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The United Kingdom's 2015 Strategic Defence and Security Review – Economic, Procurement and Brexit Implications

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Introduction

Although the United Kingdom's 2010 Strategic Defence and Security Review (HM Government, 2010) set a 5-year review cycle, the context for the 2015 Strategic Defence and Security Review (SDSR) (HM Government, 2015) changed significantly in the months before its publication was due in October 2015. The primary factor for the change of context was the unexpected success of the Conservative Party in the May 2015 general election, resulting in a small majority for the Conservatives and an end to the constraints of the previous coalition government. With the shackles released, and an improving economy, the 2015 SDSR promoted a small increase in defence spending after the austerity that had lasted since the 2008 financial crisis. However, there were distinct changes in emphasis, and the detail of the Review presents a far more complex picture than was apparent in the initial headlines.

Since then the Brexit Referendum result has further changed the delivery context, although the full impact of the vote is not yet understood, particularly as the United Kingdom has yet to activate Article 50 which triggers the start of formal exit negotiations from the European Union. However, economic uncertainty remains, as does the future nature of the UK's trading relationship with the European Union. In the short term the strength of the pound has diminished, with resulting impacts on the Defence Budget, but the longer impact on defence and the delivery of the capability programme is difficult to predict. The issue of Brexit (the UK's decision to leave the European Union) will be discussed later in this paper.

Within this dynamic context, the aim of this paper is to review the 2015 SDSR from a procurement and economic viewpoint, identifying some of the key announcements and discussing their economic, commercial and industrial impact. Commentary on their impact on the UK's military and defence capability will be left to others.

The 2015 Strategic Defence and Security Review - Background

The 2015 SDSR was published in October 2015, some 5 months after the general election. Although the necessary preparatory work had been undertaken, early strategic direction from ministers had

been lacking as they had been focused on the general election and not on the SDSR. This is likely to be an ongoing issue as the UK is now subject to fixed 5-year parliaments as well as 5-yearly defence reviews. Having achieved an unexpected majority, the new Conservative Government were now in a better position to pursue their aspirations. However, at this stage, although a Brexit referendum was expected, it was thought that a 'remain' vote was a foregone conclusion.

In some ways, this assumption had little impact on the SDSR. The United Kingdom had always seen NATO as a cornerstone of its defence activities and, in general, collaborative acquisition programmes had been undertaken on bilateral or multilateral principles outside of organisations such as the European Defence Agency (EDA) and OCCAR. Despite the potential to take on greater leadership roles in these organisations, and the potential opportunities available to UK industry, the UK always saw these organisations as being of greater benefit to smaller nations and a bureaucratic blocker acquisition cycle times. Indeed, in October 2012, the UK government had announced that an EDA membership review was in progress and that "all options, including complete withdrawal, [were] being considered" (House of Lords, 2012). Some issues, such as the creation of a European Union Army, were strongly opposed by the UK as they were seen as both a challenge to NATO and a duplication of NATO's capabilities with the potential to distance the USA from Europe. Hence, in military policy terms, the United Kingdom had always distanced itself from greater European integration.

A significant European Union issue has been the constraints imposed by EU Directive 2009/81/EC (The Defence Procurement Directive) which requires defence procurement above defined thresholds to be competed across the EU. Exemptions to this directive are covered by TFEU (Treaty on the Functioning of the European Union) Article 346. Although, anecdotally, some countries appear to take a more liberal attitude to the exemptions than others, exemptions to the requirement to compete defence contracts across Europe are becoming more difficult to justify under national security terms. Industry (and the MOD customer), at best see the Defence Procurement Directive as a delay in the procurement process and, at worst, a barrier to UK companies winning defence work. In reality, the complaints are probably exaggerated but are nevertheless a constraint on the UK's sovereign 'Freedom of Action'. However, if the outcome of the forthcoming Brexit negotiations is that the UK remains within the European Free Trade Market, then it will also need to abide by some of the constraints, such as the Defence Procurement Directive, that this imposes.

More difficult to characterise is the impact that Brexit will have on the willingness of the UK's European partners to continue collaborating with the UK under ad-hoc bilateral or multilateral arrangements once the UK leaves the UK. It will also limit the UK's access to European research funding. The 'Remainers' suggest that the strength of the UK defence industry and its research base will continue to make the UK an attractive partner for EU countries irrespective of whether or not the UK remains in the EU. However, this view is subjective and at this early stage no hard evidence is available to support such a view.

One area where the Brexit has already had an impact is in the value of the pound. Having averaged a value of $1.45 USD in the weeks prior to the referendum, the pound has now averaged $1.32 USD in the weeks since, a drop in value of about 10%. Similarly for the Euro the pound has dropped about 8% from €1.27 EUR to €1.17 EUR. An initial assessment by Taylor (2016b), based on the balance between the UK's defence imports and exports, estimates a shortfall of approximately £700

million per year, amounting to a 2% cut in the purchasing power of the total defence budget. If assessed against the equipment and support procurement budgets then the £700 million shortfall has an even greater impact. This change more than cancels out the modest increases in defence spending proposed in the SDSR over the next 5 years.

The impact of the decrease in the value of the pound on the UK defence industry is more complex. A cheaper pound could make UK exports more competitively priced, but the complex global supply chains for raw materials, components and sub-systems increases the cost of these imported goods. The net effect in the short term is difficult to assess, and will be different for different products. In the longer term, assuming stabilisation of the pound around these new rates, re-structuring of the UK's defence industry to reduce reliance on imported items could make UK defence exports more attractive. Furthermore, the UK government, which has traditionally supported a competition-based procurement policy (but see later comments) aligned around achieving a best value-for-money balance of capability and cost and not necessarily buy-British, may then find that UK companies become more competitive within the UK's own defence market. However, such predictions are currently based on very uncertain assumptions and could be no more than wishful thinking.

At this early stage in the Brexit process, the assessment is that in the short to medium term, Brexit will have a mixed impact on UK defence procurement, with the biggest impact being budgetary difficulties, especially on programmes with a significant US content. In the longer term the situation is far more uncertain and any firm predictions at this stage would be rash.

SDSR 2015 Development

In purist terms, the SDSR development process is based around a risk-based capability assessment driven from the top-down against the National Security Strategy and its delivery through three high-level National Security Objectives (HM Government, 2015). These objectives are summarised as:

1. Protect our people.
2. Project our global influence.
3. Promote our prosperity

Within each objective the underpinning policy is expanded through a number of explanatory statements which highlight the government's priorities and thus provide the context for the development of the SDSR itself. The security context is supported by the National Security Risk Assessment 2015 (HM Government, 2015, p. 85-87). The SDSR itself is then derived through a standard capability management planning process, where the capability gaps are identified by comparing the capability requirements with current and planned capability. The capability gaps are then prioritised against the risks and the constraints of the available budget to provide the detail within the SDSR. In theory, this is an objective and mechanistic process. In practice, many factors, particularly political imperatives, will impact on the purity of the process and give rise to many of the surprises seen in the final version of the SDSR.

For example, there are things that are ring-fenced, such as the requirement for an independent strategic nuclear deterrent, for which the normal rules of capability management do not apply. The requirement for a nuclear deterrent is therefore a given in the SDSR and 'which has long been, and

remains, at the heart of the UK's national security policy' (HM Government, 2015, p. 23). It thus provides a clear anchor around which the rest of the SDSR can be built.

Other factors include political sensitivities around particular issues such as employment in the shipbuilding industry, which will be discussed in more detail later. This can lead to decisions which make little sense in military capability terms. The ongoing issue, despite a referendum on the issue, is Scottish independence and the future of the defence industry in Scotland, again highlighted primarily by ship-building.

Obviously, as budgets are constrained, not all capability gaps can be filled. A risk-based approach is therefore taken where certain capability gaps are accepted, sometimes for extended periods, based on a risk assessment of the predicted defence and security environment over this time period.

SDSR 2015 – Key Points

At the time of its publication in October 2015 the SDSR was noted by many commentators, including Chalmers (2015), as providing stability in defence planning after five years of austerity and substantial reductions in defence spending. However, almost a year later, this aspiration for stability is now in question. Throughout the SDSR document, the government reaffirms its commitment to meeting the NATO target to invest 2% of GDP on defence. However, in doing so it also revised what was included in the 2% total – this now also includes the not in-considerable sums spent on war pensions, contributions to UN peacekeeping missions, pensions for MOD civil servants and much of the MOD's external income (about £1.4bn/year), so that the amount spent on current defence has reduced correspondingly. With these items included the UK was estimated to spend 2.08% of GDP on defence in 2015/16. When excluded, to provide a better comparison with previous years, this figure reduces to 1.97% of estimated GDP (Page, 2015). Some commentators (e.g. Taylor, 2016a) suggest that with current assumptions it will be difficult to maintain defence spending above the 2% of GDP minimum. In terms of actual spend, this will fluctuate with GDP itself. Current economic forecasts for the UK, post Brexit, suggest that GDP growth will fall from 2.6% per annum to 2.0%. When defence inflation is taken into account then there is potential for total defence funding to decrease in real terms.

However, SDSR 2015 clearly states that continuing to meet the target to invest 2% of GDP on defence will allow the government to:

- Increase the defence budget in real terms in every year of this Parliament (2015-2020).
- Increase the equipment budget by at least 1% in real terms and continue to meet the NATO target to spend 20% of the defence budget on researching, developing and procuring new equipment.
- Establish a new Joint Security Fund, from which the MOD will draw.
- Allow the MOD to invest efficiency savings in the Armed Forces.

Some of these objectives will clearly have to be relaxed. Most likely, there will be changes to all four. Politically, it will be unacceptable for the new government to reduce the defence budget, especially in the light of increased international tension, but smaller increases will be likely. The new Joint Security Fund, which is managed by the Treasury, could provide a source of funding, but at the expense of exposing the UK to greater risk from cyber and terrorism threats. The focus on efficiency

savings will increase still further, although scope for additional efficiency savings is reducing. For example, on top of the 30% reduction in MOD civilian staff since 2010, a further 30% reduction has already been factored in. With the MOD reducing the number of external consultants it employs under contract, scope for further reductions in MOD civilian staff numbers seems unrealistic.

The final option is the traditional approach of delaying programmes, rather than cancelling them, despite the fact that it is commonly recognised that such a result increases capability risk and results in additional expenditure, albeit over an extended period of time. Older equipment and systems have to be run on longer than expected, with the resultant increase in maintenance and support costs. This happened in the last decade when the Type 42 Destroyers were required in service far longer than planned, due to the delays in the Type 45 Destroyer programme (Young, Davies, 2010, p. 19). Already, the oldest Type 23 Frigates, which had a planned life of 18 years, may have to remain in service for 30-35 years and will be increasingly difficult to maintain over this extended period. The planned replacement, the Type 26, has not yet been ordered although some long-lead contracts are in place.

This approach poses additional problems for the government. As part of the coalition, it came to power in 2010 with the promise to sort out the estimated £38 billion black hole in the equipment budget. Some tough capability choices and risks were taken, such as the cancellation of the Nimrod MRA4, the demise of the Harrier Force and the early retirement of the carrier force before the new Queen Elizabeth class ships entered service. Although risky, this approach has generally been successful. However, the loosening of the reins whilst the economic outlook is has the potential to create overheating of the defence equipment programme yet again. Some tough choices will therefore have to be made.

Then Prime Minister David Cameron announced on 4 Sep 2014 at a NATO Summit that the UK would retain the two new Queen Elizabeth Class aircraft carriers in service (with one available at all times), rather than selling or mothballing one as had been widely predicted. This commitment creates a clear anchor for SDSR around which other commitments must be developed, thus saving political face and ensuring military creditability.

Key to the military credibility of the aircraft carriers is the availability of carrier-borne combat aircraft. This will be the F35B Lightning aircraft (the STOVL version of the F35). The SDSR remained vague on both numbers and order timescales for these aircraft, although information has leaked out since. The SDSR stated that the number of aircraft being bought in the early 2020s would be increased to 'make best use of this world-leading capability' (HM Gov, 2015, p.30). It also confirmed that the plan to buy 138 aircraft over the life of the programme would be maintained (HM Gov, 2015, p. 31). Subsequent statements (Quintana, 2015) indicated that 24 aircraft would be deployed on the carriers from a total of 42 aircraft by 2023. This is a modest increase over the original commitment to 37 aircraft by about the same time. There was also a lack of clarity over whether the balance of aircraft, to take the total to 138, would be further F35Bs or the conventional land-based F35A aircraft, which is being purchased by other European air forces as well as the United States Air Force.

Having faced a number of headlines in the popular press regarding aircraft carriers going to sea without aircraft, these announcements go some way to ensuring that the UK has a viable, if

marginal, Carrier-Strike capability within the foreseeable future. Press reports about the cost, delays and poor performance of the F35 have not helped matters in terms of public perception.

Although the additional clarity over numbers and timescale is welcome, the industrial impact in respect of UK aerospace industry is marginal. The order is small compared to the US requirement and has marginal impact on the UK's overall industrial contribution to the programme.

Of more industrial significance has been the somewhat confusing announcements regarding new frigates for the Royal Navy. The so-called Global Combat ship has had a very long gestation period, requiring the old Type 23 frigates to be further extended in service, and additional Offshore Patrol vessels to be purchased to keep ship-building capability and skills maintained in the intended build facilities at BAE Systems in Glasgow, Scotland.

Warship –building in the UK is always a politically sensitive issue. In recent years, construction of frigate and destroyer-sized ships has focused on the BAE Systems facility on the River Clyde in Glasgow, albeit with contributions from other shipyards around the UK (Young & Davies, 2010). Matters came to a head in the build-up to the 2014 Scottish Independence Referendum, with implied threats that the Global Combat Ship would not be built in Scotland if the Scottish voted for independence. Conversely, there was the implied promise that if the status quo was maintained then the ships would be built on the Clyde. Subsequently, after the 'Yes' majority, BAE Systems announced a programme of investment in their Clyde yards resulting from anticipation of the orders, and the commitments made by the government in the Surface Ship Terms of Business Agreement (HM Gov, 2009) signed by the government, BAE Systems and BVT/VT (who were subsequently taken over by BAE Systems).

The unexpected announcement in SDSR 2015 (p31) that the Government would purchase eight T26 Global Combat Ships, to replace the T23 frigates in their Anti-Submarine Role, that the number of frigates and destroyers would be maintained at 19, and a new class of general purpose frigates, with export potential, would result in an increased number of ships by the 2030s, was initially seen as good news. Further Offshore Patrol Vessels were also to be ordered. However, no timescales were quoted. To date, the Type 26 frigate has still not been ordered. The new general purpose frigate has not yet progressed beyond paper designs and the procurement strategy for these vessels is not clear. Meanwhile the construction of Offshore Patrol Vessels is continuing, but the Royal Navy has neither the manpower nor the requirement for these ships (although the ongoing migrant crisis in the Mediterranean, and the potential for the crisis to move closer to the UK, may change this).

Therefore, warship-building in the UK remains a political football with the government seeking to spend the minimum amount needed to maintain the industrial capability without committing to the substantial orders needed to maintain the Royal Navy's operational capability.

SDSR 2010 resulted in the risk-based decision to terminate the Nimrod MRA4 programme, and to scrap all Nimrod aircraft, leaving the UK without a maritime patrol aircraft capability. Since then, a resurgent Russia has resulted in increasing underwater incursions into the seas around the UK and the wider North Atlantic. The risks associated with not having this capability have therefore increased. It had been an open secret for some time that the UK was considering re-establishing this capability and an associated announcement was expected in SDSR 2015. What was not expected however, was the announcement that the UK would buy nine Boeing P8 Poseidon maritime patrol

aircraft from the US under the Foreign Military Sales (FMS) process. It was generally expected that the government would run a competition for this requirement and industry had been positioning itself accordingly. In addition to the Boeing P8, the Japanese Kawasaki P1 aircraft was seen as a strong contender, and had recently been seen at air shows in the UK. In addition, there were a range of other potentially cheaper options, albeit with a lower capability, which may have delivered good value-for-money alternatives. All these other options were likely to have an increased UK-sourced content compared to the chosen solution, although delivery timescales would be extended. Commentators also criticised the announcement of the chosen solution in an official government policy document, thereby weakening the UK Government's position in subsequent contractual negotiations.

SDSR 2015 also indicated that the government would upgrade the Apache attack helicopter fleet, but provided no details on how these would be procured. In July 2016 however, the Ministry of Defence announced that 50 Apache AH64E helicopters would be purchased, again under FMS arrangements directly from the United States. They would replace the existing Apache fleet which had been built in the UK and were heavily modified from the original US design with significant UK content. The new helicopters would be built in the US, although UK suppliers would contribute about 5% of the global Apache Supply Chain (Ministry of Defence, 2016).

This announcement put further pressure on the long-term viability of helicopter design and manufacture in the UK. Re-structuring of Leonardo (formally Finmeccanica), the parent company of Agusta-Westland, had already put the future of the Agusta-Westland facility in the UK in doubt. This was then further compounded by the Brexit vote. The loss of this order, coinciding as well with the completion of the Wildcat helicopter order for the Royal Navy, is therefore a major blow.

Also resulting from SDSR 2015 was the April 2016 announcement (Jennings, 2016) that the UK would procure over 20 General Atomics Predator Unmanned Aerial Vehicles to meet its Protector Requirement. Again, these would be purchased from the US under FMS arrangements.

This order further reinforces the trend for the UK MOD to purchase off-the-shelf or nearly-off-the shelf systems from the US under FMS. Although this has the advantage of procuring effective capability within reasonable timescales, in the longer term it is likely to reduce UK defence design and manufacturing capability. This would result in the ability of UK defence industry to compete for future contracts being degraded, thereby increasing dependence on US industry and limiting the UK's 'Freedom of Action' (to maintain, support and upgrade military capability), which was a key tenet of the UK 'National Security Through Technology' whitepaper (HM Gov, 2012). Furthermore, this high degree of dependence on the United States with regards to these major procurements makes them very sensitive to US-UK exchange rates, and the knock-on effect of a negative shift onto the rest of the UK's procurement programme is significant.

Conclusions

This overview of the UK's 2015 Strategic Defence and Security Review, and a more in-depth analysis of some of the key announcements resulting from the review, has highlighted a number of broader defence economic and procurement issues.

Brexit is already having an impact on defence procurement activities, particularly as a result of the decline in the relative value of the pound. With an increasing focus on buying military systems from

the US this puts corresponding immediate pressure on defence budgets. In the longer term it is possible that UK defence industry may re-structure but at this stage the predictions are difficult to make.

Although the SDSR and associated decisions and announcements were pre-Brexit, there is a strong trend to purchasing off-the-shelf from the United States under FMS arrangements, indicating prioritisation of delivery of short-medium term defence capability over supporting UK industry and European relationships. However, in the longer term, this approach is likely to result in a degradation of UK defence industrial capability and restrict the UK's freedom of action in being able to support and upgrade military capability.

The FMS approach also contradicts the UK's well-established policy of open competition in defence procurement. Traditionally the UK has seen competition as a means of delivering value-for-money. Ignoring exchange rate fluctuations, purchase under FMS is transferring risk from the UK to the US Government and gives greater certainty and stability to the UK's acquisition programme. However, reduction in this risk can be more than offset by the increased budgetary risk caused by the fluctuations in the exchange rate, with the pound currently heading towards parity with the US dollar.

Although having been written as a result of a comprehensive risk analysis and a broad review of capability requirements and gaps, the objective nature of the SDSR is then complicated by political drivers. A particular political imperative has been the retention of warship-building capability in Scotland to the extent that public money is being used to procure ships for which there is no extant capability requirement. On the other hand, the government seems to risk the future of helicopter manufacturing in the UK with little or no public debate. This paper does not seek to question the wisdom of these decisions, but it does highlight the lack of consistency that the government applies when dealing with different sectors of the UK's industrial base and geographical regions.

The SDSR gives clear direction to the UK's defence and security planning for the next 5 years. The devil, as always, is in the detail and its successful delivery is dependent on the development of a coherent defence industrial strategy. There are significant risks in the approaches that have been taken and these are further exacerbated by events, such as the Brexit vote and the decline in the value of sterling.

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