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MINISTRY OF DEFENCE
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MO 8/2/12 31st October 1980

They live in a different world from ordinary industry. Here it seems everything is handled on a cost-plus basis without any incentive to keep down the costs.

Prime Minister
Answers to questions you raised on Mr Pym's minute (Flag A).
TL 31/10

Dear Tim,

THE DEFENCE PROGRAMME 1980-81

We had a brief word on the telephone about some points arising out of my Secretary of State's minute of 23rd October.

I explained that the main difficulty lay on the Defence Vote 2 - which is our main procurement vote - and it is through this vote that our payments are made to industry. The Dockyard Vote 5 also carries expenditure with industry on contract repair on HM ships and some expenditure on plant and machinery, but our current forecast shows that this Vote will not overspend given the stringent conditions now in force for further expenditure from the vote. The position on the Royal Ordnance Factories is that they operate a Trading Fund: we buy equipment from the ROFs and pay the Trading Fund from our Vote 2. We do make progress payments to the Trading Fund (as we would do to any major supplier) but as a result of industrial action (particularly at ROF Bishopton) we have in fact not paid out as much as we had expected.

You drew attention to my Secretary of State's statement (para 7a) about the current rate of inflation on defence goods and services. Our cash limit for our equipment programme was derived from the agreed Treasury re-valuation factor of 14% between the average price levels of 1979/80 and of 1980/81. This was abated for what were then the assumed lags in the presentation and payment of bills, to give an overall inflation allowance of 10.6% on our procurement Vote. Recent discussions with industry suggest that costs in manufacturing have been rising faster than the RPI would indicate. Our own latest

With whom?

Other manufacturers have nevertheless had to keep down prices.

T P Lankester Esq

Then MOD is not being nearly tough enough on / renegotiation. Other contractors can't just pass on their costs. — So they have to keep cutting them to compete.

SECRETARY OF STATE

measurement of price increases on our procurement vote indicates a $4\frac{1}{2}\%$ differential over the RPI which is itself about $1\frac{1}{2}\%$ greater than the original cash limit factor. Applied to the original volume of the Estimates this adds up to £200 million cash squeeze. A further £130 million squeeze has been caused by an inflation rate on general supplies and services (including oil) that is double the original cash limit provision. Savings on the service personnel votes because of favourable exchange rates broadly balance cash deficits in the works, dockyard and other areas so that even with the August cash limit uplift of £150 million there is a residual deficit of some £150M-£200M.

Finally you asked about the rise in industrial overheads which my Secretary of State reported (para 7c). The base of industrial activity over which overhead - or indirect - costs (rent, rates, energy, indirect labour etc) can be spread has reduced temporarily on the civil side. Until economic activity picks up again (or until firms trim their outgoings) the rates of overhead are higher for many firms than otherwise might have been the case. We do face increased costs as a result, although I should emphasise that Ministry prices bear only the share of overhead costs proportionate to the Ministry's own purchases which of course is generally an incentive to firms not to keep on any long term excess of capacity.

Yours ever,

David Omand

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