be borne in mind. Firstly, last year's White Paper (Cmnd 8288) stated specifically that the

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*I don't think he can send the shorter one often - this is long by time. Please mark the letter as signed Alan White, and the envelope PR100010 & CONFIDENTIAL. No date - look page 11*

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size of the surface Fleet would decline over the next few years. It is, of course, this very fact - more than any other - which has given rise to considerable public debate, and the House cannot possibly have thought that - contrary to what Cmnd 8288 had said - Mr Nott was trying to give the impression that the Government planned to increase the size of the Navy. Second, as you will see from the Hansard, the immediate context makes it clear that my Secretary of State had in mind the increase planned expenditure on the conventional Navy, which is not how Lord Hill-Norton has interpreted the answer. Not even the least knowledgeable Member can have misunderstood exactly what Mr Nott meant.

/ My Secretary of State has approved the attached draft letter which the Prime Minister might consider sending to Lord Hill-Norton. The draft deals with only some of the many points Lord Hill-Norton has raised but if the Prime Minister nonetheless preferred not to comment at all on the substance of his letter my Secretary of State would be entirely content for a very brief reply to be sent on the lines of the one which I also attach, and which Mr Nott actually prefers.

*Yours ever,*

*D T Piper*

(D T PIPER)

CONFIDENTIAL

DRAFT LETTER FROM PRIME MINISTER TO LORD HILL-NORTON

Thank you for your letter of 22nd June.

Before I make any comment on some of the points you have raised I must say that the Government's overall naval policy was very clearly set out in the White Paper the Secretary of State for Defence published last Summer "The UK Defence Programme - The Way Forward" (Cmnd 8288). Decisions about our future defence policy had to be taken in response to changes in the technological environment and the rapid growth of defence equipment costs, and one decision was a reduction below the then current plans for the size of the surface Fleet. Others were mentioned in your critique. You are right to say that most of the major warships that have entered service since April 1979, or will enter service over the next five years, were ordered by the last Government but that is bound to be the case since the Labour Party were in power over most of the relevant period. But given their commitment drastically to reduce defence spending to the average of our NATO Allies it would have been impossible for them to pay for them - indeed the defence programme was too large prior to Command 8288 even to be accommodated by the 3% growth target to which we are committed.

*H.P.* For our part we have explained our policy and defended it on many occasions in both Houses of Parliament. It has also been analysed in the Press, and there has been wide support for its overall thrust although I realise that there are a significant number of people, like you, who find difficulty in accepting aspects of it. The note to which you refer must be seen as an attempt to highlight the favourable points in the naval programme in contrast to the criticism which has been one-sided and unbalanced. For instance,



your critique makes no mention that the naval programme is higher today in real terms than when we took office and we have, as a matter of policy, made a switch in the programme to weapons as opposed to platforms.

You referred to a statement by John Nott in the House of Commons on 11th March on Trident. I cannot accept your assertion that the House was misled on that occasion. It is to my mind clear from the context in which John Nott made his remarks that he was seeking to refute the criticism that had been made on a number of occasions, and was implicit in Keith Speed's question, that Trident was funded at the sole expense of the Navy Programme, with the implication that if Trident had not gone ahead the associated funding would have been devoted to enhancing conventional naval forces.

You also mentioned what John Nott said in the House on 7th April. I have re-read the paragraph in which the quotation appears; and, bearing in mind that it is dealing principally with levels of expenditure and that our plans to reduce the surface Fleet are well known, I do not think that there can have been any doubt that John Nott was intending the specific remarks to which you draw attention to refer to increases in the naval budget rather than the size of the Fleet.

I realise how strongly you feel about some of the decisions contained in Cmnd 8288. It is, however, a very serious charge to say that a Member of Parliament - and particularly a Minister - has deliberately misled the House of Commons and I hope that on reflection you will withdraw <sup>it</sup> such a charge.

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11 3 JUL 1982

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DRAFT

Thank you for your letter of 22nd June.

I have noted your comments about the note which was issued by the Secretary of State for Defence. All I would say on the note is that it must be seen as an attempt to highlight favourable points in the naval programme to counter-balance the criticisms which have often been one-sided.

I was particularly concerned to read your charge that the Secretary of State for Defence had deliberately misled the House of Commons. Having personally looked into this I believe that your allegations are completely unfounded. I just do not think that anyone in the House of Commons with any knowledge of the Defence White Paper of last June (Cmnd 8288) and of the general thrust of our defence policy, particularly with regard to Trident, could sensibly have interpreted Mr Nott's words in the way you have.

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ANNEX A TO  
D/DS4/118/1/2 (387/82)  
DATED 1 JUL 82

THE ROYAL NAVY

(Commentary on Lord Hill-Norton's Critique)

Naval Budget

1. This financial year the RN's share of the Defence Budget will be 29% as compared with 28% in 1978/79. On present plans it will be 30% at the end of the decade. Discounting expenditure on the strategic deterrent the figures for 1982/83 and 1989/90 are 27% and 25% respectively. There are, however, likely to be changes as the programme develops over the coming years. In public, therefore, we should take the line that no final decisions have been taken on the detailed size and allocation of the defence budget in the late-1980s.
2. It is agreed that the cost of ships and their weapons continue to increase rapidly in common with other armaments. One of the purposes of the Defence Review was to recast the programme so as to create the headroom necessary to deal with the problem of cost growth in the longer term.

Ship Numbers

3. As Lord Hill-Norton concedes 'operational' is a broad term and open to different definitions. At one end of the scale, availability at A1 readiness for NATO is the strictest criterion (fully operational in all respects and available in the Alliance area within 48 hours). At the other end of the spectrum it can be argued that recent experience has shown that the majority if not all ships not well into refit can be called on at varying notice for operations. The figures underlying the comment in the handout that more ships and submarines would be operational in 1985 than now were based on a projection on the best data then to hand of ships and submarines likely to be available in Category A1 plus those undergoing essential repairs (available at reduced capability within 2-4 days) together with ships undergoing training and trials available at no more than a fortnight's notice. Full account was taken of the decreased amount of time that individual ships will spend in major refit following the decision to cease mid-life modernisation. This said, it should be noted that any assessment of this kind is subject to considerable change in both the short and long term because of developments for example in the dockyards programme; in the physical condition of ships and in changes in plans for the use of ships. Ship losses in Operation CORPORATE will also have a major impact on the forecast until they are replaced. The need to repair damaged ships will have a significant effect on availability in the short term. Any consequential adjustments to the dockyards programme in the medium term would also have an impact on operational availability.
4. Lord Hill-Norton's comment that the size of the Fleet has reduced from 98 major warships in 1978/79 to 86 at present is correct. The size of the Armed

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Forces has, however, consistently reduced for many years in response to budgetary pressures, technological advance and changes in policy. As regards S of S's remarks in the House on 7 April, the immediate context referred to future planned expenditure. Cmnd 8288 also accepted a reduction in the size of the surface Fleet. Taking these two factors together there cannot be any doubt that S of S intended his remarks to refer to increases in the naval budget rather than the size of the Fleet.

5. A large-scale modernisation programme is under way. For further details see below. At the same time Cmnd 8288 made it clear that we could no longer hope to sustain all our previous plans and announced a number of changes (reductions in future carrier and DD/FF force; RFA reductions; abandonment of Type 44 and cessation of further Type 42s; abandonment of mid-life modernisation; dockyard cuts). Others were announced subsequently (abandonment of Sea Dart improvements; early disposal of Counties and BRISTOL). Lord Hill-Norton is therefore drawing attention to facts concerning the reduction in the navy which are already on the public record as a means of attacking the cuts in the Fleet. He is correct in saying that the scope for future improvements to our capability will be reduced by limited dockyard facilities but our aim is to incorporate as many improvements as possible in the course of the new cycle of refits and restorative refits. As he points out, the SSN force will be less than that envisaged by the Labour Government. This was brought about principally by the decision to proceed with Trident and to rephase the SSN programme around it. Resources could not be found to transfer the SSNs displaced by the Trident boat to a second shipyard. Guidance for the Defence Review also directed that the SSN programme should proceed at no faster pace than was necessary to maintain shipbuilding capacity for Trident.

6. We shall be considering in the light of experience gained during the Falkland Islands crisis whether any changes are needed to the programme within the overall framework announced last year. Cmnd 8288 stated clearly that we would be flexible in implementing the new policy. FEARLESS and INTREPID were reprieved in March. Plans for the retention of FIFE, GLAMORGAN and BRISTOL are due to be announced on 1 July.

#### Recent Orders

7. Lord Hill-Norton's comments on the Government's order rate and on the number of ships having entered service since 1979 or due to enter service over the next 5 years are correct. His remarks on the value of orders placed are also correct.

8. This said, with a long-term construction programme such as the RN's many orders placed by its predecessor are inherited by an incoming Government. Cmnd 8288 confirmed that the programme would proceed in full, with the consequence that expenditure on the naval shipbuilding programme has risen sharply and continuously

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since 1979. A copy of a recent draft parliamentary answer on this subject is attached together with a note by Head of Mat Coord(N) on the issue of public presentation of the figures.

9. In addition work on the design of the new Type 23 frigate is proceeding and its outline configuration was announced on 1 July, together with tenders for the ninth Type 22 (the third order in a year). Tenders for a new nuclear powered submarine have also been invited recently and for the first batch of a new class of minesweeper.

10. The critique makes no mention of the fact that, in accordance with the philosophy outlined in Cmnd 8288, resources are being ploughed on a large scale into weapons rather than platforms. War reserves are due to be built up and since the publication of the White Paper the following major projects have been announced:

<u>Project</u>	<u>Value £M</u>
Heavyweight torpedo	775
Sea Wolf improvements	75
Sea Eagle	320
Satellite communications	100

Others entering service this year include the Stingray torpedo (value: £1200m) and the Sea Skua air-launched missile (value: £210m).

#### Carriers

11. Lord Hill-Norton's claim that the handout goes no further than Cmnd 8288 is correct. Presumably his purpose is to draw attention to the need as he sees it to retain three in order to be able to deploy two at any one time. This possibility is now under consideration following the Australian Government's offer not to hold us to the sale of INVINCIBLE, if we now wish to retain her. BULWARK was indeed paid off early - but by only six months as an economy measure. This was announced in January 1981.

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During the currency of the procurement of the system it will not be cancelled, either at the whim of the United States Congress or as a result of changes of President or changes of presidential mood or attitude over the next 20 years?

**Mr. Nott:** On the whole, our allies tend to keep to their agreements. I do not think that such a hypothetical situation has ever arisen, nor do I think that it is probable.

The answer to my hon. Friend's question is that most of the system will be built here, by British industry. It is only the missile and the missile control system that we are buying from the United States. The majority of the expenditure will be made here in the United Kingdom. There is nothing in this technology which we in this country are not inherently capable of producing. Indeed, the French Socialist Government—and in the French Socialist Government the Communists actually declare their colours—are spending 25 per cent. of their present defence budget on their nuclear deterrent. We can do this ourselves, as we have proved with Chevaline, but it would be enormously expensive to do so and it is cheaper to buy the technology from the United States.

**Mr. Dick Douglas (Dunfermline):** Does the Secretary of State recall a speech he made in which he indicated that the cost of Chevaline had gone bananas? What chance is there that the cost involved here in relation to Trident will not go the same way? Additionally, whilst he is talking about jobs, has he noted that in the financial statement one of the worries of this country is import penetration? The cost of going for Trident in this way, and at this time, may be a diminution by British industry generally to compete across the board and thus, whilst strengthening our defence, may be weakening our total economic position.

**Mr. Nott:** I do not underestimate the technical difficulties which face the United Kingdom industry in competing successfully for the United States Trident programme. On Sub-Harpoon, Chinook, the advanced Harrier, Rapiere, and a whole range, we have just recently done about £1,000 million worth of business in defence equipment with the United States.

If the Hawk, the Searchwater and other programmes go forward, we hope to do another £1,000 million worth of business with the United States. If this two-way street did not exist, if we were not buying and selling each other's defence equipment, those extra jobs would not be created for British industry.

I do not accept that this is a programme which is any more subject to escalation of costs than any other highly advanced technology, because most of the content of this programme is already well developed. To say that we have not tested our warheads is not true. We have. It is the same warhead as the Trident I. There is a misunderstanding on this. There is a great deal of business for British industry in this. I hope it succeeds in doing as well on this programme as it has done on the other American programmes.

**Mr. Keith Speed (Ashford):** If the choice is between modernising Polaris or between C4 and D5, we are undoubtedly right to stay with D5. There is no alternative. Will the Minister answer two questions? First, we have not heard what will be the percentage of expenditure of the naval equipment programme at the apogee of the Trident expenditure. Secondly, I am concerned about the

submarine building capacity, because we need a regular building programme for the SSN. Some of the SSNs are getting old and the first one is already to be scrapped. We must be ready to build the new 2400 SSKs.

**Mr. Nott:** We have a defence equipment programme, and what I am concerned about is defence capability. I look at our overall defences. We are finding money for the Trident programme as a separate item. Trident will be manned by the Royal Navy. It is easier to manage this programme under the Royal Navy and put it in its programme. But it is not right to say that if we had not had Trident the naval programme would have been different. That does not follow logically. It is financed by the defence programme. The SSN programme is going forward as planned when the hon. Member was in the Department. We shall build as many SSNs as we can at Vickers, Barrow, until the moment comes for Trident to take up. We have not yet placed the orders for the SSK programme, but as soon as we are in a position to do so we shall consider which yard shall take them.

**Mr. Stanley Newens (Harlow):** Will the Minister tell us how he proposes to meet the costs of this weapon after 1985 when they escalate to the peak? Does he propose to meet them out of the normal defence budget, which will mean cutting down on conventional expenditure, or does he propose to have a special budget which will add even more to the gigantic escalation of defence expenditure which his Government are proposing? If so, how on earth will this country afford it?

**Mr. Nott:** We have to look ahead over 10 years to see when the peaks of different items of equipment will come. At no point, even in the peak year of spending on Trident, will it be as expensive as Tornado will be next year in my programme. The peak year will probably be in the last year or two of the 1980s. At the peak of our programme D5 will take up about 11½ per cent. We shall pay for it, as we are now paying this year and next year, for a much more expensive programme, namely, the Tornado aircraft. It will be financed in exactly the same way as our conventional programme is being financed now.

**Sir Timothy Kitson (Richmond, Yorks):** Will my right hon. Friend clarify one point in his statement? If the cycle between refits for the new Trident submarine is to be seven years, can he assure the House that there will be no need to order a fifth vessel?

**Mr. Nott:** Because of the extended length of the refits—seven years—four Trident submarines are equivalent to at least five Polaris submarines. We do not now need to contemplate five submarines. Four Trident D5s, with a much longer refit interval and the in-tube life of seven years, plus the missile, are equivalent to more than five Polaris submarines. We shall have three in the operational cycle for a large proportion of the time.

**Mr. Bruce George (Walsall, South):** Does the Minister agree that it is not simply a replacement programme but that in terms of quality and quantity of warheads D5 represents almost a quantum leap forward? Will the Minister tell the House why we require a hard kill capability? Will he inform his hon. Friends what cherished projects are likely to be cancelled as a result of this £8,000 million expenditure?

file BK  
Defence

8 July 1982

PUBLIC EXPENDITURE AND  
THE DEFENCE PROGRAMME

The Prime Minister was grateful for the Chancellor's minute of 6 July about the public impact of what has been said recently about the consequences of the Falklands operation for defence expenditure.

The Prime Minister has read this minute and noted it without comment.

John Kerr, Esq.,  
HM Treasury

SK



Prime Minister

②



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

A cri de coeur (which  
might have been addressed  
to Mr Nott).

PLS 6/7

PRIME MINISTER

## PUBLIC EXPENDITURE AND THE DEFENCE PROGRAMME

I am concerned about the Parliamentary and public impact of what has been said recently about the consequences of the Falklands operation for defence expenditure.

2. The limited arrangements which we agreed a fortnight ago, and which were succinctly set out in your Private Secretary's letter of 22 June, may I fear be in danger of misinterpretation.

3. There is a danger that a climate of opinion is being created, not least amongst our own backbenchers, which believes that our defence programme has been jeopardised by lack of money and that substantial increases in defence expenditure, going well beyond 3 per cent annual real growth plus additional Falklands costs, are now to be expected.

4. It needs to be said that our record to date is good. We have accorded the highest priority to defence, standing by the NATO 3 per cent growth target even during a period of declining GDP - in contrast with our European allies. In real terms we are spending £500 million more on conventional naval forces than when we came into office. If we are not gaining the credit we deserve, it is only because we are not getting this message across.

5. Over-ambitious expectations, if allowed to continue unchecked, could damage our economic policies. I have little doubt that other colleagues will follow suit and publicly press claims for their own particular programmes. We shall be faced with strong pressure for



substantial increases in public expenditure which cannot be removed in the normal course of the public expenditure Survey. Our aim of holding public expenditure to its planned levels might be prejudiced, and such headroom as I had hoped to provide for tax reductions in the next Budget would then be threatened.

6. We cannot afford to allow the defence programme to pre-empt an ever-growing proportion of public expenditure. In the plans published in this year's Public Expenditure White Paper, defence accounted for 12.2 per cent of the planning total. Some increase in this proportion will be inevitable after Falklands additions. But to accommodate the defence bids made so far in this year's Survey, defence's proportion of public expenditure would have to increase by 20 per cent in three years. The implications for other programmes would be dire.

7. The usual response to this not unfamiliar dilemma would be to set up a major package of expenditure cuts and other economies. This could lead to an arbitrary amalgam of hastily thought-out short-term measures, the effect of which would be to impede economic recovery and possibly to damage the credibility of the Government. If, as is likely, some proved impracticable or unacceptable, further increases in public expenditure (and thus in borrowing or taxation) would be inevitable.

8. This might be avoided by greater circumspection in our current public statements. It is enough to promise that the costs of the Falklands operation will not prejudice our commitment to 3 per cent annual real growth. That alone will put a strain on our resources, which may require adjustment of other programmes. We should not encourage the belief that, on top of this, there will be major improvements in our defence capabilities which would require a still higher growth rate in defence expenditure, of proportions which would not be matched by any of our European NATO partners and which

PERSONAL AND CONFIDENTIAL



we simply cannot afford. We should concentrate instead on more positive presentation of our real achievements in defence spending and capabilities.

*gh*

G.H.

6 July 1982

PART 8 ends:-

Mod to Ps/CST

PART 9 begins:-

Chare Ex to 14 6.7.82



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