



Ministry  
of Defence

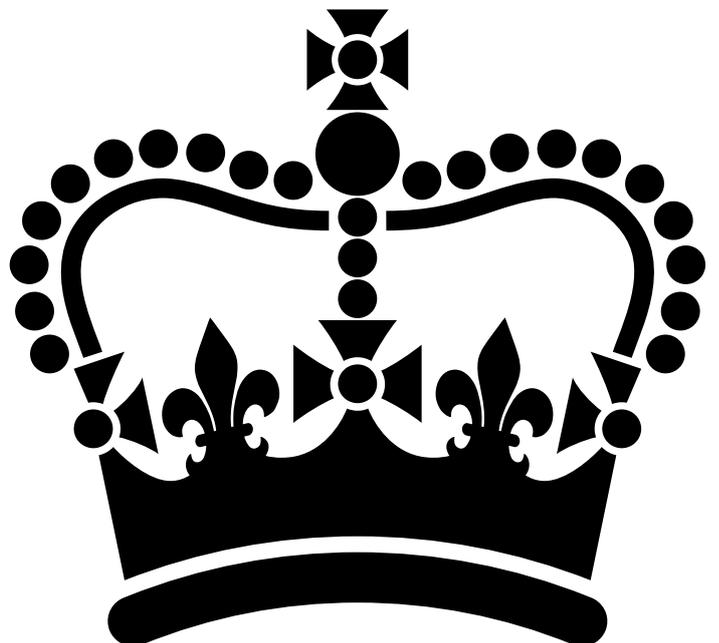
## Better Defence Acquisition

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Improving how we procure and support  
Defence equipment

Presented to Parliament by the  
Secretary of State for Defence  
By the Command of Her Majesty

June 2013





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This publication is available for download at [www.gov.uk/government/publications/better-defence-acquisition-improving-how-we-procure-and-support-defence-equipment](http://www.gov.uk/government/publications/better-defence-acquisition-improving-how-we-procure-and-support-defence-equipment)

ISBN: 9780101862622

Printed in the UK by The Stationery Office Limited  
on behalf of the Controller of Her Majesty's Stationery Office

ID 2556647

06/13

Printed on paper containing 75% recycled fibre content minimum.

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# Foreword

by the Secretary of State for Defence

**K**eeping the United Kingdom secure and dealing with threats to our national interests is a priority for this Government. Without national security we cannot thrive as a nation. It is the bedrock on which all other achievements depend, whether stimulating renewed economic growth, improving public services or making the country a centre for innovation and enterprise. To keep the country secure we must provide our Armed Forces with the equipment and capabilities they need to operate in a rapidly changing security environment. Without the right equipment, delivered on time and where they need it, our Armed Forces simply cannot function and our national interests are put at risk. Effective procurement and support of defence equipment is therefore not a “nice to have”, but an essential part of maintaining flexible, battle-winning Armed Forces.

The global economic situation means that nearly all countries are faced with the need to limit public spending. Limited funds must be focused on where they will deliver most benefit, and we must make best use of the expertise available, whether it is in the private or public sector, to ensure that value for money for the taxpayer is achieved. Defence cannot be immune - like all areas of public expenditure it needs to play its part in reducing the deficit and balancing the nation's accounts.

To maintain our defence capabilities at this challenging time we need to look hard at how we carry out every aspect of our business to see if it can be improved. Every pound we can save on support functions is a pound that can be spent on the front-line.

For at least the last twenty years our defence equipment programme has suffered from waste and cost overruns. Equipment has been delivered late and to a specification that has not always met the requirements of our Armed Forces.

That is why I have made it my priority to establish a fully costed and deliverable ten year equipment programme. This has necessitated hard choices. But it has now been achieved and for the first time in decades the Armed Forces have certainty that the equipment they need has been planned for and properly funded.

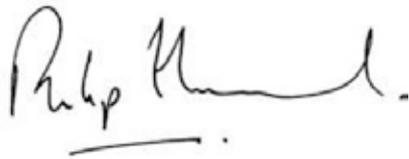
Great progress has already been made, but if we are to maintain a balanced budget and continue to provide a better service to the front-line, we must make real changes to our Defence Acquisition systems – tinkering at the edges is not enough. My Department has therefore considered carefully the options available and subjected these to detailed analysis. As a result, this White Paper sets out proposals for two major changes:

- a. Creating a new Government-Owned Contractor Operated (GOCO) operating model to manage the procurement and support of defence equipment by the Defence Equipment and Support organisation as the Agent of the MOD, subject

to demonstrating affordability and value for money. This will bring in incentivised private sector expertise to improve the delivery of the MOD's equipment programme by introducing systems and ways of working that provide staff with the best access to the necessary skills, processes and tools to enable them to do their jobs better, driving value for money in equipment projects.

- b.** Creating a new statutory framework to ensure transparency and to encourage efficiency in single-source procurement contracts. This will provide an assurance that value for money is being obtained for the taxpayer in this significant area of MOD business.

The proposals set out in this White Paper will deliver the real reform to our acquisition system that is needed to provide the support our front-line forces deserve. The changes will be real and long lasting, underpinned by legislation where required. I hope these changes will enjoy widespread support. They are the right thing to do and now is the right time to do them.

A handwritten signature in black ink, appearing to read 'Philip Hammond', with a horizontal line underneath.

The Rt Hon Philip Hammond MP  
Secretary of State for Defence

June 2013

# Executive Summary

- i. This White Paper sets out the Government's intentions for reform of defence equipment delivery, equipment support and logistics supply. It covers two major reforms – the creation of a new body to replace the existing Defence Equipment and Support organisation, and the strengthening of the arrangements governing the procurement of equipment where MOD is unable to source its requirement through open competition. These reforms represent a real change to how the Ministry of Defence conducts its business, delivering a more effective and efficient way of providing the equipment and capabilities the Armed Forces need to keep the United Kingdom secure. They will help to ensure that equipment and capabilities are delivered on time, on budget and to specification – cutting out waste and ensuring that precious resources are concentrated where they are needed most – on the front-line.

## Reform of the Defence Equipment and Support organisation

- ii. Reforming the Defence Acquisition system is a key part of the Defence Transformation programme. The Materiel Strategy and its supporting work has identified three root causes of the problems that have been experienced by the system for decades: the over-heated Equipment Programme; an unstable interface between those parts of the MOD which request equipment and support services and the Defence Equipment & Support organisation (DE&S) which delivers them; and a lack of business capability (processes, tools and skills), including management freedoms. While the recent work to balance the budget has addressed the first problem, there is little doubt that without systemic change to resolve the latter two issues, the substantial work to deliver a balanced programme will be undone. The three problems together are estimated to waste hundreds of millions of pounds per annum – the proposed reforms will significantly reduce this waste, generating benefits to the Armed Forces and the taxpayer.
- iii. Analysis carried out to date suggests that the establishment of a 'GOCO' operating model would realise significant benefits over those that could be achieved from a wholly public sector model for reform DE&S.
- iv. The MOD is proposing to introduce a GOCO model, by letting a contract with a private sector contracting entity. The Contracting Entity will operate on behalf of the MOD a limited company (the Operating Company) into which certain services currently being provided by DE&S will be transferred, together with the employees providing those services. The Government would own a Special Share in the Operating Company on national security grounds. On expiry or termination of the contract, the Operating Company would either transfer to a new company or revert back to MOD.

- v. We currently believe that a GOCO operating model offers the greatest likelihood of focused and sustained improvement, and that it will deliver the strongest incentives for culture change, productivity enhancement and reduced operating costs over time. The MOD proposes, subject to negotiations, affordability and value for money, to award a contract of up to a nine year term, subject to performance in transition, transformation and operational delivery.
- vi. The MOD intends to contract for the GOCO to operate as its Agent, allowing the GOCO to negotiate and sign new contracts on behalf of the Secretary of State as the Principal. The Defence Acquisition programme costs (over 90% of the current DE&S budget) would be paid **directly** from the MOD to the suppliers following verification and validation by the Operating Company, and therefore would not flow through the GOCO.
- vii. The MOD will remain the Approval Authority for all projects and the Comptroller and Auditor General will have absolute right of audit. Moreover, the GOCO will be required to act in accordance with the Government Financial Reporting Manual (FReM) in respect of all transactions related to MOD approved projects and will also be required to support MOD in their obligation to comply with the Government's policy on disclosure and transparency of voted funds.
- viii. The hard contractual boundary between MOD and the GOCO with clearly defined accountabilities and responsibilities underpinned by a rigorous change control process, together with an incentivisation regime, will drive effectiveness, efficiency and innovation as well as developing the capability to provide full transparency of 'cost' information to the MOD. Taken together, these measures will get to the underlying causes of the problems in Defence Acquisition that we are trying to address.

## Reform of Single-Source Procurement

- ix. The MOD's preferred approach to procurement is through open competition in the domestic and global market, as set out in the '*National Security Through Technology*' White Paper<sup>1</sup>. By its nature, however, Defence equipment often requires advanced and specialist technology, and we are often limited to a single supplier if we want to ensure we get the capability we require, or we need to preserve industrial and technological capabilities in the UK for strategic reasons. Single-source procurement has averaged over £6Bn per annum over the last five years<sup>2</sup>, and it is likely that it will remain a significant proportion of MOD procurement in the future.
- x. In a competitive market, suppliers must price keenly and continuously seek efficiency improvements in order to survive. In the absence of competition, value for money (VFM) is at risk because suppliers can price without fear of being under-cut by competitors and, because we need the military equipment and support services they provide, they can be confident of follow-on work even if costs are high or performance is poor.

<sup>1</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/27390/cm8278.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/27390/cm8278.pdf)

<sup>2</sup> The average is based on data from the 2007/8, 2008/9, 2009/10, 2010/11 and 2011/12 Financial Year.

- xi.** Since 1968 the MOD and industry have used a single-source pricing framework known as the Yellow Book<sup>3</sup>, overseen by a small Non-Departmental Public Body (NDPB), known as the Review Board for Government Projects. The Yellow Book is a non-legally binding framework, any amendment to which requires consensus, making change impossible if one party has a vested interest in the status quo. As such it has remained largely unchanged for forty five years, despite far-reaching changes to the industrial landscape and procurement practices. In short, the Yellow Book was designed in and for the mid-20th century and it is no longer fit-for-purpose.
- xii.** In January 2011, MOD commissioned Lord Currie of Marylebone to undertake an independent review of the current single-source framework. Lord Currie published his report in October 2011<sup>4</sup>, which recommended a new framework based on greater transparency and standardised reporting, with stronger supplier efficiency incentives; and underpinned by stronger governance arrangements.
- xiii.** The MOD has, after extensive consultations with its major single-source suppliers, developed a new framework in line with Lord Currie's recommendations. In exchange for a fair profit for industry, the new framework will provide the MOD with far greater transparency, helping us to investigate whether suppliers are being as efficient as possible. Standardised reports will allow us to better monitor single-source projects and identify areas where suppliers can reduce cost. Stronger protections will ensure the onus is on suppliers to use the most reasonable and appropriate pricing assumptions they can.
- xiv.** The new framework will be introduced on a statutory basis, rather than being negotiated into contractual terms on a contract by contract basis. This will ensure widespread coverage across our single-source suppliers, and wider application across their single-source supply chains. We will also introduce stronger governance of the framework through a civil penalty regime to ensure compliance, and by replacing the Review Board for Government Contracts with a stronger arms-length body to be known as the Single Source Regulations Office (SSRO). The SSRO will ensure the regime is kept up to date, periodically recommending updates to the Secretary of State. It will also monitor the application of the regulations, and provide binding determinations in the event of disputes between MOD and single-source suppliers in its role as an independent expert in single-source procurement.
- xv.** These changes will introduce a new single-source framework fit for the 21st century. They will provide greater transparency and protections for the MOD, in exchange for a fair profit for industry. And they will incentivise efficiency to make the UK defence sector increasingly competitive, both at home and in export markets.

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**3** The Yellow Book's formal title is 'The Government Profit Formula and its Associated Arrangements'.

**4** [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/35913/review\\_single\\_source\\_pricing\\_regs.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/35913/review_single_source_pricing_regs.pdf)

# Introduction

1. Keeping the United Kingdom secure and dealing with threats to our national interests is a priority for this Government. To keep the country secure we must provide our Armed Forces with the equipment and capabilities they need to operate in a rapidly changing security environment. Without the right equipment, delivered on time and where they need it, our Armed Forces simply cannot function and our national interests are put at risk. Effective procurement and support of defence equipment is critical in meeting this aim and is an essential part of maintaining flexible, up to date and capable Armed Forces.
2. Since the publication of the Strategic Defence and Security Review (SDSR) in 2010, the Department has faced significant challenges in delivering this output. Reduction in DE&S manpower levels places considerable strain on the delivery of the Equipment Plan.
3. The Defence Transformation initiatives have addressed significant areas of this challenge, including the delivery of a balanced, if taut, MOD budget. However, this work does not address the underlying issues which cause underperformance in Defence Acquisition. Poor specification by the Requester, a lack of understanding of cost drivers, poor initial cost estimation and poor project control by the DE&S Deliverer have all served to drive up the eventual costs of projects in the past and, uncorrected, will do so again.
4. A radical improvement in the ability of the whole of MOD to set requirements and deliver equipment, “right first time”, is needed if the Department is to be able to continue to deliver an Equipment Programme of roughly the same size and complexity year on year with 28% fewer people (the reduction required by the 2010 SDSR).
5. This White Paper sets out the background to the proposed changes both to the structure of DE&S, and to the single-source procurement regime, and the legislative requirements that will be needed to make those changes operational.

# Chapter 1

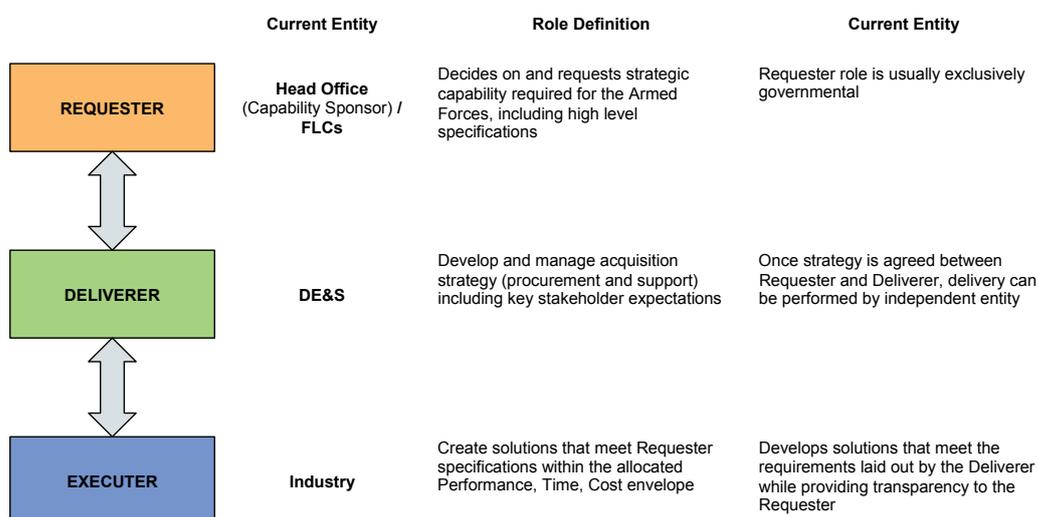
## Reforming the Defence Equipment and Support organisation

### Section 1: What is Defence Acquisition?

6. The procurement and support of the equipment used by our Armed Forces and the supply of logistics to them is undertaken by the Defence Equipment and Support organisation (“DE&S”), which is an integral part of the Ministry of Defence (MOD) and is led by the Chief of Defence Materiel.
7. DE&S works alongside its equipment customers (predominantly the Royal Navy, Army and Royal Air Force but also on behalf of our Partners across Government) to procure equipment and services, provide support and manage logistic supply.
8. DE&S procurement activity ranges from multi-billion pound programmes and projects, such as the purchase of warships, armoured fighting vehicles and aircraft, to the supply of high-volume commodity items, such as ammunition. Equipment support covers the maintenance of this equipment to meet readiness, availability, deployability and sustainability requirements specified by the Armed Forces, both for peacetime and global military operations. Logistics involves the procurement of commodities such as food and fuel, and the storage and distribution of items within the UK and around the world.
9. In Financial Year 2011/12, DE&S was responsible for some 48% of the MOD’s entire budget. £7Bn was spent on the purchase and development of new equipment, with £8Bn on supporting equipment already in service. A further £2Bn was spent on logistics and other services provided to MOD and the Armed Forces. The manpower and operating costs for DE&S are £1.4Bn.
10. Approximately 16,500 people currently work in DE&S (reducing to some 14,400 by 2015), a significant proportion based in the headquarters in Bristol – although DE&S staff are based at about 200 locations worldwide. About 75% are Civil Servants employed by the Ministry of Defence and the remainder are military, drawn from across ranks and Services.
11. Beyond its core procurement and support roles, DE&S, on behalf of the Chief of Defence Materiel, acts as Process Owner for MOD’s Logistics and Commercial functions, defining Defence-wide policy on procurement-related issues, ensuring compliance and driving performance improvement in these areas. In his capacity as the UK National Armament Director, the Chief of Defence Materiel works with his international equivalents on equipment issues.

## Section 2: The need for Reform

12. Reduction in DE&S manpower levels places considerable strain on the delivery of the Equipment Plan. A radical improvement in the ability of the whole of MOD to set requirements and deliver equipment, “right first time”, is needed if the Department is to be able to continue to deliver an Equipment Programme of roughly the same size and complexity year on year with 28% fewer people.
13. Driven by the challenges of the MOD financial position in 2010, Lord Levene was invited by the Secretary of State for Defence to conduct a fundamental review of the structure and management of MOD<sup>5</sup>. In his review, Lord Levene concluded that the Defence Acquisition system was under-performing and that corrective transformation activity must be system-wide and coherent in order to deliver significant and enduring improvements. These conclusions were consistent with the 2009 report by Bernard Gray<sup>6</sup> which critically examined the performance of DE&S for the first time as a single entity under the auspices of a review of the acquisition system.



**Figure 1 – Defence Acquisition**

14. This is not a new problem. For years, successive governments have struggled to reform Defence Acquisition and support, with little success. The same problems have been identified time and time again, and have remained, apparently intractable, despite our best efforts to resolve them. While balancing the Defence Budget has eased the situation to a degree, there remains a high probability that, unless we are able to resolve the root causes of the problems, programmes will continue to run over time and over budget.
15. The Materiel Strategy review of Defence Acquisition was launched in 2011 and, building on the Gray Report, set out to consider what changes would be required to make DE&S the most efficient and effective it can be. The Materiel Strategy work complements Lord Levene’s wider Defence Reform activity and is one of the main

<sup>5</sup> Defence Reform: An independent report into the structure and management of the Ministry of Defence, Lord Levene, June 2011

<sup>6</sup> Review of Acquisition for Secretary of State for Defence: An independent report by Bernard Gray. October 2009

elements of Defence Transformation. From its outset, the Materiel Strategy has had three desired outcomes:

- a. A balanced and affordable Equipment and Support programme;
  - b. The delivery of best value for the taxpayer in Defence Acquisition;
  - c. A DE&S with engaged and motivated staff with the behaviours, accountabilities, skills and processes required to do the job.
16. Achieving these outcomes means ensuring the right leadership of the staff in DE&S, providing them with access to the necessary skills and giving them the processes and tools which will enable them to do their jobs better, so that the front line (and taxpayers) are provided with battle-winning equipment on time and to budget.

## Section 3: The Root Causes of Underperformance

17. Analysis undertaken as part of the Materiel Strategy review has identified three historic issues that are at the root of the problems experienced by Defence Acquisition. Addressing these root causes offers the best opportunity to deliver the sustained improvement in Defence Acquisition that is required. These shortcomings cause substantial waste within the Defence Equipment Programme. Two exercises, conducted by independent consultancies – LEK and Booz & Company<sup>7</sup> – over the past four years have estimated the frictional waste incurred in delivering the programme. These estimates range from £1.3Bn to £2.2Bn per annum, with a common central estimate of £1.5Bn per annum lost to defence, some 22% of all initial acquisition spend.
18. Three root causes of the problems in Defence Acquisition and support have been identified by these exercises:

### Root Cause 1: An overheated Equipment Programme

19. The annual financial Planning Round has traditionally generated competition between the Single Services for scarce resources. This can be exacerbated by the very natural ambition throughout MOD to maximise the level of capability that can be achieved from the resources available, and a historic reluctance to make painful choices to balance budgets. Too broad a range of tasks and too many types of equipment being ordered (sometimes at too high a specification) has led to a situation where all too often the list of planned requirements has significantly exceeded the funding available to pay for them. This behaviour has been reinforced by a “conspiracy of optimism”, between military specifiers and industrial partners, systematically underestimating the costs (and delivery times) of new projects.

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<sup>7</sup> Both leading international business strategy consultancies.

20. Historically, this has resulted in an equipment programme that is overheated: and that in turn has led to an annual consideration of what should be delayed or deferred in order to balance the budget that year. These delays themselves often carry significant financial implications, known as “frictional costs”.
21. The significant work undertaken across the MOD during and since the 2010 Strategic Defence and Security Review has delivered a balanced, if taut, MOD budget. This work has addressed some, but not all, of the underlying issues which cause underperformance in Defence Acquisition, and the system will return to imbalance if all of the issues are not robustly addressed.

## Root Cause 2: An unstable interface between the Requester and Deliverer

22. At present, the interface between the DE&S and the rest of the MOD (including the three Service headquarters, known as the Front Line Commands) is porous. The moral imperative to ensure that our servicemen and women have the best possible equipment and support has given rise to a tendency to agree to changes requested at any point in the programme, without a full understanding of the consequences of these changes. For example – the Requester may ask for changes to be made to the specification of a particular piece of equipment late in its development, when incorporating those changes would delay the in-service date by years, and make it considerably more expensive. If the Requester had been better able to understand the implications of making that change, he may have chosen to retain the original specification.
23. This behaviour is in part the result of a situation in which individuals in DE&S, both military and civilian, can feel unable to express and maintain an independent position, perhaps for reasons of hierarchical pressure, even when they believe that it is supported by robust analysis. It is exacerbated when demands to incorporate changes over short timescales make accurate cost and time estimating difficult.
24. Over time, this “can do” attitude in fact harms the Armed Forces by driving an unsustainable programme, necessitating deep cuts to make savings when a more effective, disciplined control of the programme could have made better use of taxpayers’ money and resulted in increased operational output.

## Root Cause 3: Insufficient Skills and Management Freedoms Within DE&S

25. The skills and expertise which DE&S needs to perform its role effectively are very different to those required and valued by much of the rest of the Civil Service. Rather than classic policy skills for example, DE&S requires a high proportion of Project Management, Commercial and Financial experts as well as engineers and other technical specialists. It needs this expertise to discharge its responsibility for delivering a project portfolio that is amongst the most complex in the world.

- 26.** These specialist skills have a much higher market value than can be recognised within the civil service pay framework. Whilst many civilian staff in DE&S have wider motivations than simply the size of their salaries, for example the interest and variety of the work on offer, and the satisfaction of supporting our Armed Forces, it is becoming increasingly difficult to recruit, develop, and retain those with the particular skills needed at all levels of the business within the confines of the Civil Service HR framework.

## Section 4: Potential Solutions

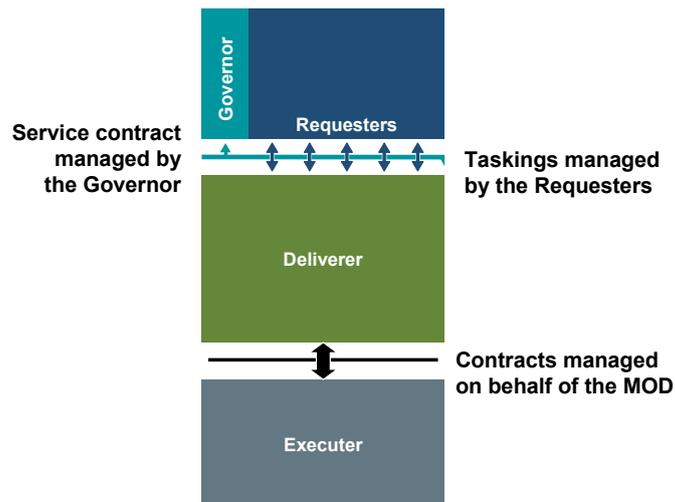
- 27.** The Materiel Strategy programme has given detailed consideration to three external models for the future operation of DE&S:
- a.** A Trading Fund: also known as an executive agency, carries out a service or function within Government, and comprises a well defined business unit that has a clear focus on delivering specific outputs. The accounts are not consolidated into the accounts of the Department to which the fund is linked and the entity is generally treated as a Public Corporation in the National Accounts. The Trading Fund model is intended to encourage personnel to think commercially and to seek efficient ways of operating and cutting costs.
  - b.** An Executive Non-Departmental Public Body with Strategic Partner (ENDPB/ SP); ENDPBs are not part of the Crown but work within a strategic framework set by Ministers. They undertake a service or function to be carried out at arm's length from the Government.
  - c.** A Government Owned Contractor Operated (GOCO) organisation: an entity operated by the private sector over which Government retains strategic control, but which has substantial operating freedom and incentivised through a performance based contract.
- 28.** In July 2012 the Secretary of State for Defence announced that work undertaken to date suggested that the strategic case for DE&S to become a GOCO was stronger than that for other options. Further Value for Money work confirmed this assessment whereupon the Secretary of State decided that the MOD should focus its effort on developing and testing the GOCO option further, and in parallel consider a second option which seeks to deliver the identified benefits of the GOCO model, but is fully within the public sector, known as DE&S+.
- 29.** In April 2013, the Secretary of State announced that the Materiel Strategy programme, which includes the consideration of these two options, would formally enter the Assessment Phase, which will elicit commercial propositions from potential GOCO partners, enabling a comparison to be made of the costs, benefits and risks presented by the two models for the organisation of Defence Equipment & Support: the DE&S+ model and the GOCO operating model. Although, based on the current analysis, the GOCO model is the stronger option in terms of potential benefits, the purpose of the Assessment Phase is to critically evaluate the two options and to determine if a business case for the GOCO option can be established. A final decision on the future operating model is expected to be taken in the Summer of 2014.

## DE&S+

- 30.** DE&S+ is the value for money benchmark against which the GOCO option will ultimately be judged. It is being developed to demonstrate exactly how far we could go towards solving the problems in Defence Acquisition and support whilst retaining DE&S wholly within the public sector.

## Government-Owned, Contractor-Operated (GOCO) operating model

- 31.** The MOD is proposing to let a Contract with a Contracting Entity to:
- Operate on behalf of the MOD a limited company (Operating Company) into which certain services currently being provided by DE&S (the “Deliverer” role) would be transferred, together with the employees providing those services;
  - Provide and improve the MOD’s defence equipment, support and logistics acquisition services, enhancing business capabilities by introducing best-in-class processes, tools and skills, and controlling the management and operation of DE&S.
- 32.** As shown in Figure 2, the MOD’s contract with the Contracting Entity would be managed by a Governor function, which will sit within the MOD’s Head Office. Tasks under the Contract would be set by the three military Commands, Joint Forces Command plus the Strategic Programmes function (the Requesters). The Contracting Entity, through the Operating Company, would also work with Defence contractors and other suppliers in the wider supply chain (the Executors), e.g. to negotiate and manage contracts on behalf of the MOD and to manage supplier relationships.



**Figure 2: Governor, Requesters, Deliverer, Executer**

## Role / Scope

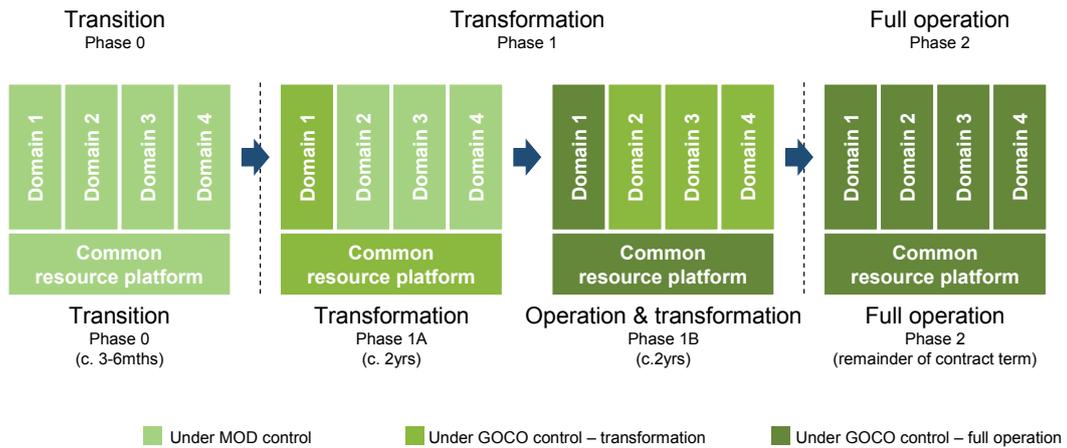
- 33.** The Contracting Entity's core role (through the Operating Company) would be to act as the Deliverer and to inform and deliver the equipment and logistic components of each of the MOD Requester's plans. The Contracting Entity and the Operating Company would provide delivery performance and financial reporting, including input to Parliamentary reports. The Contracting Entity and the Operating Company would also be likely to continue to play a key role in contributing to pan-MOD standards, policies and strategies (e.g. with respect to equipment safety, commercial operations and supply chain management, including the strategic industrial landscape), but ownership of such standards, policies and strategies would be retained in the MOD.
- 34.** The Contracting Entity will be required to demonstrate as part of the bidding process and whilst performing the contract, capability and capacity to manage defence equipment delivery, equipment support, logistics and related services efficiently and effectively through-life to reflect demand and offer solutions which provide value for money for defence whilst optimising decision-making.
- 35.** The Contracting Entity will need experience and a proven track record of working in technically complex and challenging high hazard sectors, where inter-relating roles, responsibilities and accountabilities need to be set out with clarity for many organisations and individuals, so that effective governance arrangements for the collective management of risk can be explained clearly and acted upon. With particular respect to safety management, the Contracting Entity will need to be able to work within a range of regulatory regimes and bodies from statutory regulators to the MOD's internal safety regulators. This would involve delivery to statutory and MOD requirements and assessment of the Contracting Entity's performance through appropriate regulatory and contractual monitoring arrangements.
- 36.** The Contracting Entity's competencies therefore need to include:

  - a.** Managing a very large professional acquisition programme management organisation;
  - b.** Business transformation;
  - c.** Project and programme management (including risk and stakeholder management);
  - d.** Engineering and technology management;
  - e.** Safety management;
  - f.** Logistics and inventory management;
  - g.** Investment case development;
  - h.** Procurement and contract management;
  - i.** Financial management;
  - j.** Human resource and talent management;

- k. Partnering; and
  - l. GOCO operation experience (or other similar models such as operating complex Public Private Partnership type arrangements).
- 37.** The Contracting Entity would have corporate authorities and responsibilities for financial management, contracts let in support of running the Operating Company, people management, pay, security, health and safety, environmental protection and sustainable development as specified in the Contract.
- 38.** It is anticipated that any Departmental and wider Government roles that can only be performed by the Government, as well as some existing services currently undertaken by DE&S would be retained by the MOD. Departmental and wider Government roles that are inherently governmental or pan MOD are currently not expected to be transferred to a Contracting Entity or Operating Company. Services currently provided by DE&S but expected to be initially out of scope include: DE&S services relating to Naval Bases, Defence Munitions and Information Systems and Services other than where related directly to defence equipment and support, leaving a civilian workforce of approximately 8000 in scope. The scope of services required from the Contracting Entity would vary over time to reflect:
- a. programmes already underway to outsource components of DE&S such as the activities of Logistics and Commodity Services Transformation programme;
  - b. any MOD in/out of scope considerations; and
  - c. more general changes to the defence programme.

## Implementation

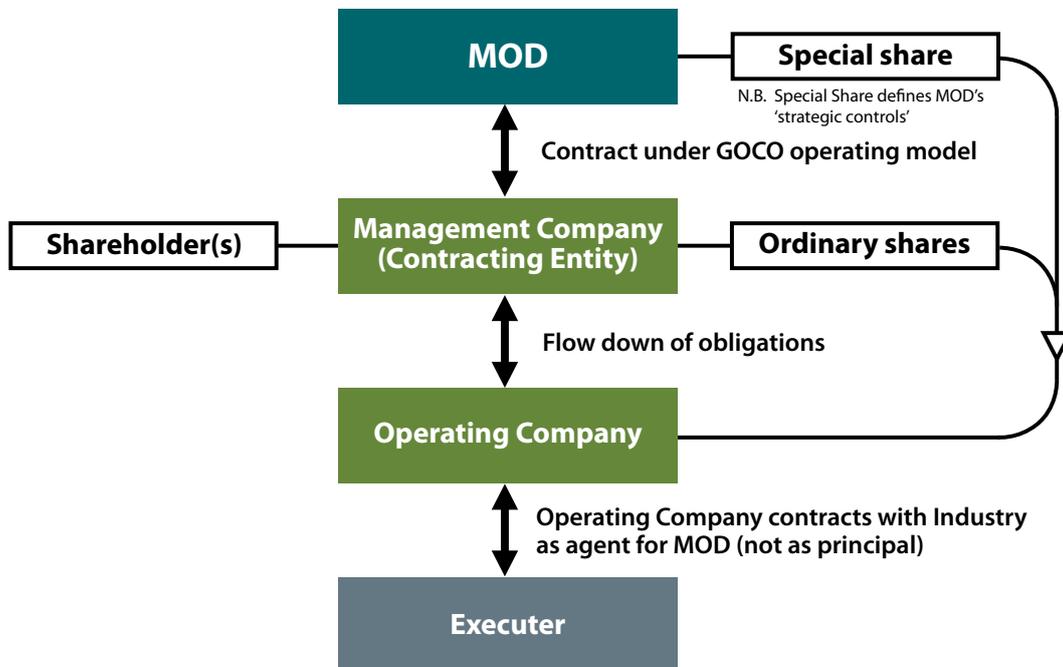
- 39.** It is envisaged that the transfer of in-scope DE&S business to the GOCO would be done in stages, as shown in Figure 3. Initially, in phase 1A only a segment of the DE&S programme of work (to be determined) would be transferred to the Contracting Entity, along with a Common Resource Platform (consisting of commercial, finance, technical specialists and human resources). The remainder of in-scope DE&S business would transfer after two years (Phase 1B), subject to the Contracting Entity meeting pre-determined criteria including value for money assessments.
- 40.** The MOD therefore intends, subject to negotiations, affordability and value for money, to award a contract of up to a nine-year term, to match the phasing shown in Figure 3 and subject to successful transition, transformation and operational delivery.
- 41.** It is assessed that this approach would achieve the desired end state with lower risk, and overcome some of the practical issues of implementation. A staged approach would allow the selected bidder to assume control progressively, allowing time for greater focus on transformational activities.



**Figure 3: Implementation of the GOCO operating Model**

## Corporate structure

42. Under a GOCO operating model, the Contracting Entity would control the Operating Company for the duration of the Contract subject to certain controls (see Governance and Controls, below). If the Contracting Entity is a consortium it is envisaged that the holding company of the Operating Company would be a special purpose vehicle established for the purposes of performing the Contract. Figure 4 shows the corporate structure that might follow from this model:



**Figure 4 – A Proposed Corporate Structure**

43. The MOD would contract with the Contracting Entity, which would flow obligations to the Operating Company. The Contract will initially be competed in the commercial marketplace. Periodically thereafter, following expiry or termination of the Contract, the Contract (including the management of the Operating Company) could be re-competed or revert to MOD.
44. The Operating Company would conduct business in response to MOD requirements (as a Crown customer), providing an enduring business capability that would retain the benefits of investment over time in its skills, processes and tools under the direction from the Contracting Entity. The Operating Company might also, on a case by case basis and subject to MOD approval, be permitted to provide services to other Government organisations. Requesters would use the Operating Company's business capability for the duration of the Contract.
45. On expiry or termination of the Contract, the Contracting Entity would, at no cost to MOD, transfer any shares in the Operating Company to a successor Contracting Entity or to MOD, at MOD's discretion.
46. The MOD is currently running a commercial competition for a Potential Contracting Entity. Variants to the model proposed above (in terms of equity arrangements, governance, etc) will be considered as part of the commercial process.

## Governance and controls

47. The Secretary of State may delegate responsibility for any new DE&S arrangements to the Minister for Defence Equipment, Support and Technology. In support of the Minister, the "Governor" which would manage the Contract within the MOD, would be accountable to the Defence Board, and would be responsible for communicating to the Contracting Entity the policy, strategy and top level programme to be delivered through its contractual arrangement. The Governor would also have responsibility for overseeing the Contract in areas such as contract management; performance monitoring; dispute resolution; cost assurance; the payment regime and Operating Company's costs. The MOD might also need to retain a separate delivery role in some areas, (e.g. sensitive technology that could not be devolved to the Operating Company due to legal obligations and/or obligations arising from international Memoranda of Understanding).
48. Given the critical importance of DE&S services, the MOD would retain a number of strategic interests and corresponding controls over the Operating Company. Most controls would be exercised via the Contract, but the MOD intends to adopt a special share in the Operating Company on the grounds of national security to control share ownership and enable the reversion of operational control of the Operating Company to MOD.
49. In addition to the Contract and Special Share in the Operating Company, other contractual arrangements might be required to secure the controls MOD requires over the Operating Company or to provide the assurance necessary to underpin the contractual arrangement. These may include:
  - a. Direct Agreement between the Operating Company and MOD to ensure continuity of operation should the contract between the MOD and the Contracting Entity be terminated;

- b.** Parent Company Guarantees or performance bonds from the parent companies of the Contracting Entity, to underwrite certain risks or liabilities held by the Operating Company.
- 50.** MOD would also be likely to mandate some controls in the Articles of Association of the Operating Company (including for conflicts of interest) and to require some controls in respect of the Contracting Entity.

## Managing Public Money

- 51.** The MOD would remain responsible for approving all projects. We envisage that the Contracting Entity, via the Operating Company, would act as Agent for the MOD to authorise payments to suppliers who provide goods and services on those approved projects, direct from money voted by Parliament. The Contracting Entity would be required to act in accordance with the Government Financial Reporting Manual (FRoM) in respect of all programme related transactions and would also be required to support MOD in their obligation to comply with the Government's policy on disclosure and transparency of voted funds. The Comptroller and Auditor General will retain the absolute right of audit.

## National Security/Protecting National Interests

- 52.** DE&S delivers, supports and supplies equipment that is critical to our national security and gives rise to specific security considerations. We take the protection of UK national security extremely seriously and therefore any Contracting Entity will be required to maintain the standards to which DE&S currently adheres (for example ensuring that staff are appropriately security cleared, and that classified and other sensitive information is correctly handled). These requirements would be set out in the Contract, and reinforced by special share arrangements put in place for national security considerations (as set out above).

## Conflict of interest

- 53.** Conflict of interest is a situation in which an individual, or organisation, has or may be perceived to have competing interests or loyalties and therefore is or may be perceived to be in a position to exploit a professional or official capacity in some way for their personal or corporate benefit and in these circumstances to the detriment of value for money for the taxpayer or to distort a competition unlawfully.
- 54.** In the initial stages of the commercial process potential Contracting Entities have been asked to demonstrate how they intend to deal with perceived, actual, or potential conflicts of interest. Any potential Contracting Entity with a current conflict of interest that is assessed by the MOD to be unmanageable will not be allowed to bid for the Contract. The final contract will include clauses to entrench any agreed

conflict management process and to ensure that no unmanageable conflicts of interest will occur in the future.

## Personnel

- 55.** Ensuring that the DE&S staff have the right skills and incentives to perform is critical to addressing one of the three root causes that the Materiel Strategy has identified. Existing DE&S (and potentially other MOD) civilian staff would be transferred to the Operating Company. Terms and Conditions of service would be protected by Transfer of Undertakings (Protection of Employment) (TUPE) regulations. It is envisaged that the Contracting Entity (in relation to the Operating Company) would seek to benefit from greater HR freedoms and flexibilities to change culture and behaviours in DE&S, subject to compliance with employment legislation and any restrictions imposed by the services contract. Assuming that a GOCO proposition is successful, It is envisaged that:
- a.** The Contracting Entity would have the freedom (in relation to the Operating Company) to set its own talent management strategy, (recruitment, retention, reward and release of staff) and to introduce changes to the contractual employment terms of transferred civilian staff (through the normal course of business), subject to consulting employees and their representatives in line with employment law; and,
  - b.** The Contracting Entity would be able to provide new recruits to the Operating Company with a different employment contract and would also have the freedom (within certain constraints) to manage the terms and conditions of its employees in the Operating Company to deliver the required outputs.
- 56.** Military staff drawn from all three Armed Forces provide military skills, knowledge and experience to support the delivery of Defence Acquisition in the current DE&S organisation. We envisage that this will not change under the GOCO operating model. Military personnel would be seconded to work in the Operating Company, but they would not be employees of the Contracting Entity or the Operating Company.

## Transparency and access to information / Accountability

- 57.** The Contract will make clear that the right to access information is crucial to ensuring accountability and transparency in spending taxpayers' money. The contract will include an enforceable obligation on the Contracting Entity (and through it on its Operating Company) that will ensure MOD retains ability to continue to meet its Freedom of Information requirements. The Contracting Entity will be required to provide all information and appropriate subject matter expertise to the MOD to allow MOD to adhere to its obligations under the Freedom of Information Act (FOIA). The Contracting Entity will also be required to store, maintain and handle information in line with specific provisions in the Contract.

- 58.** All relevant information held by the Contracting Entity and its Operating Company related to MOD business and the expenditure of public funds will be subject to the FOIA. GOCO management data (both Operating Company and Management Company) will not be subject to the FOIA.

## Section 5: Is legislation needed?

- 59.** In the event that the GOCO operating model is the selected option for transforming DE&S, primary legislation is needed to ensure that the GOCO can operate effectively in delivery of defence procurement services.
- 60.** The legislation will therefore make specific provision, amongst other things:
- a.** To allow the new body to have access to intellectual property and confidential information currently enjoyed by the MOD;
  - b.** To extend certain statutory immunities and exemptions enjoyed by the Crown to the new body in relation to, e.g. The Health and Safety at Work Act and the Nuclear Installations Act;
  - c.** To allow the Secretary of State for Defence, if need be, to create a Transfer Scheme that will give him the ability to transfer shares in the Operating Company and/or property, rights and liabilities in the Operating Company or Contracting Entity when the contract comes to an end;
  - d.** To ensure that the MOD Police have the appropriate jurisdiction to be able to operate within the GOCO environment;
  - e.** To allow the Secretary of State for Defence to authorise financial assistance to the new body if he believes it necessary or expedient.

The legislative process will also provide a further opportunity for Parliament to scrutinise the proposed changes as set out in this White Paper.

# Chapter 2

## A New Framework for Single-Source Procurement

### Section 1: The Current Approach to Single-Source Procurement

#### MOD single-source procurement

61. The MOD's approach to procurement was set out in the '*National Security Through Technology*' White Paper (February 2012). Single-source procurement of equipment and support occurs where the MOD is unable to source its requirements through open competition. This is most common where only a single supplier has the ability or rights to perform the work or where, for national security purposes, a single supplier is chosen so as to protect the UK's Freedom of Action and Operational Advantage. In these cases, we use single-source procurement.

#### Single-source procurement examples

- A maintenance contract for a fast jet engine, where only the original manufacturer has the design rights and experience to service the engine.
  - A manufacturing contract for an additional nuclear submarine, to add to the existing fleet, where it would be impractical to either have a different type of submarine or to pay for another supplier to replicate the same design.
  - A contract to test the operational limits of a tank's armour, where only one UK supplier has the right facilities, and we do not want anyone outside the UK to know what the limits are.
62. Over the last five years the proportion of contracts placed on a single-source basis has averaged 45%<sup>8</sup> (by value), circa £6Bn per annum, and is likely to remain significant in the future. Single-source procurement is concentrated in a relatively limited number of high value contracts with a small number of suppliers. There are around 100 existing single-source contracts, above £50m in value, which account for over 90% of the value, and most of these are with our top ten single-source suppliers.

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8 The average is based on data from the 2007/8, 2008/9, 2009/10, 2010/11 and 2011/12 Financial Years.

63. In the absence of an alternative supplier, VFM is at risk. Suppliers can price without fear of being undercut by their competitors, so they are not subject to normal market pricing pressures. Furthermore, because we require the military capability they provide, suppliers can be confident of follow-on work even if costs are high or performance poor. The volume of single-source procurement, together with the risk to VFM inherent in this approach, means assuring VFM in single-source procurement is of great importance to both the MOD and the taxpayer.

## The current single-source framework

64. The MOD currently uses a framework to price single-source procurement known as the Yellow Book. The aim of the current Yellow Book is to give industry a fair and reasonable price, based on an annually published profit rate to be used in price setting, in exchange for rights granted to MOD to help us assure VFM.
65. The Yellow Book was established in 1968 following instances where suppliers made high profits by effectively double-charging their overhead costs to the MOD<sup>9</sup>. It is underpinned by a non-legally binding Memorandum of Understanding<sup>10</sup>, and is published by an advisory Non-Departmental Public Body (NDPB) called The Review Board for Government Contracts (the “Review Board”).
66. The Yellow Book framework is typically reviewed every three years and may be updated, but only if agreement can be reached between MOD and industry. This requirement for consensus means it is hard to make any change where one party has a vested interest in the status quo. In consequence, it has remained largely unchanged since 1968 despite many significant changes to both the industrial landscape and MOD procurement practices over the years.

### 1968 vs 2013

1968	2013
<b>Industrial landscape</b>	
<ul style="list-style-type: none"> <li>● Large number of smaller companies</li> <li>● Extensive state ownership of defence suppliers</li> </ul>	<ul style="list-style-type: none"> <li>● Small number of global companies</li> <li>● Predominantly private sector</li> </ul>
<b>Government expertise</b>	
<ul style="list-style-type: none"> <li>● Substantial Government resources directly involved in equipment design and support</li> </ul>	<ul style="list-style-type: none"> <li>● Government role is primarily to set capability requirements and manage industry delivery</li> </ul>
<b>Technology</b>	
<ul style="list-style-type: none"> <li>● Larger number of simpler assets with shorter development times</li> </ul>	<ul style="list-style-type: none"> <li>● Smaller number of ever more complex assets with development cycles up to twenty five years</li> </ul>

<sup>9</sup> Report of the Committee of Inquiry into Certain Contracts made with Bristol Siddeley Engines Ltd., 21 Feb 1968.

<sup>10</sup> The Memorandum of Understanding was between Her Majesty’s Treasury and the Confederation of British Industry; although originally set up as a potential cross-Government regime, MOD and the defence industry are now the sole users of the Yellow Book.

Nature of contracts	
<ul style="list-style-type: none"> <li>● Shorter, simpler contracts</li> <li>● Price set by applying a fixed profit rate to costs that a supplier had already incurred (cost plus)</li> <li>● Little subcontracting</li> </ul>	<ul style="list-style-type: none"> <li>● Contracts for ten or more years</li> <li>● Predominately fixed price, with suppliers accepting and pricing in risk</li> <li>● Significant use of subcontractors</li> </ul>

## Section 2: Review of Single-Source Pricing Regulations

### Lord Currie's Report

67. Following the 2010 Strategic SDSR, the Minister for Defence Equipment, Support and Technology commissioned Lord Currie of Marylebone to chair an independent review of the single-source pricing regime. The objective of the review was to propose a fit-for-purpose framework that could be applied to equipment and support contracts between MOD and its single-source suppliers. Lord Currie met with senior executives of UK-based defence contractors, senior MOD and Government officials, trade bodies and the Review Board. He also sought views from other Ministries of Defence undertaking substantial single-source procurement.
68. Lord Currie's report, published in October 2011, recommended a fundamental recasting of the current Yellow Book. He identified the following serious shortcomings:
- a. **Poor focus.** The Yellow Book focuses on profit and overhead costs but does not adequately cover direct costs, subcontracted work, or risk. This means the bulk of the price is not closely considered.
  - b. **Inadequate incentive for efficiency.** The Yellow Book does little to provide suppliers with ongoing incentives to reduce their costs once on contract, or to support the MOD to replicate the missing competitive pricing pressure.
  - c. **Inadequate protections for MOD.** Under current provisions MOD has to wait until the end of a contract, which may be ten years or more, before it can challenge whether the pricing assumptions provided to the Department by a supplier were reasonable or appropriate.
  - d. **Insufficient challenge to overhead costs.** The current framework allows suppliers to charge the MOD for millions of pounds of overhead costs without any need for prior approval or consultation. This is clearly inappropriate when the MOD accounts for the majority of the output of a supplier's business unit. The Yellow Book also puts the onus on the MOD to prove that overhead costs are "unreasonable, extravagant or wasteful".

- e. **Weak governance of the regime.** The Review Board, through no fault of its own, is very constrained in its resources and remit<sup>11</sup>. The Review Board has no visibility of how or whether the Yellow Book is applied to specific contracts.

## Lord Currie's proposals

69. In order to address these serious shortcomings, Lord Currie made several recommendations for improvements to ensure the new framework benefitted from:
- a. **Better focus.** Lord Currie recommended mandatory standard cost reporting and increased transparency (open book) to support the MOD in assuring VFM across all of the elements of the price including direct costs, subcontracted work, and risk. These reports would allow the MOD to learn the true costs related to single-source contracts in a much more timely fashion.
  - b. **Stronger supplier efficiency incentives.** Standard pricing and actual cost reports would enable benchmarking across projects and suppliers, which should be used by the MOD to better challenge supplier prices. Greater transparency and audit rights should be used by MOD to ensure suppliers were looking for continuous improvements once on contract. Lord Currie also noted that profit is a supplier's strongest incentive for efficiency. He recommended that the link between a supplier's costs and profit should not be unduly undermined by contractual sharing arrangements, and that projects where a supplier carries higher risk should attract a higher profit rate (and vice versa).
  - c. **Stronger protections for the MOD.** The MOD should be able to investigate whether a supplier's pricing assumptions were reasonable and appropriate at any point during a contract, rather than just at the end. The standard reports should allow the MOD to target these investigations appropriately (e.g. where costs are much higher or lower than anticipated).
  - d. **Improved visibility and challenge of overhead costs.** New mandatory overhead reports from suppliers would support a pre-approval process for significant overhead costs, and would require suppliers to be more transparent with MOD about industrial over - or under - capacity. The supplier should have to demonstrate that overhead costs are reasonable and appropriate, rather than the MOD having to argue that they are "unreasonable, extravagant or wasteful".
  - e. **A stronger Single Source Regulations Office (SSRO) replacing the current Review Board.** The new arms-length-body would keep the new framework under review and would publicly recommend changes to the Secretary of State. It should lead the debate rather than requiring consensus between the MOD and single-source suppliers. It would also monitor the application of the regulations, and provide analysis that would aid the MOD to better forecast future costs. It should be supported by full time staff.

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<sup>11</sup> The Review Board has no permanent staff; the MOD pays for its part-time Secretariat under a contract with Deloitte LLP.

## Section 3: The New Framework

### A New Approach

70. The Yellow Book was designed to deal with the issues that industry and Government faced over forty-five years ago. It has been kept in the past by a process that has made revision very difficult, and change is now long overdue.
71. The MOD has consulted extensively since Lord Currie published his report, including a formal public consultation and detailed discussions with our largest single-source suppliers. Although there have been areas of difference, defence suppliers have accepted the need for change, and we are grateful for their constructive engagement throughout the process.
72. The MOD and our single-source suppliers need to adopt a new framework designed to address the current challenges in single-source pricing, and which is supported by a process that ensures it is kept current. We no longer wish to rely upon a non-legally binding memorandum, supported by custom and practice, and wish to move the regulations onto a statutory basis. This will ensure widespread coverage of the framework across our single-source suppliers, and their single-source supply chains.
73. Our new approach to managing defence single-source procurement has two principal characteristics:
  - a. New statutory regulations which help to ensure both that industry gets a fair return on single-source work and that the taxpayer is effectively protected.
  - b. New governance regime, supported by the SSRO, which will help to ensure widespread application and adherence, and which will ensure the regulations are kept up to date. We must ensure that we do not have to wait another forty-five years before these regulations are reviewed.

### Principles underpinning the New Regulations

74. At the heart of the new pricing framework is the principle that industry gets a fair and reasonable price in exchange for providing the MOD with the protections we need to assure VFM. We will retain the current profit formula for defence single-source procurement, which provides the defence industry with a profit rate comparable to the rest of UK industry, in exchange for greater transparency.
75. In designing the new approach the key guiding principles of the new framework have been to:
  - a. **Address issues that arise from single-source procurement** – For example supporting the MOD's ability to replicate the missing competitive pressure.
  - b. **Focus on areas where standardisation is of value** – The framework proposed benefits from wide application and stability over time.

- c. **Be proportionate** – Higher value contracts carry a greater risk to VFM, so there should be greater protections. We also do not want to discourage the greater involvement of Small and Medium Sized Enterprises (SMEs) in defence by a framework that is too burdensome.
- d. **Provide value for money** – We have taken a balanced approach between asking for information we would ideally like, and asking for information that is readily available using current industry systems and processes. We have ensured that the framework is practical by engaging with industry on these proposals.

## Better price negotiation

- 76. In single-source procurement the MOD must take the place of the missing competitive pricing pressure by challenging a supplier's price. The new single-source framework will support the MOD's ability to negotiate prices that are fair and reasonable to both suppliers and taxpayers, by providing an underpinning reference framework that defines how those prices should be calculated.
- 77. To do this the MOD needs better quality and more standardised historic outturn data. The regulations will introduce standard reports at the beginning and end of each single-source contract (and substantial contract amendments), that will allow us to build up a database of defence benchmarks. We will use these benchmarks to identify pricing assumptions that are at odds with other comparable projects, and to embed tough, but achievable efficiency targets into the contract.
- 78. Defence benchmarks can also be used to support capability planning and to improve the accuracy of early budgets. By allowing capability planners to make high-level trade-offs for a given level of cost, for example between a ship's range and its maximum speed, the MOD will be better placed to optimise equipment specifications and make more robust long-term cost forecasts in the early acquisition phases.

## Stronger efficiency incentives

- 79. In a competitive environment, suppliers must continuously improve or they risk being overtaken by their competitors. Whereas in single-source procurement, a lack of an alternative means that follow-on work is less dependent upon any improvement. The single-source framework must help provide a proxy for the missing on-going efficiency incentive.
- 80. We accept Lord Currie's view that the strongest motive for supplier efficiency is higher profit. Profit should be the reward for good performance and should motivate a continuous drive to improve. To ensure this, we need to get the price right in the first place, so high profits cannot simply be incorporated into the price, and we must also ensure that the only way to higher profits is through greater efficiency, or assuming a higher share of the risk in the project. The new provisions will increase the current profit-risk range from a possible  $\pm 1\%$  adjustment to a more significant  $\pm 2.5\%$ .

81. Getting the price right requires a number of things. We have already described how the new framework will improve our understanding of cost drivers, and how the proposed reform of DE&S will improve commercial skills. However suppliers will always know more about their costs than we will. We need to put an onus on single-source suppliers to use reasonable and appropriate pricing assumptions. If supplier costs turn out to be lower than expected, we will have the right to investigate if the price was genuinely based on a supplier's best estimates at the time. We will then be able to refer any such concerns to the SSRO, as an independent expert body which, if it believes reasonable and appropriate pricing assumptions were not used, will have the power to require the supplier to compensate us accordingly<sup>12</sup>.
82. Ensuring the only way to higher profits is through greater efficiency means being confident that there are no weaknesses in the system that could be used to achieve higher profits without cost reduction. To achieve this we will address three known weaknesses in the current framework:
- a. **No profit on profit.** Suppliers often subcontract work to their own subsidiaries, who in turn can subcontract to other business units in the same corporate group. At each stage it is possible to add a layer of profit. The current framework addresses this poorly and we are therefore introducing a clearer system where "profit on profit" is adjusted for at the contract level, at the time the contract price is agreed.
  - b. **The current overhead recovery methodology can result in over-recovery of overheads.** Overhead allocation and recovery is a complex activity, and our current approaches can result in systematic over-recovery or under-recovery. We will require suppliers to provide a report that compares overhead recovered with overhead spending to ensure we are not paying twice for the same capabilities.
  - c. **Onus of proof.** Under the current arrangements the onus of proof is on the MOD to demonstrate that costs are unnecessary, extravagant or wasteful. Given that we did not incur the costs in the first place, and were not involved in any investment decisions, this is hard to do. The new framework will place the onus on suppliers to demonstrate that costs they claim are reasonable and appropriate for MOD to pay.
83. No framework can offer complete protection, and we will therefore have a general audit right to investigate how our money is being spent and how the supplier is performing. This will allow us to continuously monitor performance to both evaluate the framework, and where appropriate, further encourage ongoing efficiency improvement. We will also put a duty on suppliers to let us know in a timely fashion of any cost, performance, or schedule risks or changes. This over-arching obligation on single-source suppliers provides an important back-stop protection that means the MOD can accept a lighter-touch framework as opposed to one that attempts to address all potential issues with explicit measures.
84. Our concern for supplier efficiency is based on a desire for VFM. In the past, the assumption has been that greater efficiency will result in lower supplier costs, which in turn will result in lower follow-on prices and better VFM. However this does

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<sup>12</sup> We also accept that we have a duty to provide supplier with any information we have that is relevant to pricing, and that if this information is not shared or if misleading information is provided, suppliers will also be able to refer the matter to the SSRO.

not always work for MOD as not all contracts lead to follow-on work. We accept Lord Currie's view that there can be a trade off between strong supplier efficiency incentives and VFM. Suppliers must benefit from cost reduction or they will not do it. However if we do not share in this benefit, then VFM has not been improved. The new provisions will mean that industry does not automatically have to pass back to MOD 75% of any additional profits that arise after the standard profit rate is exceeded by 5%. Instead we will introduce a more graduated sharing of excess profits and losses that will ensure the efficiency incentive on suppliers remains strong over all likely scenarios, but which will still provide MOD with protection against excessive industry profits. We accept that it would not be fair to share potential gains without also taking a share of potential losses, so the regulations will also provide for some share of any such losses. It is not in our long-term interests to force suppliers to provide us with capability while they suffer from on-going and potentially crippling losses.

## Better joint planning on key facilities

- 85.** Where only one supplier can provide aspects of the capability we require, the sustainment of industrial capability can be a matter of national security. There is also a risk to VFM as this capability sustainment is paid for through the overheads that suppliers charge to us via single-source contracts. To help ensure that we optimise industrial capability with our long-term military requirements (building, sustaining and rationalising as appropriate), we need a single-source framework that allows us to be appropriately involved in the long-term planning of facilities where MOD makes a significant financial contribution.
- 86.** The current methodology for overhead recovery does not require suppliers to provide the MOD with any transparency of current and future over-capacity, or any rationalisation and redundancy plans they may have. The new regulations will require suppliers to submit annually a long term plan for the key facilities where substantial overhead is (or is planned to be) recovered through MOD single-source work. This will show current and forecast activity and plans for closure, enhancements, or significant changes. This plan will be used as the basis for joint long-term planning, to ensure we can address potential national security or VFM issues.

## Stronger financial and performance management regime

- 87.** Given their complexity, size, and long duration, single-source projects have historically been at the highest risk of cost growth, programme changes, and delay. The single-source framework should allow these risks to be highlighted to MOD in a timely fashion.
- 88.** Cost reporting on our current large contracts is ad-hoc and sporadic. Reporting requirements and adherence to these requirements is highly variable, and what reports we do receive come into multiple points across the Department and in multiple formats. This makes it labour intensive for MOD to collate such information. In recent years most of our single-source suppliers have introduced, for their own internal purposes, standardised project reporting, including cost reporting. The additional overhead cost in producing standardised reports is justified by their improved ability to understand their portfolio of projects. Standardisation allows for

aggregation at different levels (e.g. project, programme, portfolio), and for systems and process to be easily introduced to convert lower-level information into useful information for our suppliers' senior management. Given we are paying through our single-source work for much of this information to be generated, MOD senior and project management should be entitled to similar information, for similar purposes.

89. The regulations will require standard quarterly reports, for all single-source contracts above £50m. That will allow MOD senior and project management to be given assurance and confidence concerning project health, and to be better enabled to jointly identify cost, performance, and schedule risks and opportunities. These contract reports will be included in standard MOD processes; helping to support a stronger financial and performance management regime and helping the MOD to become a more intelligent customer.

## Encouraging SMEs

90. The MOD set out in the '*National Security Through Technology*' White Paper its approach to providing greater defence opportunities for SMEs, and we have made good progress implementing these reforms. We wish to encourage the use of SMEs in single-source contracts, even though we expect that large suppliers will continue to account for the majority of the value of single-source procurement. We are therefore introducing simplified single-source procurement processes for smaller contracts and suppliers.
91. We would also like to encourage the use of SMEs in our larger suppliers' supply chains and will require our larger single source suppliers to generate an annual SME report describing their subcontractor procurement processes and outlining how they have encouraged greater involvement of SMEs to enter their supply-chains.

## Better compliance

92. The lack of commercial leverage in the single buyer/single provider environment makes it more difficult to ensure compliance with contract conditions; the ultimate sanction of contract termination due to non-performance is of little value when there is no alternative supplier.
93. Current reporting requirements are usually not linked to any direct financial consequence. We will move to a stronger compliance regime where failure to provide transparency and reports results in the name of the supplier being made public and a fine under a civil penalty regime. This will ensure a fast and straightforward means of addressing breaches. The SSRO, which will be at arms-length from MOD and industry, will act as the appeal body for the compliance regime.

## Summary of the new single-source contract regulations

Area	Element	Purpose
Transparency	Open Book	To provide a general back-stop right to help assure VFM in single-source procurement and to check the new framework is working
	Audit rights and referral rights to an independent expert	To put a duty on suppliers to use reasonable and appropriate pricing assumptions
Pricing	Standard profit	To provide industry with an independently assessed fair return, equal to the average of UK industry
	Incentivisation of efficiency	To allow additional profit where it is earned by performance
	Variation of profit with risk (+/- 2.5%)	To allow additional profit where it is earned by performance
	Protection from excessive profits and losses	To provide the MOD with protection in the event of excessive supplier profit, and suppliers protection against excessive losses
	No profit on profit	To ensure suppliers get a fair profit, and not an unwarranted profit achieved simply by clever deal structuring
	Standard list of allowable costs	To ensure both parties negotiate fair prices within a clear and coherent approach and on a level playing field
	Onus of proof	To put a duty on suppliers to demonstrate the overhead costs they claim are reasonable and appropriate for MOD to pay
Standard contract reports	Benchmark reports at start/end/ amendments	To improve price negotiation (and capability planning) by building up a database of defence benchmarks from comparable projects
	Quarterly contract reports	To get timely checks on project health that can be used to support a stronger financial and performance management regime; and so that MOD can negotiate follow-on prices with a good understanding of historic costs
	Annual contract reports	To maintain an audit trail of the cost baseline that is directly comparable to the original price
Standard overhead and supplier-level reports	Annual overhead benchmark reports	To improve overhead negotiation by building up a database of overhead benchmarks
	Overhead comparison report	To check the effectiveness of the range of overhead recovery methods we have available
	Long term overhead report	To optimise the industrial capacity we pay for with our long-term military capability requirements
	SME report	To support SMEs down the supply chain

Area	Element	Purpose
Compliance regime	Publically naming the supplier	To increase the timeliness and likelihood of adherence to the new regulations
	Financial penalty	

## Industry information

- 94.** The changes we are introducing will provide unprecedented levels of industry information to the MOD. This information is essential to enable us to understand supplier costs and deliver cost effectiveness for the UK taxpayer in single-source procurement. Some of this information will have a very high level of commercial and market sensitivity and would typically be restricted to a few senior managers within the supplier company. Release of this information could significantly damage a supplier's commercial position and we take seriously our responsibility to handle it in a confidential and secure manner.
- 95.** In order to give industry the confidence they need to provide the MOD and the SSRO with the information we require, we intend to make unauthorised release of the most sensitive information obtained under the new regulations a criminal offence. This approach is also taken in industries subject to price regulation such as water, telecommunications, and rail, where a similar level of information is provided to Government.
- 96.** This offence will not limit the application of the Freedom of Information Act 2000 (FOIA) to information the MOD receives as part of the new regulations. The FOIA already includes exemptions to protect commercial information and information provided in confidence. It will also not reduce the information that the Department currently publishes. We will take a power in the legislation to introduce a full statutory bar on disclosure should evidence arise that further protection of industry information is required, beyond what is already available under the FOIA. This would align the single-source procurement regime with other price regulated industries.

## Section 4: Governance of the New Framework

### The Single Source Regulations Office

- 97.** A key element of Lord Currie's recommendation was the replacement of the current Review Board by a stronger SSRO. The SSRO will keep the new regulations under review, periodically recommending changes to the Secretary of State for Defence. It will monitor the application of the regulations, and provide an expert determination role between MOD and single-source suppliers. It will also analyse the standard reports to help it to better understand the issues of single-source procurement, extract independent defence benchmarks, and highlight areas where it thinks greater efficiency might be achieved.

98. The SSRO will be an arms-length body and is expected to have five non-executive Board members (and two from the executive) and a full-time staff of around twenty-five people. It is anticipated to cost approximately £4m per annum, with the costs to be shared equally between the MOD and single-source suppliers.
99. The creation of an independent, arms-length body is central to the effectiveness of the new framework. If MOD were to unilaterally set the pricing framework, including the profit rate, there would be a risk over time that the framework would tend to favour Government and become overly burdensome on suppliers. However, if any change or agreement to the pricing framework was based on gaining consensus between the MOD and industry, it would suffer from the same limitations as the existing framework.
100. The MOD therefore agrees with Lord Currie's recommendation that updating and managing the single-source framework is best done at arms-length from both MOD and industry through the SSRO, which will become an independent expert in defence single-source procurement. The overriding duty of the SSRO will be to maintain a single-source procurement framework that assures value for money for the UK taxpayer and allows a fair and reasonable price for suppliers. The principles underpinning this duty will be enshrined in legislation. The SSRO will also monitor the application of the framework, have a role in ensuring compliance and will offer binding expert determination in the event of disputes.

## A Statutory Approach

101. The benefits of the new framework will depend upon its widespread application across the spectrum of single-source work. There are two alternative approaches to ensuring the new framework has a firm legal basis: contract law or statute.
102. A contractual approach would require us to negotiate terms on a case by case basis with suppliers. This is likely to limit the application of, and adherence to, the new framework. Our commercial leverage is limited in single-source procurement because there is only one possible supplier and we cannot walk away without losing the required military capability. In the absence of strong commercial leverage, suppliers will be able to demand concessions, as they can under the current arrangements, and may only agree to watered-down versions of the new transparency and reporting requirements, or indeed may refuse them altogether. This would create poor coverage and multiple approaches across different MOD suppliers.

- 103.** By contrast, a statutory approach allows the MOD to counteract the poor commercial leverage inherent in single-source procurement and ensure wide, consistent and fair application across defence single-source suppliers. In addition to providing widespread coverage and adherence, there are also secondary benefits to using statute:
- a. A more effective compliance regime underpinned by civil penalties.** It is difficult to attach any financial remedy to non-provision of information using contractual terms.
  - b. Wider application up the supply chain.** Single-source contracts frequently involve subcontracts which are also single-source and which we pay for in the prime contract price. The same risk to taxpayer VFM exists in these subcontracts, yet the prime contractor currently lacks the commercial leverage to flow down the obligations; if the subcontractor refuses, there is little he can do. A statutory underpinning will allow the new pricing framework to be more effectively applied up the single-source supply chain, ensuring widespread adherence to the new regime.
- 104.** Putting the framework on a statutory basis will help ensure wider application and greater adherence and thus a more competitive UK defence industry, delivering costs savings for the MOD and the UK taxpayer, and making industry better able to succeed in a highly competitive global market.



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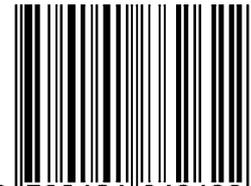
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ISBN 978-0-10-186262-2



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