From: Director General Finance, Catherine Little

DG Fin 1.5 (111 18) 11 April 2018

Meg Hillier MP
Chair of the Public Accounts Committee

{Via email}

Dear Chair,

PAC HEARING – DEFENCE EQUIPMENT PLAN 2017-2027

Following the discussion of foreign exchange risk during the PAC Hearing on the Defence Equipment Plan 2017-2027 held on 14 March, I want to provide you with an explanation of my evidence about contingency and apologise that that this information was not made sufficiently clear to you and your staff as you were preparing your report.

As your report sets out, foreign currency in the Equipment Plan 2017 was costed using planning assumptions that were not aligned to exchange rates at the start of the Equipment Plan period (April 2017) or the most likely forecast rates at the time.

As I set out in the hearing, we assess potential changes in cost from our planning assumptions using scenarios based on up-to-date economic forecasts¹ and manage the impact of this risk using two separate controls: we buy a proportion of our forecast requirement in advance; and we also allocate corporate provisions to fund the most likely cost of our requirement for US Dollars and Euros. This provision is allocated from a contingency that we also use to manage fuel price risk.

At April 2017, we allocated a provision of around £2bn over 10 years to fund our assessment of the most likely cost of foreign currency. Of this provision, £1.8bn was for the expected additional costs of unhedged demand in the Equipment Plan. The enclosed annotated diagrams aim to explain this as clearly as possible. I would be very happy to discuss this further if you would like.

¹ Our economics team publish a five year forecast for US Dollar and Euro exchange rates each month. Short term forecasts are based on data from professional forecasting agencies, including Consensus and Oxford Economics, while longer term forecasts are estimated using theoretical economic models (interest rate parity relationship and the purchasing power parity relationship), populated by data from the Bank of England and Oxford Economics.
I have apologised separately to the NAO that we did not provide them with a clear enough explanation of how we manage foreign exchange risk as they prepared their report. I am committed to full transparency of our financial management and continuing to improve the support we provide to NAO reviews in future.

I am copying this letter to Stephen Lovegrove and Sir Amyas Morse.

Yours sincerely,

CATHERINE LITTLE