

# **Review of Single Source Pricing Regulations**

October 2011

An independent report by Lord Currie of Marylebone

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An independent report into the single source pricing regulations used by the Ministry of Defence

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# Foreword

Single source procurement has accounted for around 40% of MOD's total procurement over the last five years. This is too high and this Government intends to reduce the figure. We will set out how we will achieve this in our forthcoming White Paper on technology, equipment, and support for UK defence and security. However, the particular nature of the defence market means we will still have to place some large non-competitive contracts for military equipment, where there are a limited number of suppliers or where we need to protect our operational advantage or freedom of action.

This means it is essential that the arrangements for single source procurement ensure value for money for the UK taxpayer in today's commercial and economic environment. This is clearly not the case with the current arrangements, which have been in place for over 40 years and which lack incentives for industry to reduce its cost base. That is why I am grateful to Lord Currie for agreeing to undertake this urgently needed and demanding review.

I agreed with Lord Currie that he should produce an independent report and that is exactly what he has done. Some of what he says about both MOD's and industry's ability to deliver value for money is uncomfortable reading, but there is little in his analysis that I do not recognise or that we are not addressing.

The key question now is how to take his work forward. MOD wishes to consult widely on Lord Currie's recommendations, so it would not be appropriate for me to comment on them in detail now. However, I do want to highlight some key issues.

In broad terms, Lord Currie's report focuses on achieving a more open relationship between the MOD and its suppliers, in particular ensuring that standardised high quality cost data is provided by contractors to the MOD. This would help ensure greater transparency of costs and should improve the MOD's ability to negotiate realistic prices. Industry would be incentivised to deliver efficiency by the opportunity to make greater returns should they deliver cost savings for the MOD. Making industry more efficient should not only achieve value for money to the taxpayer, but also lead to a more competitive role for the UK industry in the export market.

Small and Medium Enterprises (SMEs) would have fewer data reporting requirements and a simplified profit rate process. Larger contractors would be expected to provide an annual statement on how they have engaged SMEs in their supply chain.

A key recommendation is the proposed new Single Source Regulations Office. We will need to consider this in the light of other MOD changes under Defence Transformation and the Materiel Strategy, as well as wider opinion. We are clear that the new single-sourcing rules will need a tougher framework to support them and I strongly believe that by having an open discussion of Lord Currie's findings and his proposed solutions, we can develop a clearer understanding of what will work best for industry, Government, and the taxpayer.

We had originally envisaged that Lord Currie would conduct the consultation himself. However, after extending the period in which he developed his report, we have concluded that in order to maintain the momentum of the expected reform, the next phase should be undertaken by Government.

We will continue to discuss the issues with Lord Currie during the consultation period, which will run from the publication of the report on 10 October until 6 January 2012. Further details on how to take part in this consultation are set out at the back of the report. Following consultation, the Government will produce a public response and a high-level implementation plan for taking forward its conclusions.

Tackling industry's cost-base and improving the MOD's procurement process are at the heart of this Government's transformation agenda for Defence. I am grateful to those in industry and elsewhere that have already engaged constructively on this important issue and look forward to continuing this discussion.

A handwritten signature in black ink, appearing to be 'PL', written in a cursive style.

**Peter Luff MP**  
**Minister for Defence Equipment, Support and Technology**

# Preface

When the Minister for Defence Equipment, Support and Technology, Peter Luff, asked me to undertake a review of the regulations applicable to the procurement of military equipment and services on a single source basis, he gave me the opportunity to understand the challenges and complexities of procurement in this area. The existing regulations, the so-called Yellow Book, were drawn up in 1968, and although they have evolved somewhat in the forty or so years since, they have not changed nearly as much as the industrial and technological landscape. It quickly became apparent that they needed to change, possibly radically. The real challenge has been to find practical solutions to the issues that I and the team uncovered.

The Yellow Book arrangements were originally envisaged as applying across Government. In practice these arrangements have become exclusive to the MOD, reflecting the unusual prominence of single source procurement within the Department. While it is desirable to use competitive tendering where possible, there are sound reasons why single source will continue to represent a significant part of total MOD procurement. It is thus essential that the governing regime for this activity is robust and fit for purpose. This is the aim of our recommendations.

It is easy to be critical of the failures in procurement, and we have heard much about such issues in the press. Little of this reporting recognises the fast changing world of technology in which the MOD and industry operate, nor the changing nature of the national security threats against which the MOD must protect. Having visited some of the facilities operated by the main defence contractors, we have a much keener appreciation of the demanding nature of the activities in which both industry and the MOD are engaged. Our consultations with those involved in similar procurement in other countries made clear that no one country has the perfect procurement process; but it was also clear that important lessons could be learnt from others.

We are encouraged by the changes the senior MOD team are introducing to address the past problems of defence procurement, including the commissioning of this report. Our proposals are designed to complement and strengthen these changes.

Susanna Mason, the MOD's internal sponsor of the review, has been a most effective champion of both the approach to the review and the solution. I am appreciative of her support.

In finding a way through these challenges, my load has been greatly eased by the wisdom, guidance, and major input I have received from Charles Bellringer, a consultant independent of the MOD. Jason Petch has done an admirable job leading the MOD team. Without his and the team's command of the subject matter, this review would have been much the weaker. So I also extend my thanks to members of the team: Sue Ware, Andrew Palmer, John Clark, Phil Gaskill, Graham Saunders, Peter Thompson, Nigel Rix and Oliver Houseman. I am also grateful to the many people from industry and Whitehall who gave their time so generously to brief us and debate the issues with us in so constructive a manner.

The original timetable envisaged publication of our report in July. In the event, the refining and testing of our recommendations, together with the need to fit in with the Parliamentary timetable, required a little more time – hence our October publication. The extension has also led to the Minister modifying the next phase of the review, which will now be a consultation with stakeholders conducted by the MOD.

The recommendations in this report have been developed with a keen eye to the burden of implementation. We have sought to develop a new approach to single source procurement that meets the objectives of incentivising efficiency and ensuring value for money for the taxpayer, but which avoids becoming a bureaucracy. We believe that the approach is practical. Inevitably there will be one-off costs of migrating to the new approach, but most of the data that will need to be submitted by industry already exists within the constituent companies, so that these one-off costs should be modest.

The reward is a more stable environment for the single source defence sector, where industry is more cost competitive in export markets, and the MOD maintains a balanced budget. That balance will avoid the need to cut or delay programmes and greatly reduce the level of waste that results, with benefit to the MOD and industry, including SMEs. This is a much healthier position for both parties, and one that should help to take them out of the spotlight. The real prize of a more effective single source procurement process will be better value for money for taxpayers and a better equipped front-line.

Achieving this goal will require co-operation from industry and the support of the leadership within the MOD. With this support we think that much can be achieved to improve the position of all the interested parties.

A handwritten signature in black ink, appearing to read 'David Currie', with a long horizontal flourish underneath.

**David Currie**  
**Lord Currie of Marylebone**

# Executive Summary

1. The Minister for Defence Equipment, Support and Technology, Peter Luff, asked me to undertake an independent review of the regulations the Ministry of Defence (MOD) applies in single source procurement. The aim is to recommend a system that encourages value for money and efficiency, provides industry with a fair return, and encourages exports and small and medium enterprise (SME) participation. For formal terms of reference, see Annex A. I have been supported in this task by a review team made up of external consultants and MOD staff.
2. The scope of the review does not include considering why the MOD uses single source procurement, this being a matter for MOD policy and EU and UK procurement law. Also excluded from our review is how the MOD specifies its requirements: we concentrate on the pricing and cost management regulations and processes to apply to contracts written subject to these requirements. We do note, however, the benefits of the MOD using competitive tendering wherever possible, so that single source procurement is held to the minimum feasible.

## Background

3. Over the last five years, single source procurement has accounted for an average of 40% of total MOD procurement by value or £8.7bn per annum<sup>1</sup>. Commitments under the current regulations will continue for over twenty years, so any significant inefficiency in procurement, or in delivery, will represent a very major and continuing cost to taxpayers. There is a mutual dependency between the MOD and its major defence contractors. The companies rely on the MOD as a major customer (though for some this dependency has diminished over time because of international diversification), while the MOD relies on the technical capability and capacity of the industry to meet its needs. This MOD reliance is particularly strong in areas where freedom of action requires a domestic capability and the presence of a single supplier means procurement is necessarily single source.
4. Single source contracts are currently governed by the so-called Yellow Book.<sup>2</sup> The Yellow Book dates from 1968 and takes the form of an agreement between Her Majesty's Treasury (HM Treasury) and the Confederation of British Industry (CBI), overseen by the Review Board for Government Contracts.<sup>3</sup> More than forty years on, neither party to the agreement wishes to own it and the Yellow Book has become the sole preserve of the MOD and its contractors. The Yellow Book provides for 'Equality of Information'<sup>4</sup> at the point of contracting, a much more limited concept than the open book arrangements standard in strategic collaborations between private sector companies. There is also provision for post-costing which allows the MOD to examine the numbers ex post both to inform follow-on pricing and to reveal any failure to comply with Equality of Information. It also enables the MOD to claim back any 'unconscionable profits' through negotiation or through a contractual route involving the Review Board. However, post-costing has been used sparingly, because a reduction in the MOD's financial analysis skills led to a focus by CAAS<sup>5</sup> on new contracts rather than learning financial lessons from the past. Moreover,

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1. UK Defence Statistics 2010, Table 1.15, MOD.

2. The Yellow Book is more formally known as the Government Profit Formula and its Associated Arrangements, published by the Review Board for Government Contracts.

3. An advisory Non-Departmental Public Body (NDPB) associated with the MOD.

4. No agreed definition of 'Equality of Information' exists: the presumption is one of good faith between the parties, to bring to one another's attention information which is material to the agreement of a fair and reasonable price.

5. The Cost Assurance and Analysis Services, the investigative accounting and cost estimating branch of the MOD.

proving a breach of the Equality of Information requirement after the passage of many years is very difficult (as a recent case before the Review Board has illustrated).

5. The Yellow Book has been revised over time, but the revision process has been incremental and very slow. This is because of the need, under Yellow Book regulations, for each amendment to be agreed by both sides to the agreement. A serious weakness of the arrangement is the focus on the appropriate profit rate on contracts, not on achieving efficiency gains in the cost base on which this profit rate is charged; i.e. the focus is on the 10% profit element of the contract value and not on the 90% or so of cost. It has been a source of frustration to the Review Board itself that its initiatives on efficiency have been thwarted by the need to secure the agreement of both the MOD and industry.
6. The Yellow Book method of charging for overheads as a mark-up on unit costs, traditionally labour costs, gives rise to considerable difficulty when order volumes change, as they do quite frequently. In effect, through such overhead payments the MOD is often paying for the maintenance of a strategic capability, but the overhead methodology is not conducive to thinking strategically about the maintenance, management and efficiency of such capability. Another important aspect of current arrangements is that financial reporting to the MOD is on bases that vary by programme and over time. This reflects the relatively autonomous contracting and project management processes across the MOD, coupled with different approaches by contractors, and the relatively weak degree of central financial oversight. As a result comparison across programmes and over time is very difficult, if not impossible, so the MOD is appreciably impaired in its ability to be an intelligent customer.
7. These difficulties are compounded by the relatively weak nature of CAAS: it is advisory (in contrast to financial analysis functions in other NATO defence organisations), and we have found examples from the past where its advice has been ignored. It was run down during the mid-nineties, so that capability and capacity was weakened; and although it is now being rebuilt (with external support) the success of this has yet to be established. A centrally positioned capability in financial analysis and cost estimating is required for MOD to be an intelligent customer.
8. A key aspect of the Yellow Book regulations is the requirement that the MOD bears the restructuring and redundancy costs associated with the cancellation or completion of programmes that fall under the Yellow Book regulations. This feature came to the fore in the recent Strategic Defence and Security Review (SDSR<sup>6</sup>). It means that when the MOD cuts programmes, the overall cost savings are less than the headline cuts may suggest as funding has to be found to meet these contractor costs. The alternative would be a more conventional commercial arrangement whereby the contractor bears such costs. For reasons set out later (see paragraph 22), we do not recommend adopting this alternative.
9. In our discussions within the MOD, in wider Whitehall, and with industry, the need to promote and incentivise efficiency was universally accepted. The corollary that high profits made by improving efficiency are entirely acceptable (provided that the taxpayer shares in the benefits and that the targets for industry are not too soft) was also generally accepted as a principle. However, we did observe within the MOD some challenge to high profits being made, even when major efficiency gains were being delivered.
10. In looking at contractor efficiency and value for money for taxpayers, we have also considered those aspects of the MOD's procurement processes that influence efficiency

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6. 19 October 2010, the SDSR set out how the Armed Forces will be reshaped to tackle emerging and future threats, and how the government will deliver the priorities identified in the National Security Strategy.

and value for money. These have been analysed by Bernard Gray in his 2009 report<sup>7</sup>, and more recently in Lord Levene's report on defence reform<sup>8</sup>. Our analysis is complementary to, and consistent with, those reports.

11. Our discussions with industry echoed the analysis provided in the Gray Report, that there have been appreciable inefficiencies resulting from MOD budgetary and procurement processes. As Gray showed, this has arisen from the way long-lived programmes have been managed, and the fact that there has always been a greater demand for new weaponry and kit than there has been available funding. For a variety of reasons analysed by Gray it has been difficult for the MOD to make hard choices between alternative programmes. Rather than cancel lower priority programmes, the common practice has been to impose current-year cuts across all programmes to remain within overall budget. These cuts have usually resulted in deferred spending and programme delays, which increases future costs by significantly more than it saves in the current year. In his 2009 report, Gray estimated the annual cost of delay to be between £0.9bn and £2.1bn<sup>9</sup>. The constant change has also reduced contractors' ability to plan effectively, which in turn has undermined contractor efficiency, detracted from their export competitiveness, and created severe challenges for SMEs. These problems have been especially prevalent in single source contracted programmes<sup>10</sup>.
12. The result overall has been that current defence spending includes, through legacy contracts, an appreciable margin of waste arising from past budgetary decisions to defer, and which cannot now be avoided. If such practices persist, current decisions to defer would necessarily entail waste in future MOD spending. The understandable aim of project teams to protect their programme to the benefit of their service has resulted in a process in which all services typically have ended up worse off. More effective central control has often been weakened by potential programme cuts being represented in the press as endangering vital national security, thus undermining dispassionate debate and making it hard for the MOD to impose the required budgetary constraints.
13. This paints a gloomy picture, but it also highlights considerable potential upside. With more ordered procurement processes in place, military equipment can be delivered more cheaply so that there is more kit available to the services. The challenge is to change the rules of engagement so as to ensure that the MOD maintains a meaningful and realistic multi-period resource plan that fits within planned HM Treasury budget allocations to the MOD.
14. We are very conscious that there are a number of key individuals seeking to change resource planning and procurement processes within the MOD, including the Permanent Secretary, Director General Finance and Bernard Gray following his appointment as Chief of Defence Materiel (CDM). Levene and Gray plan to give more centrality in MOD decision-making and the strategic review of procurement plans undertaken this year, with an enhanced input from the role of Director General Finance (DG Fin), aims to impose a more rigorous approach to resource rationing. However, it will be a challenge to embed these changes and it will take time to reap their full benefits; the waste resulting from past poor procurement processes will cast a long financial shadow. Essential to these reforms is enhanced data in a form available and usable for overall central management. We see our recommendations for reforming the current single source arrangements, including those on data reporting, as complementing and strengthening this broader programme of change within the MOD.

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7. Review of Acquisition for the Secretary of State for Defence, An independent report by Bernard Gray, October 2009.

8. Defence Reform, An independent report into the structure and management of the Ministry of Defence, June 2011.

9. Review of Acquisition for the Secretary of State for Defence, Bernard Gray, 2009, Appendix G.

10. Single source contracts are estimated to account for approximately 70% of cost overruns, significantly greater than their 40% share of procurement value. Based upon Review Team analysis of MPR reports.

15. In summary, then, the upshot of our analysis is that there have undoubtedly been inefficiencies in single source MOD spending. Part of that has arisen from inefficiencies on the side of industry and from skilful deployment of Yellow Book regulations to secure returns that, although within the regulations, have not been appropriate. As important have been the inefficiencies in MOD procurement processes previously highlighted. We see the need for three main sets of measures to tackle these problems: a fundamental recasting of the Yellow Book regulations and arrangements to ensure that the necessary data is available to senior MOD decision-makers in a usable form; changes in MOD procurement processes; and a new mechanism replacing the existing Review Board for external assurance of compliance with the single source procurement regime that we propose. All three measures are important to effect a major change for the better. The changes being introduced by Levene and Gray are addressing the second set of measures. So although we discuss all three, the emphasis of our report is on the first and third<sup>11</sup>.

### **Recommended Changes to the Current Arrangements for Single Source Pricing**

16. In the light of our analysis, a fundamental rewriting of the current arrangements is required. The new Single Source Pricing Regulations (SSPRs) are designed to put the emphasis on incentivising greater efficiency and ensuring value for money for taxpayers. A key principle is the need for the MOD to have access to information that allows it to act as an intelligent customer and drive efficiency across the board. An essential element is to enable better scrutiny and challenge of all costs, getting away from the Yellow Book focus on the profit element which is a small portion of the overall price. The key elements are:
- Open book accounting
  - Uniform reporting arrangements across projects and companies
  - Incentivising of efficiency
  - A new system for overhead reporting and monitoring
  - A richer approach to the treatment of risk and return
17. We recommend that the Yellow Book provision for Equality of Information at the point of contracting should be supplemented with full open book accounting<sup>12</sup>. This is standard in private sector contracting for complex projects, and we see no reason why it should not be standard in single source defence procurement. Indeed, it is already incorporated in many procurement contracts, and in our consultations with industry it was generally accepted. In addition to open book accounting there should be supplementary rights to review contractors' skills, processes and infrastructure. Our recommendation is that these rights should be mandatory. They would allow for joint scrutiny of costs with a view to driving down cost to achieve value for money for taxpayers. They should not be used as a means of challenging profit margins. It is important that open book arrangements are designed to give the MOD the information it requires in a useful and useable form, and so as not to impose undue ongoing cost on contractors.
18. Coupled with open book accounting, we recommend standardised arrangements for financial reporting across single source projects, companies, and through time. This is essential if the MOD is to operate as an intelligent customer. The ability to analyse data and trends across projects, companies, and through time is necessary if the MOD is to learn lessons from project outturns and enhance procurement performance over time.

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11. Measures of greater emphasis are identified as Key Recommendations, as opposed to Recommendations.

12. There is no standard definition for open book. For our definition of what is included, see Annex E, paragraph E152.

It is also essential to the effective incentivising of efficiency. While there will be set-up costs to introduce systems to allow standardised reporting, the on-going benefits in terms of value for money will greatly outweigh these initial costs.

19. We recommend significantly strengthening contractor efficiency incentives in two ways. Firstly, the MOD should accept that profit is a contractor's strongest efficiency incentive. In commerce profit is king. Compared with fixed price contracts, where contractors take all the benefit of efficiency gains, TCIF<sup>13</sup> pain/gain share contracts reduce the incentive to be efficient. In some cases this is extreme, with the MOD bearing 90% of over-runs. This makes the contract effectively cost-plus, removing cost control and efficiency incentives. Care needs to be exercised in the sharing arrangements within TCIF contracts and we recommend that, if a TCIF contract is appropriate, the gains and losses should be shared equally. The Yellow Book also undermines the incentive in fixed price contracts through the so-called 'unconscionable profits and losses' provisions, which in simplified terms require contractors to give back three-quarters of any additional profit above 5% of the contract price. We recommend that this be relaxed.
20. Secondly, better transparency will allow the MOD to apply more pressure on contractors to be efficient. Improved open book rights, consistent contractor reporting and greater transparency on overheads all support this aim. They are key to helping the MOD to challenge inefficient spend, both at the point of pricing and once on contract. Consistent data across programmes and through time will enable the MOD to maintain more effective pressure for efficiency gains, using past performance to establish more demanding performance benchmarks in future contracts.
21. The treatment of overheads in the Yellow Book is complex and not always transparent, leading to concerns that overheads may be over-recovered. We therefore propose a new and more transparent system for overhead reporting which will enable more accurate recovery of overheads. More transparent and improved cost information will also allow for more effective management of those key sites that have a capability of strategic national importance. We would expect there to be the development of five or ten year plans to maintain such essential facilities while delivering cost efficiencies through time.
22. We do not recommend moving away from the requirement that the MOD should bear the redundancy and restructuring costs associated with programme curtailment or cancellation. The alternative, whereby the contractor bears such costs, would be appreciably more expensive. Faced with the possibility of bearing such costs, the contractor would necessarily need to price in a significant, possibly prohibitive, risk premium into contracts against that eventuality, over which it has little or no influence. Given that the risk is one in the control of the MOD, with good management it will be appreciably cheaper for the MOD to assume that risk and bear the costs. In effect self-insurance is the better option, conforming to the more general principle that contracts should be designed to place risks with the party better able to manage that risk. This is subject to two important provisos. Firstly, restructuring and redundancy costs need to be scrutinised to ensure they are the minimum possible, so the MOD does not incur undue expense. Secondly, the MOD budget needs to have an explicit provision that recognises potential claims going forward for costs resulting from the cancellation or curtailment of programmes.
23. The focus of the Yellow Book is the profit calculation, which represents only a small fraction (typically some 10%) of price. Within this element, the Yellow Book provides

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13. Target Cost Incentive Fee (TCIF) contracts have a target cost, and any cost over-, or under-, run is shared between the MOD and the contractor according to an agreed share.

in principle for an analysis of risk and return, with higher risk projects attracting higher return. In practice, this risk/return matrix is infrequently applied. In consequence, despite the Yellow Book's focus, risk is not well handled by the existing regime. Given the complexity of many defence projects, we think it essential that there is a richer and more effective reporting of risks on projects. We also recommend that much more attention is paid to risk in the negotiation and subsequent monitoring of projects, and that allowed profit should be differentiated to a much greater degree in the light of differing risk profiles.

24. The proposed elements of the new SSPRs outlined in the preceding eight paragraphs represent a major change in the reporting and management of major single source defence contracts. They are set out in detail in the main body of the report and in the supporting annexes. Properly implemented, they should enable better management of major projects resulting in better value for money for taxpayers. The details of the proposals and their implementation are a matter for consultation.

### **SMEs and Exports**

25. Our terms of reference make specific reference to the promotion of SMEs within defence procurement and to the importance of exports by the defence sector. We are conscious of a range of initiatives being undertaken by the MOD to help SMEs in line with Government policy, and expected to be discussed in a forthcoming White Paper<sup>14</sup>. We have two specific additional proposals. Firstly, while the reporting and other obligations that we propose to place on contractors are proportionate for large contractors, we recognise that they may be unduly burdensome for SMEs. We therefore recommend that a materiality threshold should apply, below which the requirements are relaxed. Secondly, we recommend that the major prime contractors should be required to produce an annual report that sets out how they manage their SME contractors, and how they provide support and assistance to this important sector.
26. The export potential for MOD single source projects varies considerably, and depends on a number of factors. One is the degree of bespoke specification required by the MOD for its purposes, a matter which is beyond the scope of this review. Other factors include the efficiency and timeliness of the projects. These are impacted by the budgetary and procurement processes on which our recommendations bear directly, and should therefore be helpful.

### **Financial and Commercial Controls within the MOD**

27. A crucial context for this review is provided by the changes in organisational structure and decision-making responsibilities within the MOD resulting from the appointment of Bernard Gray as CDM, and the review by Lord Levene. These are aimed at bringing much more financial control and discipline to the MOD budget in current and future years than has been evident in the past. We very much support this aim, which is central to our objective of ensuring better value for money for taxpayers in single source defence procurement.
28. The recommendations that we have made for changing the current arrangements are designed to enhance appreciably the quality and usefulness of financial information coming to the MOD. We have noted the considerable degree of autonomy that seems to have been exercised by project teams, both in the terms of contracts that are negotiated and in the nature of the financial information required from contractors. We see the

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14. A White Paper on Equipment, Support, and Technology for UK Defence and Security is due to be published later this year.

need for more central oversight within the MOD, in terms of greater standardisation of contracts (building on the work that has been underway between the MOD and industry) and greater standardisation and frequency of reporting. Both of these are essential if the MOD is to operate as an intelligent customer across the range of its single source projects. For such oversight to be effective an enhanced capability in financial analysis, cost estimating and accountancy will almost certainly be necessary.

29. We also believe that that it should be standard practice to have independent assessments of the cost estimates provided by project teams. We see a conflict of interest in CAAS, within DE&S<sup>15</sup>, providing cost estimates to project teams while also auditing these estimates. We see advantage in a separate and independent internal audit function which would comply with accepted corporate governance practices.

## External Assurance

30. The current Review Board for Government Contracts oversees the profit element in single source contracts. We see considerable advantage in transforming the Review Board into a new body (which we have called the Single Source Regulations Office or SSRO) to oversee the overall efficiency and value for money of single source procurement. The SSRO would take on the functions of the current Review Board, with the exception of the role in arbitration, and also a much wider remit. The SSRO would oversee the new contract regime outlined in paragraphs 16-24, and would receive the enhanced standardised reports described there. It would have access to financial and cost estimating expertise which would enable it to scrutinise the progress of major programmes. The SSRO would receive regular reports from industry and the MOD on progress in single source defence contracts, and could identify inefficiencies in such contracts, whether arising from the procurement process, re-specifications, or from inefficiencies and cost-inflation by industry. Its analysis would provide informed insight to assist the MOD in achieving value for money. It would provide independent reports to the MOD's Accounting Officer (PUS) on overall single source defence spending and by major projects, commenting on value for money, procurement efficiency and the relative efficiency of different contractors. It would analyse whether the forward, multi-year procurement commitments under single source contracts conform to reasonable expectations as to how the defence budget is likely to evolve.
31. The high level financial and analysis skills required to fulfil these roles are highly sought after within the labour market. Contractors, in their negotiations with the MOD, are able to pay market rates for both in-house staff and external consultants. Furthermore, they are usually reimbursed for these costs by the MOD through the overhead recovery method within the current arrangements. The restriction of civil service pay scales, under which the MOD operates, limits the MOD's ability to compete with industry on an equal footing. We recommend that the SSRO have the freedom to pay appropriately competitive rates for these skills, and that the funding of the SSRO be met through a levy upon the profit rate applicable to future single source contracts. It is expected that this levy would be less than ten basis points (0.1%).
32. We see the existence of the SSRO as helping to reinforce the important changes in financial and commercial controls referred to in paragraphs 27-29 that are aimed at overcoming the culture within the MOD for capability needs to prevail over long-term financial planning. It will provide strengthened external scrutiny of the MOD planning and budgetary processes alongside effective mechanisms for scrutinising MOD contractors and thereby aid the MOD in achieving value for money. Such enhanced assurance will

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15. Defence Equipment & Support, the organisation responsible for equipment procurement and support within the MOD.

strengthen the position of those within the MOD seeking to ensure proper financial and budgetary control, and therefore will reinforce, rather than cut across, the organisational and decision-making changes previously referred to. The SSRO will not have executive powers but is designed to accelerate the time it would otherwise take the MOD to become an intelligent customer. We note also that government procurement processes in other major defence spending countries, such as the US and France, are governed by laws that provide important alternative means of external scrutiny and constraint. We have considered this alternative, but have concluded that the SSRO is a preferable approach which builds on UK experience and practice.

33. We have considered the proposed SSRO against alternative mechanisms through which external scrutiny can be enhanced, all of which were proposed to us in our consultations with relevant stakeholders. Alternatives included: the creation of an external regulator along the lines of a utility regulator overseeing control of essential facilities; external control of the MOD budget; and greatly enhanced HM Treasury, National Audit Office (NAO) and Public Accounts Committee (PAC) oversight. The first two involve giving powers over MOD spending to an outside body; the last involves no such transfer of powers, but increases the degree of external scrutiny and challenge.
34. We do not believe that the answer is to give an outside body powers over MOD spending. The argument for an external regulator along utility lines is that some of the key facilities involved with single source defence contracting are monopoly facilities developed in public ownership and since privatised. The utilities are private monopolies supplying a multitude of private sector customers, and a principal function of regulation is to prevent the exercise of monopoly power to the detriment of those customers. In the case of defence spending, the customer is the MOD, which has considerable purchasing power of its own. An independent regulator would, in effect, need to have powers over the decisions of government, which raises both constitutional and practical problems. It is the wrong answer to require an independent external regulator to provide a substitute for intelligent contracting by the MOD. The idea of external control of the MOD budget is equally problematic. Whichever body controls the defence budget would need considerable technical expertise and would be subject to the same pressures and lobbying as is the MOD at present.
35. We therefore envisage enhanced external scrutiny and challenge, which the proposed SSRO would achieve. An alternative way of achieving this would be to enhance the current scrutiny by HM Treasury, the NAO and the PAC. This would require HM Treasury and/or the NAO greatly to enhance their defence industry technical skill base, particularly in financial analysis and cost estimating. We do not favour this option because we see considerable advantage in giving one body responsibility for scrutiny of value for money issues, and with the ability to examine both contractor efficiency and MOD processes.
36. We anticipate at least two objections to our proposal of an independent SSRO. Firstly, it means that the MOD will be subject to scrutiny both by the SSRO and by the NAO and HM Treasury, which might be seen as unduly duplicative. However, we do not think this objection has weight. We expect that the SSRO will develop such expertise and authority that HM Treasury and the NAO will come to rely on its analysis in their scrutiny roles. While respecting commercial sensitivities, the SSRO would provide whatever information the NAO required for it to fulfil its duty to scrutinise public spending. The NAO may well wish to use SSRO expertise when reporting to the PAC. We do not see the SSRO as in anyway cutting across, or diminishing the NAO's key role of oversight of public expenditure answerable to the PAC. Secondly, it may well be said that the SSRO will lack teeth. We have already spelt out why we think formal powers to determine MOD spending would be inappropriate. However, we do think that more powerful, independent

scrutiny and challenge will work together with the organisational and decision-making changes already underway to put future single source procurement on a sounder basis. There is an analogy with the approach the Government has taken to enhance macroeconomic fiscal stability through the creation of an independent scrutiny body in the form of the Office of Budget Responsibility.

37. To fulfil its role, the SSRO will require powers to gather information on single source defence contracts from the MOD and contractors (in line with our recommendations concerning the new SSPRs). It is expected that these powers will be agreed with industry, so that industry and the MOD sign up to a joint code of conduct, backed up where appropriate with new contract conditions. In the event that such agreement is not forthcoming, we would recommend formalising such powers in legislation (following the example of other leading defence procurement countries and the Gray Report's recommendation for legislation).
38. Transition from the Yellow Book regime, both the contractual arrangements and the Review Board role, will take time. Existing contracts can either be left to run their course or re-opened to change the terms to comply with the new regime. Given the time and resource required to re-open contracts, we recommend applying the new arrangements when new contracts are being negotiated or existing contracts are being re-opened for other reasons. The transition of the Review Board is likely to occur after the 2012 annual Yellow Book review.

## **Summary of Conclusions**

39. We recommend a fundamental recasting of the regulations for single source defence contracting. When finalised after consultation, we recommend that the new SSPRs are applied to all new single source contracts and all single source contracts that come up for renegotiation. (Key recommendations 1, 2, 3, 4 and 5.)
40. Internal reform of MOD organisational and decision-making structures should be complemented with enhanced external assurance of contractor efficiency and of MOD single source procurement processes to ensure value for money for taxpayers. To this end, the current Review Board should be replaced by an independent Single Source Regulations Office with a much wider remit to scrutinise single source defence procurement and the efficiency of contractors with a view to value for money for taxpayers. It will have the requisite information gathering powers but no formal decision making powers; it will exercise its influence through authoritative analysis and scrutiny. (Key recommendations 6 and 7.)
41. The detailed reporting requirements recommended in this report should be subject to a materiality threshold to avoid any undue burden on SMEs. Major primes should be required by the MOD to produce an annual report on how they manage their SME contractors. The MOD should help export performance by ensuring efficient and timely delivery of its projects. (Key recommendations 8 and 9.)
42. See page 65 of the report for a full listing of our recommendations.

## **Benefits**

43. Our recommendations will provide for greater transparency of industry costs and forecasts. Access to standardised cost reports will allow the MOD to establish defence industry benchmarks, which will in turn allow the MOD and industry to agree more realistic prices and to embed appropriate efficiency targets. Standardised reporting,

including forecasts, will also facilitate continuous project monitoring at a suitably senior level within the MOD. Increased transparency will be particularly important in overheads, allowing for better visibility of the costs of maintaining essential capability and encouraging more informed joint planning.

44. Industry will be more strongly incentivised to be efficient, with efficiency increases rewarded with higher profit, so both industry and the MOD will benefit from reductions in the cost base. Efficiency increases will also make industry more competitive in the export market. Greater external assurance will encourage the MOD to maintain realistic budgets, which will reduce the need for the MOD to make delays and scope reductions. These changes inevitably increase costs and hamper industry's ability to plan and optimise, resulting in the MOD getting less capability than it could. There will be fewer barriers to entry to SMEs, due to a simplified pricing framework, and encouraging the use of competition in subcontracts placed by large single source suppliers.
45. Finally, the setting up of a dedicated SSRO will ensure the new single source regulations become embedded in both the MOD and industry. The SSRO, in its role of encouraging efficiency and value for money within the single source environment, will help to counteract the negative influences of a market in which there is often a single purchaser and a single supplier.
46. Taken together, our recommendations represent a balanced approach for industry and the MOD. They will make an enduring change, altering the rules of engagement so that the MOD and taxpayer achieve better value for money, and industry is rewarded for making efficiency improvements.

### **Next steps**

47. The publication of this report marks the start of a consultation period across industry and Government. We welcome comments on all aspects, as detailed in the Next Steps section, page 68. Prior to implementation, the terms of reference of the SSRO will need to be finalised, its resourcing and financing agreed, and a dialogue between the MOD and industry (and the SSRO once this is set up) will be required, in particular regarding the details of the required reporting from contractors. The outcome will provide further details of the terms of reference for the SSRO, the reporting arrangements and templates, the scope of the regulations, and the process of transition. Further details on the recommended transition process can be found at paragraph 298.

# Introduction

48. We have conducted a review of the current arrangements for pricing single source contracts for the supply of equipment and services to the Ministry of Defence (MOD), at the request of the Minister for Defence Equipment, Support and Technology. The review process has included meetings with stakeholders (Senior Executives of Contractors, Senior MOD Executives, Senior Government Executives, trade bodies and the Review Board for Government Contracts). We have reviewed the existing pricing arrangements and assessed the appropriateness of alternative potential approaches to single source procurement by the MOD. This has included a review of the approach taken by other NATO<sup>16</sup> member states, and an assessment of how other markets where there is monopoly power are regulated. We have also gained considerable insights from visits to contractor facilities and construction sites. Finally we have considered several previous reports, including those published by Bernard Gray (now Chief of Defence Materiel), on defence procurement, and Lord Levene on the MOD's organisation and structure.
49. Approximately £8.7bn per year of taxpayers' money is spent by the MOD through single source (that is non-competitive) procurement, a significant increase in recent years. It includes the most complex and long term projects undertaken by the MOD. These include the Astute and Successor nuclear submarines, the Queen Elizabeth Class (QEC) aircraft carriers<sup>17</sup>, and the production and maintenance of many of the ships, fast jets and helicopters in current service.
50. Single source projects have more than their fair share of difficulties, as recent media coverage of cost growth on the new QEC aircraft carriers and Astute attests. Based on the annual National Audit Office (NAO) report on MOD major projects, our analysis shows that projects with the greatest time and cost overruns are predominately single source.
51. A common reason for contracting single source is that the Armed Forces require a unique capability that is only available from a single contractor. Other reasons include staying with the original design team (for example using the company that built something to also maintain it), and the need for 'freedom of action' (the ability to conduct combat operations independent of the need for support from other states or entities). For these reasons, single source procurement is likely to remain a significant part of MOD procurement for the foreseeable future.
52. A lack of the competitive discipline has significant financial consequences. Contractors can submit a price without worrying about another contractor under-cutting them. The chance of winning follow-on work is high even if performance is poor. Single source contracts are not subject to the influence of market forces, where it is often possible to set a fixed price from readily available market price information. In the absence of competition, there is thus a much greater onus on the MOD to be an 'intelligent customer', ensuring it is receiving value for money.
53. Single source contracts need closer financial and commercial supervision by the customer than competitively tendered contracts. Until very recently the MOD's Defence Equipment and Support (DE&S) organisation had been running down its financial and

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16. North Atlantic Treaty Organization.

17. The Queen Elizabeth Class is also known as CVF (Carrier, Vehicular, Future).

cost estimating competencies, whilst increasing the use of single source contracting. We have little doubt that this decision has been to the detriment of value for money in procurement.

54. There is a framework, known as the 'Yellow Book', that provides regulation of single source procurement. This came into being in 1968 following a Memorandum of Agreement between the government and the CBI<sup>18</sup>, which was born out of accounting scandals in defence procurement. It has been subject to regular reviews over more than forty years, but the changes that have occurred have not been very substantive. Over this time the composition of the defence industry has changed dramatically, primarily driven by consolidation.
55. Apart from reviewing the Yellow Book, our brief also covers contractor efficiency and value for money to the UK taxpayer (see Annex A). As highlighted by Bernard Gray in his report, there are significant issues within the MOD that undermine efficiency and value for money. So we have also looked closely at current MOD practices, focussing in particular on financial and commercial issues.
56. We recognise that there is a substantial amount of internal change within the MOD at the moment, with the appointment of Bernard Gray as Chief of Defence Materiel (CDM) and Lord Levene's Defence Reform programme. Nonetheless, in Part 2 of our report, we make a number of ancillary recommendations which are intended to contribute to the reform process that others are leading. The issues in the procurement systems and controls that we comment on can give rise to considerable financial waste within the MOD's procurement programme, though we are aware plans are in development to tackle these issues.
57. Gray identified an overheated MOD budget as the prime cause of many of the MOD's procurement problems, which was reiterated in Lord Levene's recent report. Whilst agreeing with this analysis, we have done further work that shows this is especially significant in single source procurement. We think this prevalence is due, in no small part, to the unusual nature of the relationship that exists between the MOD and its contractors within the single source environment. The MOD and its contractors both have a high degree of market power and the absence of effective competition has a crucial impact on outcomes.
58. We have undertaken a significant amount of background and specific research in order to generate options and develop recommendations. As part of this research we have had discussions with executives in the defence procurement departments of the two NATO member countries, France and the United States, which undertake the most significant volume of single source procurement. We have also undertaken analysis of regulated industries to identify other approaches to addressing issues in a market characterised by imperfect competition or market failure.
59. Key research we have undertaken to enable us to reach our conclusions is documented in Annexes to the report. Extensive description of the findings is not contained within the narrative of this main section of the report, but the reader is referred to the research that has influenced each recommendation.

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18. Confederation of British Industry

# Background

60. The MOD procures an extensive amount of equipment and services on a single source basis. We have discussed the reasons for this in the Introduction to our review. The three main reasons are the existence of only one contractor in the market; the 'freedom of action' that is afforded by independence from contractors under the influence of foreign governments; and amendments to contracts that were initially awarded competitively, though de facto are single source once the contract is awarded. The extent of single source procurement has risen in recent times, not least because of consolidation within the defence industry.
61. The financial impact of negotiating with the only contractor available is hard to quantify. It is implausible to believe that in such a scenario a buyer can procure as cheaply as in a market where there is effective competition. Competition provides an incentive to be efficient, in the form of survival of the company. Inefficient companies become uncompetitive on price and fall by the wayside.
62. In single source procurement, industry's better knowledge and understanding of costs gives it a significant advantage over the MOD in price setting. The MOD is also placed in a difficult negotiating position when an essential need arises for defence of the nation: the capability must be available and price can be a secondary consideration. This makes demonstrating that the taxpayer is getting value for money when government buys on a single source basis a considerable challenge.
63. The above needs to be set against the considerable purchasing power of the MOD, which is often the sole buyer in the UK market for industry products or services. The MOD finds it difficult to use its buying power to reduce prices, owing to industry's better knowledge of costs and, crucially, the lack of competition. However the MOD does use its purchasing power to force contractors to accept frequent renegotiations and changes to the original specification. Although the MOD pays for these changes, contractors find it hard to plan effectively and optimise their facilities.
64. The challenges are not unique to the defence industry<sup>19</sup> and the environment described warrants regulation in some form or other to ensure that there is protection of the taxpayer. In essence the lack of competition on both sides of the transaction provides incentives for behaviours that are different to those where effective competition exists. Carefully defined rules of engagement are required in such a marketplace.
65. The regulations were updated in 1968 with an extensive review and the so called 'Yellow Book' regime was introduced, discussed in the next section. The regime was initiated partly as a result of two scandals, where there was evidence of substantial overcharging by contractors. It has been modified over the years, but the structure has remained largely unaltered for over forty years.
66. With an average of £8.7bn per annum over the last five years procured on a single source basis, and the inevitability of substantial single source procurement at least in the foreseeable future, it is important that the arrangements for single source pricing are fit for purpose in driving appropriate behaviours. In particular, it is important to ensure that industry contributes to value for money for the taxpayer by striving to be ever more

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19. Similar issues have needed to be addressed in the pharmaceutical sector.

efficient and sharing the benefits of this increased efficiency. Even if there were to be no further procurement on a single source basis (which is implausible) there is a long and significant tail of existing contracts to run-off, which we consider in the Transition section of this report (see page 60).

### The Yellow Book

- 67. The Yellow Book was put in place to address some of the issues of the imperfect market. The lack of information available to the procurer as to appropriate pricing in the market was a key consideration. In addition, the ability of the MOD to apply inappropriate pressure on profit margins was a concern of industry.
- 68. The current arrangements can be described as being based on three pillars, as illustrated in Figure 1.

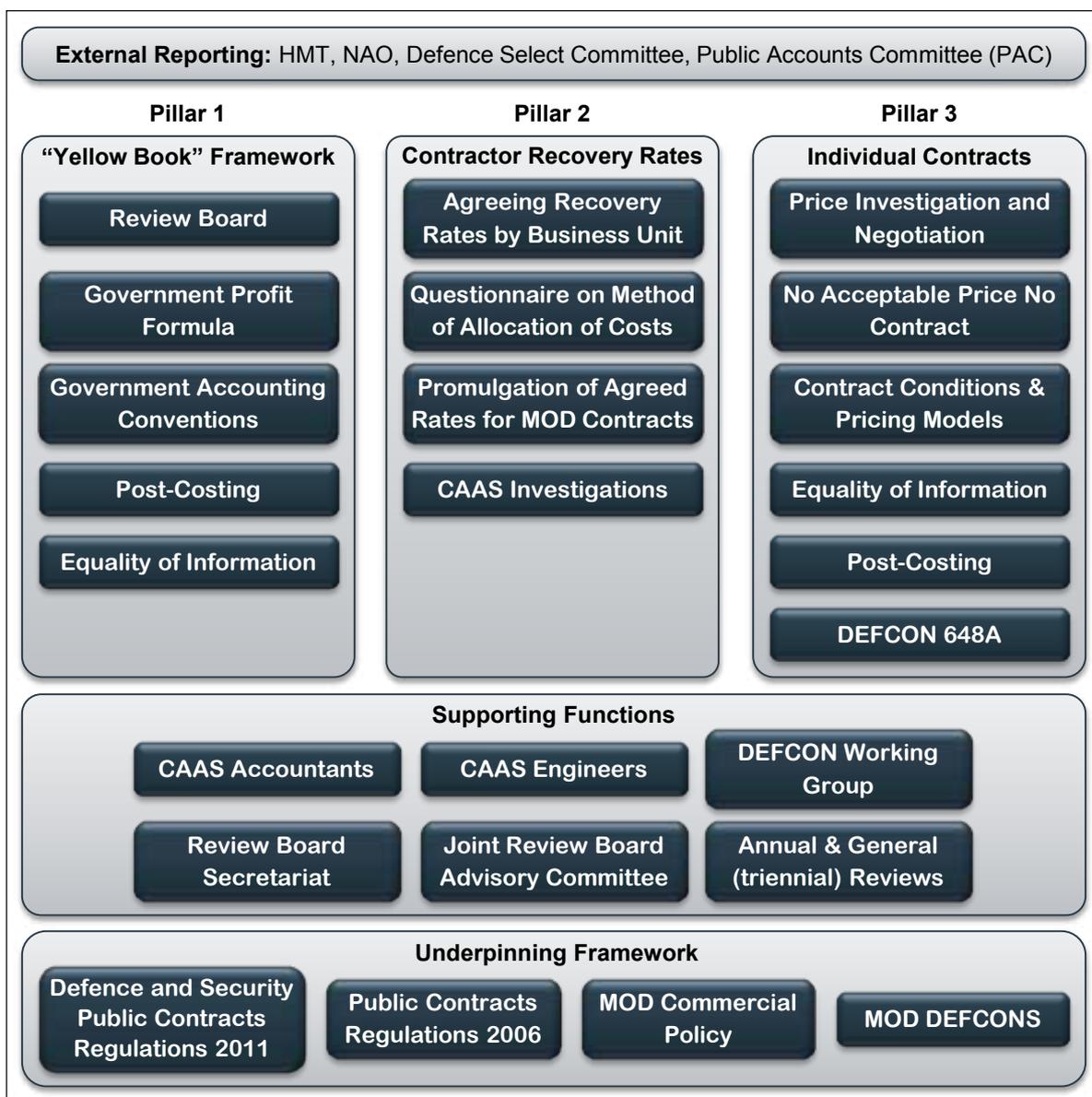


Figure 1 - Current Single Source Framework

69. The main matters covered by the three pillars are:
- a. pillar 1 - the Government Accounting Conventions, Profit Formula and the main oversight arrangements;
  - b. pillar 2 - the approach to agreeing charging rates for costs, in particular overheads;
  - c. pillar 3 - the approach to agreeing contractual arrangements primarily based on the inputs from pillars 1 and 2.

## **Pillar 1**

70. The Review Board for Government Contracts (hereafter referred to as the Review Board) was established by a Memorandum of Agreement between HM Treasury and the CBI in 1968. A simultaneous agreement established a profit formula based on comparability with UK industry and introduced new contractual conditions giving the government the rights to Equality of Information and to post-cost<sup>20</sup> contracts. The profit formula aimed to provide a fair return to industry in the absence of a market price, and to protect industry from pressure by the MOD to set profit margins at low levels.
71. The profit formula is overseen by the Review Board, which undertakes the calculation of the comparable profit rate for UK industry on an annual basis, based on an agreed reference group. It also carries out a wider review of the terms of the Yellow Book, usually triennially. Any changes to the terms are implemented only if there is mutual consent by the MOD and industry, a point we will return to later.
72. Equality of Information is an important element of the Yellow Book, though there is no agreed definition. It is based on the concept of good faith between the parties to bring to one another's attention information which is material to the agreement of a fair and reasonable price.
73. The Government Accounting Conventions (GACs) provide guidance on what costs are recoverable by industry in contract pricing. A notable recent convention has been on the topic of pension costs. The GACs are neither comprehensive in coverage nor precise in definitions, but usually provide guidance that is subject to interpretation.
74. The GACs allow as costs to be recovered those related to the financial and commercial personnel involved in negotiations with the MOD. The ability of contractors to pay rates significantly higher than public sector rates, and to use consultants, provides industry with a significant advantage over the MOD. Moreover the cost is charged, through contracts, to the MOD so the MOD is paying to maintain this contractor advantage.

## **Pillar 2**

75. In this pillar the rates used in the pricing of contracts are determined, in particular labour rates and overhead recovery rates. Despite their importance, the 'Yellow Book' (see Annex B) has little to say on the topics and these matters are largely operated by convention.
76. CAAS, within DE&S, reviews and advises commercial negotiators on the appropriateness of rates proposed by contractors for use in contracts. The rights to carry out such investigations are not set out in the 'Yellow Book', but are primarily based on custom and practice, recognising that the Equality of Information provisions would be meaningless without such investigation rights since rate investigations by CAAS are undertaken prior to contracts being negotiated.

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20. Post-costing is an investigation by the MOD, comparing the outturn costs of a single source contract with the costs originally agreed at the time of pricing. (See Annex E, paragraph E33, for more details).

77. CAAS is staffed by accountants, cost engineers and cost forecasters. Prior to a recent decision to rebuild the numbers within the department CAAS was reduced from around five hundred staff to not much more than half that level over a period of several years, in an effort to reduce the running costs of the MOD. CAAS provides not only advice on costing rates, but it performs post-costing reviews on contracts. The reduction in operating costs must pale into insignificance compared to the incremental costs that will have been incurred as a consequence of the reduced capacity to scrutinise contractual pricing arrangements. It seems an inappropriate decision that must have cost the taxpayer dearly. We welcome the decision to rebuild CAAS headcount.

### **Pillar 3**

78. The processes that generate the contractual arrangements between the MOD and the contractor, in particular the contract price, are contained in Pillar 3. The contractor is expected to provide a full breakdown of his costs which are scrutinised and discussed by project team negotiators.
79. At this stage in the process risk needs consideration in three ways: the allowance included in the contract for risk contingencies; the sharing of gains and losses where provided for in the contract; and, after consideration of the first two, the adjustment in the profit allowance for the level of risk inherent in the contract.
80. In addition to these elements within Pillar 3, the MOD needs to consider what financial provision it needs to carry for any residual risks not being borne by the contractor.
81. At contract signing, the Equality of Information Pricing Statement sets out the key information and assumptions underpinning the contract price. The MOD is expected to be as open as possible in providing information relevant to pricing of a contract, and there is an equal obligation on the contractor. The parties sign the statement as part of the contractual arrangements and this understanding forms part of the agreement between the parties.

### **Effectiveness of the Yellow Book**

82. Since 1968 there have been considerable changes within the UK defence industry. The main changes that have impacted the effectiveness of the Yellow Book regime are as follows:
- a. significant consolidation of companies within the UK defence sector - see Annex D for more information;
  - b. a marked reduction in reliance by the major contractors on the MOD as a customer, as they have diversified and become more international;
  - c. the move to outsource maintenance activities by the MOD and to cease in-house manufacture has reduced the level of engineering expertise within the department, thereby depleting the capability required to be an intelligent customer;
  - d. reduction in the MOD's capacity to be an intelligent customer as a result of the ill judged reductions in CAAS manpower.
83. Although these changes have a significant impact on the landscape within which single source contracting operates certain areas of the current regime appear to work well, described below:
- a. equality of Information is a valuable approach to ensure integrity in negotiations and provides that the two parties negotiate in good faith, though as we will discuss it is not sufficient to provide the MOD with appropriate information to evaluate pricing;

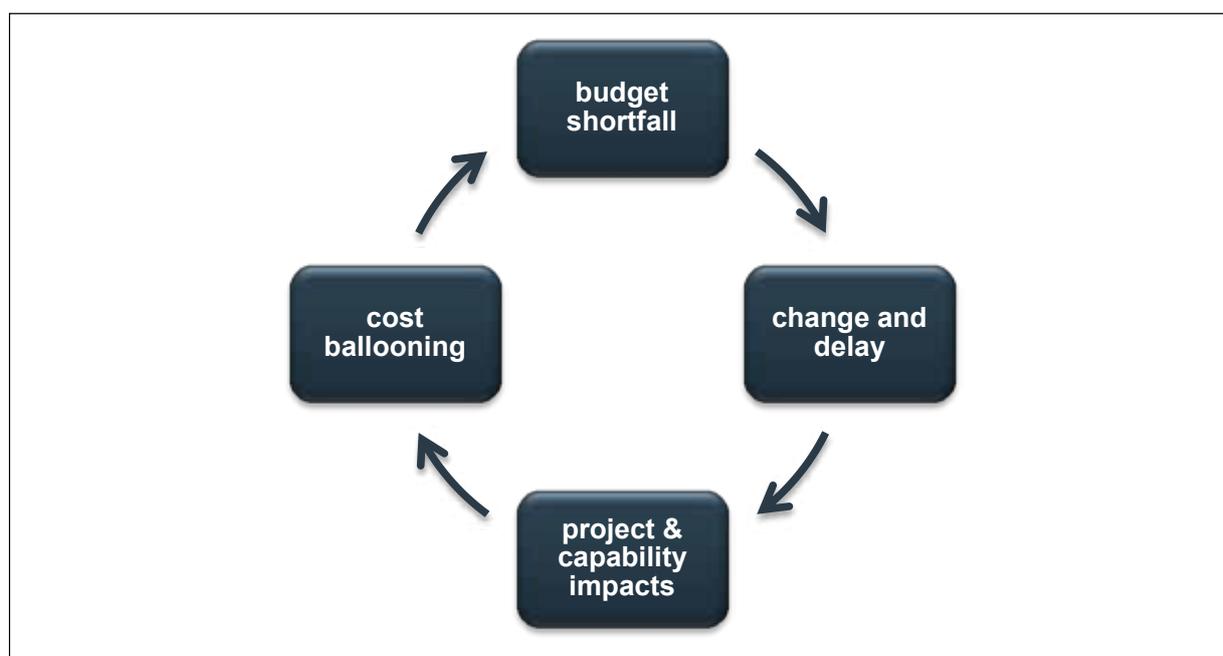
- b. post-costing is a vital element in ensuring compliance with contractual arrangements, in informing the pricing of subsequent contracts and ensuring that contractors have complied with Equality of Information;
  - c. we have found little merit in changing the approach to calculating the baseline profit allowance based on the principle of comparability<sup>21</sup>. The approach is sound and when considering efficiency we are mindful that the profit is generally less than ten percent of the total costs of a contract;
  - d. finally the recently agreed approach to the treatment of pension costs is reasonable and balanced, providing a sound treatment to a complex area of costs. We discuss wider issues with the GACs later.
84. As we articulate in detail in Part 1 there are areas that we consider are not adequate in providing an appropriate framework for single source procurement in the defence industry:
- a. although Equality of Information is helpful it does not provide adequate access to information to enable the MOD to be assured that the MOD is achieving value for money. Neither is the term defined in a clear manner, and it is open to misinterpretation and misunderstanding in contracts;
  - b. the different ways in which information is submitted by contractors (partly as a result of variations in the contractual arrangements negotiated by MOD project teams) leads to inconsistent information that thwarts efforts both to benchmark costs and to provide an overview on a consolidated basis. This impedes the MOD's ability to be an intelligent customer;
  - c. the current arrangements have nothing to say on incentivising efficiency and focus disproportionately on the profit element of contracts which, as we have already commented, is not the key to driving value for money;
  - d. overhead management is not covered in any detail in the regime and there is opportunity for complex methodologies to be used by contractors that create opacity when assessing contract performance;
  - e. the current regime provides for an adjustment to the profit allowance for above or below average risk. The adjustment is 10% of the profit allowance. It is not extensively used in contract negotiations and appears inadequate in range;
  - f. the regime has changed modestly over the years partly as a result of the principle of mutual consent. Amendments to the regime can be proposed by the Review Board but it has no powers to implement changes. Changes are only implemented if they are agreed by the MOD and industry. This has proved a slow process. We are mindful of a comment received from within the Pentagon, referring to "the golden rule". The rule means "he who has the gold rules". As the major customer, the MOD should not be beholden to industry to change arrangements;
  - g. the GACs are not comprehensive and in certain areas open to a range of interpretations. One such example is costs of rationalisation that are incurred by industry. For what can be very significant costs the GAC related to this topic is surprisingly vague.
85. We consider these deficiencies are such that the current regulations are not adequate to prevent inappropriate behaviours and to address the imperfections in the market arising from the lack of effective competition. We are particularly concerned that efficiency is not incentivised, and there is inadequate transparency in costs to be assured that the MOD is paying a fair price.

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21. We do however make recommendations on subsequent adjustments, for example for risk.

## Procurement Practices within the MOD

86. We have discussed the issues with the Yellow Book regime and why it needs changing. In considering whether the MOD achieves value for money in procurement it is appropriate to consider the behaviours of the dominant customer itself.
87. Contracts are often long in duration and subject to changes in specifications as a consequence of technology advancements. Pressures from an overheated budget have required renegotiation of contracts. Entryism, where costs are intentionally understated to gain initial project approval, and have to be renegotiated to address the underestimation of costs, contributes to overheating of the budget.
88. Renegotiation usually results in contracts being delayed, re-profiled or reduced in scope to meet MOD budget constraints. The extension of contracts results in attribution of higher time related costs, primarily overheads. So these renegotiations result in ballooning unit production costs and worse value for money for the taxpayer. This cycle is shown in Figure 2.



**Figure 2 - The Budgetary Vicious Cycle**

89. There has been insufficient use of post-costing rights by the MOD in recent years. If such activity is not undertaken it may in turn influence the behaviour of contractors to the detriment of value for money. Also, as previously mentioned, the decline in the capacity of CAAS has resulted in reduced financial and cost estimating expertise in the department.
90. It is clear to us that MOD procurement practices, whilst largely separate to the Yellow Book regime, have contributed to impairment in value for money. We discuss these issues in Part 2 of our report. However we are mindful that procurement practices are currently under review by CDM and we have limited our recommendations in this area, recognising that many of the issues are within the scope of his review.

# Part 1: Industry Regulations

91. It has been possible to assess the current Yellow Book regulations in part from an intelligent reading of the documents. However, our understanding of the operation of the existing arrangements has been considerably enhanced from our discussions with defence contractors, senior MOD executives, trade bodies, the Review Board, other Whitehall senior civil servants and others as set out in Annex A.
92. We discovered there was a high level of consistency in the comments we received from industry about the Yellow Book, and the comments were generally constructive. We received a more varied set of views from the other parties that we met, although no less constructive.
93. Our assessment of the regime has been framed in the context of a market with considerable scope for misaligned incentives, which is inevitable given the monopoly and monopsony<sup>22</sup> elements that characterise the market. Our primary aim has been to assess the impact of the Yellow Book on incentivising efficiency and value for money in procurement, and to determine whether the Yellow Book regime is effective at counterbalancing the incentives for misalignment that exist in such an imperfect market place.
94. We draw a distinction between efficiency and value for money in the work that we have undertaken. Efficiency measures how little cost can be incurred for a given output. In the context of MOD procurement, cost is controlled by the contractor, so by efficiency we mean how good a contractor is at keeping this to a minimum. Value for money, on the other hand, is a broader concept that measures the value of the output relative to the price paid.
95. Efficiency and value for money are not always aligned. A contractor may be efficient without the MOD receiving value for money. This can happen in two ways. Firstly, profit may be above market rates, so the MOD pays a high price despite the contractor being efficient. Secondly, the MOD may specify its requirements poorly so that, despite the contractor being efficient (and not making high profits), the overall price represents poor value for money. For example the MOD might provide a poor initial specification, or make frequent changes that result in rework and delays.
96. Part 1 of this report is focussed primarily on contractors. Single source pricing regulations apply primarily to contractors, and we consider how to encourage contractor efficiency and how to strengthen the link between a contract's profit and efficiency improvements. Part 2 looks primarily at the MOD, and considers improvements that could be made to MOD procurement processes, particularly in the commercial and financial areas, to help ensure the taxpayer gets value for money.

## Open Book

97. We have discussed the idea of open book<sup>23</sup> with industry, and have received no serious objections to its adoption. The fundamental aim of this recommendation is to improve transparency, trust and constructive engagement between the parties, and to reduce risk and encourage efficiency through the sharing of information.

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22. Monopsony is a market situation in which demand for a product or service comes from a single purchaser.

23. There is no standard definition for open book. For our definition of what is included, see Annex E, paragraph E152.

98. Open book accounting is commonly used in large scale construction contracts, and in other sectors in arrangements between customers and contractors, for example in the automotive sector. Open book accounting is an essential complement to Equality of Information at the point of pricing, enabling the MOD to have good understanding of costs subsequently incurred and to improve the relationship between government and defence contractors.
99. We have seen evidence of complex accounting within some contractors which seems excessive, and created a suspicion that on occasion the complexity has been designed to make the cost structures hard to comprehend. Whilst this is far from universal it has not been at all helpful in creating trust between industry and government. We also accept the concern of industry that open book could be used by government to reduce margins, rather than the total cost of projects. This needs to be addressed by a change in culture.
100. Detailed proposals in relation to provision of information are at Annex E. We consider that the specific provisions should be mandated in contracts and that MOD staff should not have authority to remove them.
101. Open book accounting requires that the contractor guides and assists with understanding of the information that is being provided. One might call it 'intelligent open book accounting'. Providing gigabytes of data to the MOD which it is left to interpret does not constitute open book accounting, and we strongly recommend that there should be an onus on contractors to provide intelligent analysis to enable the MOD to comprehend that which it is being given.
102. Under current arrangements Equality of Information provisions are concentrated on the provision of information at the time a price proposal is made, a contract price is agreed, or an amendment is made. The joint signature by the MOD and the contractor of an Equality of Information Pricing Statement (EIPS), which sets out the assumptions underpinning the price, is a strong discipline which should continue. There are also single source contract provisions that give the MOD the right to access and investigate actual cost data against an individual firm/fixed<sup>24</sup> price contract, in order to conduct a post-costing investigation.
103. When assessing the costs incurred on a complex contract spanning a long period of time, with many changes in specification over the period (as is typical), the customer will not be on an equal footing with the contractor. We judge that Equality of Information at the time of pricing, coupled with post-costing review rights, is insufficient to address this imbalance. Consider a post-costing review at the end of a ten year contract subject to hundreds of changes. To assist the MOD in undertaking this review the contractor may provide substantial amounts of data from its systems. The MOD CAAS team then faces the formidable challenge of unwinding the hundreds of changes from the original specifications, over ten or more years, to make an assessment as to whether the original data was accurate. Given the scale of this challenge, we were not surprised to learn that post-costing investigations have been in decline in the MOD (see Annex B) as the task is almost impossible to achieve, irrespective of the pay scale the MOD is able to offer to recruit skilled people.
104. The open book accounting rights will assist with post-costing reviews, and the contractor should be required to guide the MOD team through the analysis. In addition, the MOD should have rights to investigate the skills, processes and infrastructure of contractors such that they can enter a constructive dialogue regarding efficiency. Open book rights also enable continuous monitoring, an issue we discuss in the next section.

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24. Firm price contracts have payments that are not adjusted for either inflation or actual costs. Fixed price contracts are similar; however the payments are pegged to agreed inflation indices - transferring inflation risk to the MOD.

105. The right of the MOD to post-cost individual contracts is an important provision. The MOD can gain knowledge from the experience of previous similar projects and through deployment of engineering expertise can make intelligent assessments of cost for current and future projects. In practice, we believe that post-costing at the end of a long contract is a difficult task. The ability of the MOD to understand the costs likely to be incurred by the contractor and incurred during the course of a contract is fundamental to the MOD's negotiating position. Open book accounting provides improved understanding of costs in a market where there are significant imbalances in the information available to either side during negotiations. We believe it is essential in this market. Costing reviews should not be constrained to post completion. They are of more benefit, permitting remedial actions to be undertaken, if they are performed at regular intervals during the course of a contract.
106. In addition to the practical difficulties of verifying that Equality of Information has been provided at the individual contract level, we believe there is an equally important (and related) issue when it comes to the investigation of contractor labour/overhead recovery rates. We find in the current arrangements (Pillar 2) that there is a lack of more strategic, contractor-level information provided to the MOD to aid these investigations, and so inform the agreement of recovery rates used in subsequent contract pricing. In broad terms, we have already said that about 90% of the contract price is cost; we would also add that around 35% of the cost is company overhead. Yet it seems to us that there is not the same rigour around Equality of Information rights and disclosures when it comes to the agreement of labour and overhead recovery rates. This is a weakness in the current arrangements, and open book accounting should provide additional information to enable CAAS to make more informed assessments of these rates.
107. This lack of transparency leads to a lack of trust, which is not a healthy state of affairs to exist between any customer and contractor. Our recommendation of open book accounting is aimed at getting more transparency and hence more trust into the relationships between the MOD and its single source contractors.

**Key Recommendation 1:** Open book<sup>25</sup> accounting should be mandated on all single source contracts as a supplement to the Equality of Information provisions that exist under the current single source arrangements.

## Standardised Reporting Arrangements

108. The provision of data in a standardised format is essential to enable the MOD to build up information for cost comparison purposes and hence to build an intelligence capability to question costing data provided for single source contract cost estimates. Cost benchmarking data is extensively used by some other NATO country defence procurement organisations. Very limited data is held within DE&S, and the development of such data would considerably enhance its expertise in this area.
109. Standardised reporting should provide details of costs incurred, analysed into appropriate cost categories, with estimated costs to completion. All reporting needs to be in a standard format. There should be a clear onus on contractors to report cost budget overruns as soon as they are aware of them. In addition, there should be risk reporting of significant overrun exposures with narrative as to the reasoning, and documentation of significant specification changes during the period.

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25. As defined in Annex E, paragraph E152.

110. All reports, from both industry and the MOD, should be centrally held and made available to relevant parties. This central resource would enable information to be readily aggregated and analysed, providing an overview of the single source landscape within the MOD. As single source contracts contribute a significant proportion of cost overruns<sup>26</sup>, this information will particularly assist the MOD's Director General Finance (DG Fin) in maintaining a balanced procurement budget.
111. Standardisation of data should also apply to pricing proposals on new projects.
112. All contracts above a threshold would provide additional detailed annual reporting which would be subject to certification by the Board of Directors of the contractor, whom we would expect to take steps, possibly including external audit, to ensure that the controls over the accuracy of data presented are adequate prior to signing the returns. We emphasise that the certification should be by the Board. We do not consider it acceptable that any one executive signs the returns without the full authority of the Board (after discussion and minuting at the Board).
113. Certification should include inter alia the following: that costs charged to the contract are reasonably and necessarily incurred; overheads are allocated on a basis that is fair between the MOD and non-MOD customers; costs to completion are the contractor's best estimate of such costs at the time of submission; and that accounting policies have been consistently applied over time.
114. This additional reporting and certification will come at a cost and a practical balance needs to be struck between the benefits and the additional overhead. This can be done by applying a materiality threshold on the reporting requirements. Our analysis has shown that applying these additional requirements to contracts above a £50m threshold would impact less than 1% of single source contracts by number, whilst still capturing two thirds of the value.

**Key Recommendation 2:** All contracts above a threshold value of £50m should be reported on regularly by the contractor, using a standardised format, with annual certification by the contractor's Board.

## Incentivising Efficiency

115. We heard many concerns, particularly from the Government side, that the existing arrangements do not incentivise single source contractors to be efficient in the control of costs. This has been a recurrent theme for a number of years, and we note that the Review Board prepared a paper on this matter in June 2009. The Board's paper was submitted to us as part of this review, and we also received a paper in response from the industry Joint Review Board Advisory Committee (JRBAC). We note that the principal point that the Review Board makes is "to emphasise that profit is a relatively small proportion of the total price and that there will be far greater opportunities to the MOD for promoting efficiency by gaining a better understanding of cost estimates and contingencies and through effective project and risk management".
116. This observation accords with our own finding that the current arrangements are unduly focussed on profit, which currently makes up about 10% of a contract price, and focus comparatively little on costs, which make up 90% of the price. The Review Board is

26. Single source contracts are estimated to account for approximately 70% of cost overruns, significantly greater than their 40% share of procurement value. Based upon Review Team analysis of MPR reports.

constrained in what it can do to correct this anomaly because its terms of reference are set by joint agreement between the MOD and industry. The fact that 90% of price is cost may be an obvious point to make but it is one which the parties do not appear to give due weight to, instead remaining focussed on the various adjustments to the profit formula that are needed to compute the 'right' profit rate.

117. When the Yellow Book regime was introduced, the MOD had considerable cost estimating expertise within its own manufacturing and maintenance capabilities. Those skills gave the customer an intelligent view on costs, so it was natural that the Yellow Book did not focus on this area. Much has changed in this regard over the years. The transition to outsourcing much of the maintenance to equipment manufacturers, and the shift away from in-house manufacturing, has led to a considerable reduction in cost estimating skills retained in-house.
118. Efficiency is about cost reduction and the current single source arrangements have little to say on the matter. The Government Profit Formula and Associated Arrangements (GPF&AA), which includes past Review Board pronouncements thought to be relevant to future pricing, contains only two references to statements about efficiency, from profit formula reviews in 1974 and 1990.
119. This focus on profit instead of cost may be partly explained by the origins of the Agreement. In 1968, the MOD undertook a lot more cost-plus contracting: the cost was the cost, and the issue was what profit it was right to add on top. The MOD now does very little cost-plus work (at least in name), with a policy preference for firm and fixed price contracts. Despite this change, the focus within the current arrangements on the profit rate has remained.
120. We think there are two other closely related reasons for the focus on profit. Firstly, any changes to the current arrangements are only enacted through joint agreement between the MOD and industry, facilitated by the Review Board. It is a lot easier to reach consensus on whether the profit rate should be 8.8% or 9% than it is to reach consensus on whether, for example, contributions to company pension fund deficits should be allowed as a recoverable overhead in MOD contracts.
121. Secondly, there is the informational imbalance that exists between the MOD and its contractors. This makes it difficult for the MOD to challenge contractors' costs. The MOD has therefore been focussed on finding an ever-more objective measure for determining the correct profit, and then relying on pricing models such as Target Cost Incentive Fee (TCIF), or contract conditions to claw back contractor cost under-runs. This is not an ideal environment in which to try and incentivise contractor efficiency and cost reduction.
122. So we wish to shift the focus to contractor efficiency and encourage the reduction of the cost base. We consider that there are a number of ways in which the single source pricing regulations could better incentivise contractors to do this. Firstly, efficiency targets should be embedded in the initial price. To do this well, the MOD needs to have information that enables it to challenge contractor costs and compare them against relevant benchmarks. Our Key Recommendations 1 and 2 address this issue. Secondly, the MOD needs to be able to monitor on-going costs and cost forecasts, so they can engage with contractors early to address increasing costs. Our Key Recommendation 2 will help provide this continuous cost monitoring. Thirdly, contractors must be strongly incentivised to create greater efficiency. We consider that the profit motive is the strongest incentive to creating greater efficiency. Therefore it is essential that the new regime rewards improvements in efficiency.

123. In the 1990s, the MOD moved towards more firm and fixed price contracting, under the 'No Acceptable Price, No Contract' policy (NAPNOC), aimed at incentivising cost reduction. Given a firm/fixed price contract priced at the outset, the contractor is incentivised to try to reduce costs beneath those agreed in the price, since the cost reduction is all taken as additional profit. Provided the MOD learns of the cost reduction through post-costing and Equality of Information provisions, then the MOD will also benefit in the medium-long term because of reduced costs for follow-on contracts with the same contractor. The proviso is that the original pricing has to be taut and realistic. If the customer can be confident that the costs included within the price are reasonable and any cost contingency is sensible, then firm/fixed price contracts are sensible. Our proposals are designed to give the MOD increased capabilities in this regard and to enable firm/fixed price contracts to be used more to incentivise efficiency.
124. If the MOD cannot gain assurance that costings are based on efficient use of resources, then the contractor will make additional profits not through efficiency, but simply by delivering the contract at a cost beneath that agreed in the price, even though that lower cost might have been the realistic expectation envisaged by the contractor. This underlines the critical importance of the MOD having access to the right information, and using that information intelligently, for it to be in a position to reward contractors for improvements in efficiency.
125. The concern about 'excess' profit gained not through efficiency but through faulty pricing has led to the agreement of a relatively new contract condition, DEFCON 648A, effective from July 2004. This condition negates much of the incentivising effects of agreeing a firm/fixed price, since when profit exceeds that agreed in the price by more than 5% of the contract price, then the MOD takes back 75% of that excess through a reduction of the contract price. In the worst case scenario for a contractor, a super-efficient performance in cutting cost would find the MOD taking nearly 75% of the benefit (as defined by DEFCON 648A) and then seeking to reflect the efficiency into follow-on contracts.
126. The use of DEFCON 648A with fixed or firm price contracts also removes the fixed price nature of the contract. It is only fixed within certain bounds of performance.
127. Despite these reservations about the adverse aspects of DEFCON 648A we can understand why the MOD might feel the need for this provision, given the uneven playing field in knowledge and capabilities between monopoly contractors and the monopsony customer in the UK defence market. The clause provides a good degree of protection to the MOD if there has been any over-estimation of costs (and also to contractors, since it applies to losses as well as profit).
128. There is thus a trade-off between the protective regime DEFCON 648a provides to the MOD and taxpayer, and the extent to which contractors are encouraged to become more efficient. Where there is likely to be substantial follow-on work and a long-term relationship, it will be in the MOD and taxpayer's financial interest to focus more on encouraging contractors to be efficient, and benefiting financially through lower follow-on prices. Much of the value of single source procurement, such as submarine, ship, and aircraft production and maintenance, is characterised this way.
129. We consider that DEFCON 648a should be improved upon in two ways. Firstly, the 75% share to the MOD currently starts as soon as contractors make a profit only 5% above the price. We judge this to be too low a threshold, and recommend moving away from a regime that focuses on short-term financial protection to a regime that encourages contractors to reduce their cost base and become more efficient. We think 10% or 15% would represent a better threshold. The question of whether there should be a

consequent adjustment to the downside threshold should also be considered. Secondly, the sharing provision is currently set at 75%. This high MOD share will strongly reduce contractors' efficiency incentives, and represents a sharp transition from the 0% share prior to the threshold being reached. We welcome views on these, and other, potential options during the consultation phase.

130. The trade off discussed above only exists if the savings a contractor makes on previous contracts are embedded in lower prices for follow-on work. Key recommendations 1 and 2 will ensure that the MOD has a very clear view of a contractor's actual costs throughout the contract life. This will certainly help ensure that previous efficiency measures result in lower ongoing costs. We also recommend that Equality of Information requirements place an obligation on contractors to disclose all known ideas for efficiency improvement. Where relevant the benefits should be incorporated within the contract price.

**Key Recommendation 3:** DEFCON 648A should be modified from what is currently an overly protective regime to one that more strongly encourages contractors to reduce their cost base. We propose that the current 5% threshold, above which MOD receives automatic sharing, should be increased to 10% or 15%. We also recommend that the 75% MOD sharing arrangement might be better set at a lower percentage, such as 50%. We welcome views on these options, and alternatives, in the consultation phase.

## Overhead Reporting and Monitoring

131. Overheads are a significant proportion of MOD expenditure on single source contracts - we estimate £3bn per annum - and in several cases can be seen as payments that sustain areas of industrial capability. Yet we find them to be subject to significantly less scrutiny at senior levels in the MOD than other, less material, levels of expenditure. Our recommendations are aimed at correcting this anomaly - we believe single source overhead costs require greater visibility, agreement and management at a level above that of the individual contracts through which they are recovered.
132. There is surprisingly little senior MOD scrutiny and approval of overheads and the actual business activities they represent. What scrutiny and approval there is takes place in two areas, the setting of business unit recovery rates, and the appropriateness of allocations of costs to specific contracts. This scrutiny is undertaken by CAAS. We do not consider this sufficient for such a high value of government expenditure, and believe additional scrutiny and approval is necessary to evidence that the MOD is receiving value for money for the UK taxpayer. Information should be provided by contractors to enable the MOD to review and agree levels of expenditure.
133. We observe that annual overhead plans are a feature of the recently introduced voluntary regulation scheme between the Department of Health and pharmaceutical companies (see Annex G). Looking at trends in overheads on a company-wide basis removes the complexity of assessing trends in overheads in individual production business units that are periodically subject to reconfiguration. A forward plan, outlining a contractor's intentions on the maintenance of key facilities and their associated costs, would also provide much improved forward visibility, enabling the MOD and contractors to engage in a helpful dialogue.
134. The overhead plans that should be submitted relate to units that are wholly or significantly dedicated to MOD business. Where business units are not engaged in

significant MOD business then the information is commercially sensitive and the MOD should not have a right of access. The overhead plan will enable increased scrutiny of the totality of a contractor's overheads. Much of this increased scrutiny should come from within the MOD, and at more senior levels. However, as discussed later, we also see an important role for our proposed Single Source Regulations Office (SSRO) to undertake independent financial analysis, benchmarking, and scrutiny of contractor overheads in order to assist with pricing and improving efficiency.

135. The method of contractor overhead recovery, through the apportionment of estimated overheads across expected activity, will inevitably lead to either over-recovery or under-recovery of overheads in a given period. The method assumes that, over time, these over and under recoveries balance out, and contractors are fairly recompensed for the overheads they have incurred in the course of delivering single source MOD contracts.
136. Currently, there is no systematic means of verifying this assumption. We believe that, given the significant value of expenditure covered by this recovery process, further checks and balances are necessary to ensure that the MOD is receiving value for money and that contractors are receiving fair payment for overhead costs incurred.
137. Annex E (paragraph E14) sets out further thinking on this recommendation. We appreciate there are complexities to the analysis, not least where overheads are shared between competitive and single source contracts. However, we consider this recommendation crucial to protecting both parties and ensuring overhead recoveries are fair.
138. The reports to be submitted will enable CAAS and contractors to determine if there is prima facie evidence that recovery rates may need adjusting, and will enable them to assess the effectiveness of overhead costs that are being incurred.

**Key Recommendation 4:** An Overhead Report should be submitted annually by all contractors with aggregate single source contracts in excess of £100m total value. The report should have two distinct sections - Forward Planning, detailing planned overhead expenditure that will impact the prices of single source contracts; and Overhead Recovery, detailing under/over recovery of overheads on single source work during the reporting period.

## Profit and Risk

139. The principle that the profit included within the price of a contract should be commensurate with the risk being taken by the contractor is widely accepted. This applies equally to competitively let and single source contracts and subcontracts. Under competitive contracting the MOD can rely on the market to a great extent - any contractor going for inappropriately high levels of profit for the risk being taken would be priced out of the competition.
140. The existing Government Profit Formula (GPF) is recognised as performing poorly in this respect. Some efforts to address this have been undertaken since 2004 but have not been progressed into any development of the formula. In their 2009 'efficiency paper', the Review Board remind the parties that they "have consistently recommended that the current risk/reward matrix is far too simplistic to deal adequately with the diverse range of non-competitive contracts that are now negotiated between the MOD and defence contractors".

141. In reality, the GPF effectively provides only two rates to apply to single source contracts: a non-risk rate and a risk rate. The non-risk rate has been set at 75% of the risk rate and is applied only in a very small number of cost-plus contracts<sup>27</sup>. The current GPF rate is set on the basis of comparability referred to earlier.
142. The GPF risk rate can be adjusted to take account of certain factors, including the degree of risk, but the mechanism is weak (the so-called 'risk/reward matrix' referenced in the Review Board statement) and does not achieve a good alignment of risk and reward. There is therefore an inadequate differentiation in the rate of profit used in the price of a single source firm/fixed priced contract which is truly high risk to a contractor, and one which carries very little risk.
143. We believe MOD single source contractors are often protected from financial risk by the cost contingencies included in the contract price, and by the pain/gain share arrangements that are negotiated. In some contracts, this leaves the contractor with very limited financial exposure and, in such circumstance, a profit close to the risk free profit rate should be applied. The risk free rate could be debated for many more years - the parties have been discussing it on and off since 2004, with no real progress. Instead we propose that the existing GPF methodology for calculating a Baseline Profit Rate (BPR) and Capital Servicing Allowances is retained, but that the 'risk free' rate is then computed as a 30% reduction on the BPR (the current 'risk free' rate applied to cost-plus contracts applies a 25% reduction to the BPR). We are not aware of a theoretic approach that could underpin this adjustment but it is similar to the adjustment for risk currently used in France and the US.
144. The approach under the current arrangements of applying an 'average risk' profit allowance to contract prices, after adjusting up or down for risk (which rarely ever happens) can result in an insufficient assessment of risk on the part of the MOD. We believe starting the discussion at the risk free rate should mean far greater attention is paid to risk, by both parties. Application of a contract profit allowance without consideration of the degree of risk, which happens routinely under the current arrangements, should not be an acceptable practice. The use of the average rate should be justified by an overall assessment of the risk not already covered by cost contingencies and gain share provisions in contracts.
145. We accept that measurement of residual risk and the setting of a risk free rate are matters of judgement and that both industry and the MOD will develop greater expertise over time. However, setting a guideline risk free rate and requiring justification of use of the higher, average, risk rate are, we believe, important milestones on the journey.
146. As we have indicated, there are other aspects of financial risk, the cost contingency provisions and gain share arrangements, which need to be managed. We discuss these in Part 2 of the report.

**Key Recommendation 5:** The implicit starting point for the contract profit allowance should be a 'risk free' profit rate. Commercial leads should have to justify any movement away from the 'risk free' rate using an assessment of the contractor's risk. The MOD should develop guidance for commercial negotiators to follow in assessing the extent of the allowance that should be added for risk in the profit allowance.

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27. Using DEFCON 653. Over the last five years, cost plus contracts have been used in less than 1% of cases.

## Government Accounting Conventions

147. We referred earlier to the GACs (as an element of Pillar 1) which set out the cost categories allowable for inclusion within pricing. These are relatively brief in comparison with modern accounting standards and, for example, US Federal Acquisition Regulations. They are a key feature of single source contracting and should be applied in pricing of single source contracts. Consistent with all aspects of the Yellow Book regime, changes to the GACs have to be agreed by mutual consent. This provides some explanation as to why the provisions are imprecise in several areas.
148. The GACs were not originally formulated as a comprehensive statement of costs allowable in MOD contracts but have developed over the years in response to particular issues that have arisen at different times. Hence the conventions lack clarity and coherence, which can lead to inconsistencies across contractors and can create confusion.
149. There should be a review of the GACs to bring more clarity to this matter. The SSRO should have responsibility for assessing the appropriateness of GACs and amending them as required, after seeking the views of industry and the MOD. It has not been the intent of this review to revise the GACs. However, there are some observations and recommendations we would make. We offer observations on rationalisation and pension costs. We recommend a simplification to intercompany<sup>28</sup> cost transfers, and to the general definition of allowable costs.
150. We have heard arguments that the MOD should not bear rationalisation costs incurred by contractors, on the grounds that in other sectors there is no customer who bears these costs. We do not consider this argument to be sound. The GPF is calculated across industries which will have borne rationalisation costs, and those costs have been deducted in reaching the profits reported. So industry has to be compensated in some way to leave it with a comparable profit margin after such costs.
151. The MOD has better knowledge of its likely demand for use of contractors' facilities than contractors. If the risk of rationalisation subsequent to a contract was priced into a contract it is highly likely that the cost a contractor would wish to include in the contract for rationalisation would be higher than if the MOD effectively self insured by carrying the risk itself. We therefore consider that the current approach to rationalisation costs is appropriate. However, we recommend that any revision to the GAC relating to rationalisation costs should introduce a duty on contractors to mitigate costs.
152. It is important that any financial exposure to risk which is not included within contract prices, for example rationalisation costs, is understood by senior management within the MOD. The exposure to such risks needs to be factored into budgeting deliberations between the two departments.
153. A complexity in determining what rationalisation costs the MOD should bear arises where a site has had mixed use over time, comprising MOD and non-MOD business. Rather than rely on judgement, we consider that a formula should be laid down that looks at the mix of business, we suggest over the past ten years. Costs could then be allocated to determine that share which the MOD should bear. We recommend ten years as it is of sufficient length to avoid the claimant manipulating the formula to create an advantage.
154. Pension costs are a significant element of total costs and have been the subject of considerable discussion between the MOD, industry and the Review Board. In its

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28. This is described as 'Intra-group inter-unit trading', or IGIU, in the Yellow Book.

simplest form, the current arrangements provide for the inclusion of current service cost within allowable costs and exclude, inter alia, past service costs and actuarial gains and losses. Having discussed the topic with senior MOD personnel, we understand the logic of the accounting convention that has been agreed.

155. Whilst alternative approaches to the determination of allowable pension costs may exist, the determination of appropriate recoverable pension costs is a major piece of work in its own right. The current convention has been agreed between industry and the MOD and it appears fit for purpose. We therefore recommend no change to the current convention on pension costs.
156. The new Single Source Pricing Regulations (SSPRs) that we recommend are designed to enable contractors to earn a fair return on costs incurred. A troublesome issue over the years has been intercompany trading. The adjustment formula for intercompany profits was modified in the 2011 review to make it more company specific, rather than a blanket adjustment. We think that the system should be simplified by requiring costs on projects to be recorded at original cost to the group, thereby removing intercompany trading adjustments.

**Recommendation:** The current adjustment to the profit allowance for intercompany trading should be removed, and contractors should be required to record costs charged to the MOD at their original cost to the group.

157. The current GACs contain a list of contractor costs that are normally excluded. Current practice is to accept all costs charged to the contractors' accounts with the exception of these exclusions, which include costs that are 'unnecessary, extravagant or wasteful'<sup>29</sup> - an assessment that the MOD must justify. Industry must continue to receive fair payment for fair costs, and this should also reflect value for money for taxpayers. We believe that the emphasis should be amended, such that all costs charged to the MOD are both reasonable and appropriate.

**Recommendation:** The GACs should include the general provision that costs charged to the MOD should be both reasonable and appropriate. This should be included in the contractors' annual Board certification (Key Recommendation 2).

## Other Issues

158. The effectiveness with which the current arrangements are applied is naturally dependent upon the availability of a variety of skills from within the MOD. A full range of skills, for example engineering, logistics, commercial, financial, legal, and project management, is required to enable the MOD to act as an intelligent customer in its procurement activities. In practice, whilst these skills are distributed amongst a range of disciplines within the department, the specific single source pricing arrangements draw most directly upon the commercial staff and CAAS.
159. Over the last decade, CAAS numbers reduced from approximately 500 to a low of approximately 270, and this left a gap in the MOD's ability to manage single source procurement to the standard it would wish. A recent practical example of this was a substantial backlog and reduction in the number of recovery rate agreements that were being made with single source contractors. This shortfall in resources has already been recognised, and is in part being addressed by the current CAAS up-skilling initiative<sup>30</sup>.

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29. Review Board Annual Report ('Yellow Book'), 2011, Appendix D, 4.2.8.

30. Through the Defence Acquisition Reform Programme (DARP).

160. Beyond this current initiative, we recognise that some of the skills required are highly sought after, and subject to a competitive labour market. The restriction of civilian pay scales, under which the MOD operates, limits the department's ability to sustain some commercial and analytical capabilities, resulting in a loss of those skills or dependence upon expensive external resource. Dependence upon the availability of specific commercial and analytical skills will necessarily be a feature of any future arrangements, and therefore having access to appropriate skills is central to the implementation of the new SSPRs. However, relatively little of the burden of reporting under our proposed new regime falls on the MOD. We have been mindful of likely resource constraints within the MOD, and framed our proposals accordingly.
161. Under the current arrangements, most DEFCONs applicable to single source contracting contain provisions requiring the flow-down of contract terms from prime contractors to their subcontractors.
162. In principle, this extends the applicability of MOD single source arrangements through the defence supply chain, regardless of the specific form of prime contracts. It is intended to ensure that competition is applied where possible in the supply chain. Thus, even if the prime contract is single source, it may be possible to compete significant elements that are subcontracted out from the prime contractor. It is also intended to ensure that the rights and obligations of single source provisions are available for what can be very high value single source subcontracts.
163. In practice, the flow-down of arrangements to subcontractors is neither monitored nor enforced by the MOD on a consistent basis. It is, therefore, not known the extent to which this principle is applied in practice. We consider this a barrier to ensuring value for money in the single source supply chain, and the lack of transparency in this area makes it difficult to assess the success or otherwise of current provisions. In line with our Key Recommendation 2, the regular reporting on large contracts should include information on any material subcontracts signed, and whether or not they were competed. This will allow the MOD to track more effectively the flow-down of provisions.

### **Retained Elements of the Old Regime**

164. Whilst we have substantially recast the regulations that should be applied to single source procurement, there are elements of the current Yellow Book regime which would continue in force. The most notable features are mentioned below:
  - a. Equality of Information is a valuable approach to ensure integrity in negotiations and provides that the two parties negotiate in good faith though, as we will discuss, it is not sufficient to provide the MOD with appropriate information to evaluate pricing;
  - b. post-costing is a vital element in ensuring compliance with contractual arrangements, in informing the pricing of subsequent contracts and ensuring that contractors have complied with Equality of Information;
  - c. we have found little merit in changing the approach to calculating the baseline profit allowance based on the principle of comparability<sup>31</sup>. The approach is sound and when considering efficiency we are mindful that the profit is generally less than ten percent of the total costs of a contract;
  - d. finally, the recently agreed approach to the treatment of pension costs is reasonable and balanced, providing a sound treatment to a complex area of costs.

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31. We do however make recommendations on subsequent adjustments, for example for risk.

## Industry Compliance with SSPR

165. The effectiveness of the new regime in incentivising efficiency and ensuring value for money for the taxpayer is dependent upon compliance from both industry and the MOD. Compliance can never be fully guaranteed in whatever regime is constructed, including a regime backed by legislation. Part 3 of the report evaluates the various options for the establishment of the third party body responsible for providing independent assurance regarding the efficiency of industry and value for money for the taxpayer. We have concluded that a voluntary regime is the preferred option.
166. A voluntary regime provides challenges, in particular the rights of redress that ought to exist where there has been a failure in compliance. Most of the details of the compliance regime will be a matter for consultation in the next phase of the review. However, we outline the main principles of the compliance regime, as they relate to industry, that we recommend and the approach by which we see it being implemented and enforced.
167. We consider that the most effective way to implement the SSPRs is to develop a code of conduct which the SSRO will publish after consultation with the MOD and industry. The code should be incorporated into all single source contracts by the inclusion of a special condition in the contract, and be mandated through MOD commercial policy. The code should make clear that neither party shall seek to amend the code or remove the condition from any contract.
168. One of the key components of the proposals is the application of open book accounting to all single source contracts. We can envisage a situation where a contractor might offer enhancement of certain terms in exchange for removal of open book provisions (or other aspects of the SSPRs). MOD personnel in contract negotiations need to be made aware that demonstrating value for money requires open book accounting. Compliance with the code ought to be confirmed at the Investment Appraisals Committee (IAC) and other appropriate checkpoints in the procurement processes operated by the MOD.
169. Potentially the most disruptive compliance lapses are the submission of inaccurate contract or company financial returns, and the failure to submit returns. We think the remedy process should be similar in each circumstance. The SSRO should appoint a firm of accountants (other than the contractor's auditors) to oversee the preparation of the required returns, at the contractor's expense, and provide an accountant's report thereon. Should the lapse be considered sufficiently serious by the SSRO, then the SSRO should have the right to determine the period of time, both retrospectively and prospectively, that the appointed firm shall oversee the preparation of the required forms. These remedies will be included in the code of conduct.

# Part 2: MOD Protocols and Procurement Processes

170. The cost of military equipment is influenced not only by contractor efficiency, but also MOD procurement practices. In Part 1, we considered the pricing and cost management regulations the MOD should apply to help ensure contractors are incentivised to be efficient. In Part 2 we now turn to look at the MOD's procurement processes. Our particular focus, as outlined in our terms of reference, is on MOD processes that affect contractor efficiency and value for money for the UK taxpayer.
171. The 2009 Gray report provided a thorough analysis of MOD procurement, and identified a number of issues that undermine value for money. Chief amongst these was the 'cost of delay'. We have investigated whether delay and cost growth are particularly common in the single source environment, and, if so, what additional controls and support might be appropriate to help reduce this waste.
172. We have considered a number of other MOD procurement topics: in particular the use of different contract types (such as fixed price or pain/gain share contracts), methods for overhead recovery, commercial and financial controls within the MOD, requirement change, risk, and independent costing. All of these have a significant effect on contractor efficiency and overall value for money, and all currently raise issues that need to be addressed.
173. MOD procurement processes are largely under the remit of the recently appointed CDM, Bernard Gray. CDM is in the process of developing a strategy to improve value for money in defence procurement, to help maintain a balanced budget for equipment, and to make improvements in procurement processes. Lord Levene's recent report also makes recommendations to help maintain a balanced budget.
174. We strongly support the MOD's efforts to make improvements in this area. From the perspective of our report, however, it means we are making recommendations against a changing landscape. The best way of addressing the issues discussed in this part of the report depend upon the MOD's overall strategy, which is still under development. We have thus made a distinction between key recommendations, which we consider essential to improving single source acquisition and which are largely independent of these MOD changes, and ancillary recommendations, which are primarily intended to inform and enhance the debate.

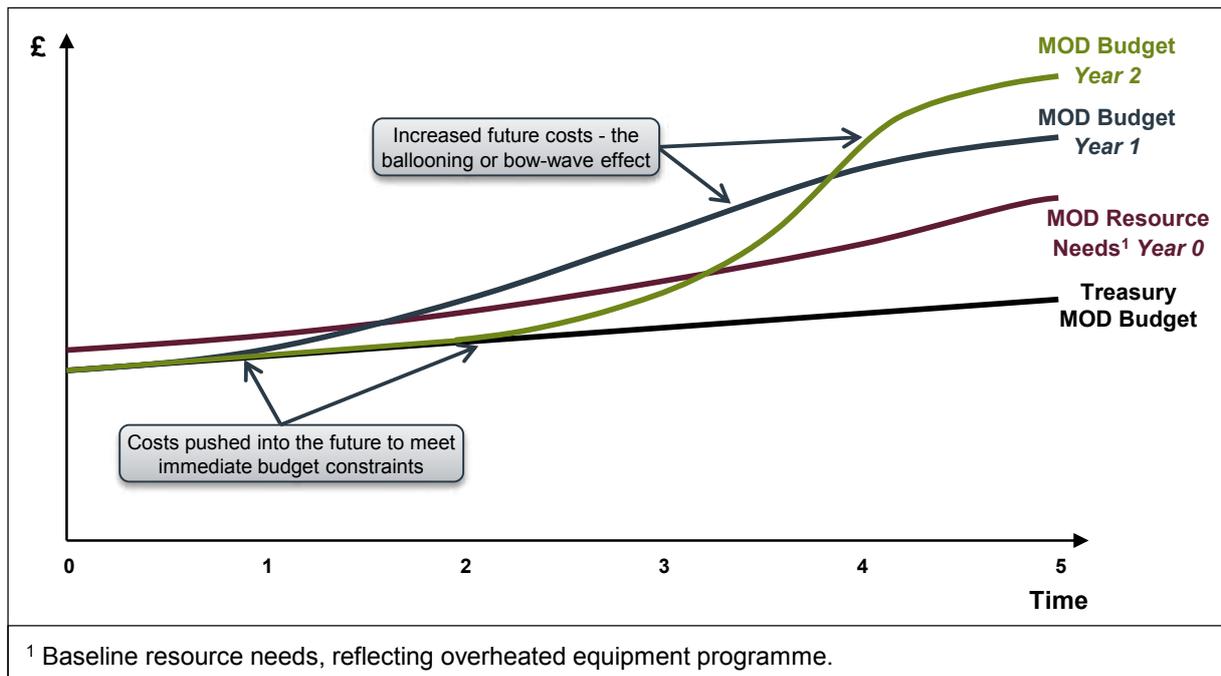
## Addressing the Cost of Delay

175. The Gray report identified that, on average, equipment acquisition projects face a delay of 2½ months for each year of acquisition. These delays have a range of impacts, and the associated costs were estimated to be in the range of £0.9bn to £2.1bn per annum<sup>32</sup>. Including the impact of delays on in-service equipment would increase this estimate further. On balance, we believe that achieving better value for money depends as much on improving MOD behaviours as it does on improving contractor efficiency.

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32. At 2009 prices.

176. The reasons for delay were investigated by Gray, who identified an unrealistic budget as the primary cause. Usually the MOD is faced with a funding requirement that exceeds the budgetary provision, or to put it another way, the budget is unrealistic. To bring the budget into balance, a raft of savings measures are introduced. Because the capability is still needed, by far the most common savings measures are delays and/or reductions in scope. Unfortunately the impact of these measures is to increase the overall cost of capability. This then increases the problem faced in the following year. This is shown figuratively in Figure 3.



**Figure 3 - Indicative View of the Budget Bow-wave Over Time**

177. The estimates of the cost of delay relate to all MOD procurement, yet the impact upon single source contracts appears to be disproportionately high. Recent NAO Major Project Reports (MPRs) have identified projects with the greatest cost growth and delay. Although single source contracts over the last five years have accounted for approximately 40% of MOD procurement, we have identified that 70% of projects with major delays and cost overruns were single source (see Annex C).
178. SDSR decisions were driven by the need to correct the inherited substantial imbalance within the MOD budget. We have been shown an analysis of recent SDSR changes which identified that over 90% of the contracts affected by the SDSR were single source<sup>33</sup>. For most contracts, this meant a delay and/or a reduction in scope, both of which inevitably contributed additional costs that made the savings harder to achieve<sup>34</sup>.
179. The cause of this bias is not explained by the value and number of single source contracts - as previously noted, the proportion of single source contracts impacted is greater than would be expected. Other factors appear to drive the disproportionate delays and cost

33. MOD Renegotiation Strategy Team, 26 May 2011.

34. We are not suggesting that SDSR decisions were made on the basis of single source vs. competitive procurement, but that the outcome of the SDSR impacted strongly on single source contracts.

overruns seen in single source contracts compared to contracts in general. We suspect that some of these factors relate to the non-competitive market conditions in which single source procurement occurs.

180. One possible factor is the context in which single source contracts are placed and managed. With some contracts spanning over 20 years, a relationship of long-term familiarity between the MOD and contractor can develop. The same commercial discipline applied to competitive contracts by both parties may not be applied to single source contracts, for example by defining and applying contractual remedies or by setting and keeping to taut change parameters. This gives the MOD greater freedom to place change on the contractor without the contractor seeking recourse through contractual terms. Contractors will accept this situation as long as they are paid for the cost of change incurred, which they invariably are.
181. Whatever the reasons, it is clear that if the MOD could reduce the cost of delay associated with single source projects, this would address a substantial element of budgetary pressure. It is important to reiterate the contribution this makes to continuing the bow-wave of future costs; delay does not just postpone cost, it significantly increases the overall cost of a programme.
182. Ideally, what is needed is a realistic budget for all projects. The more realistic the budget, the fewer savings measures will be required. Although single source projects represent only a portion of the total MOD budget, our analysis shows that they have accounted for more than their fair share of the cause of the overheated programme, so improving the realism of this portion will make a big difference to maintaining the realism of the total budget.
183. To evaluate whether the budget is realistic, the budget for a given single source contract needs to be compared against the best available contractor cost forecasts including an evaluation of the cost risk the MOD has accepted. This requires access to good quality contractor cost information, and the skills to analyse MOD risk and determine whether contractor estimates are themselves realistic. This is a complex task requiring access to high quality analytical and engineering skills.
184. Gray and Levene both identified powerful motivations within the MOD, and in some cases extending to contractors<sup>35</sup>, that increase the difficulties of setting a realistic budget. We have the unfortunate combination of a complex technical task, requiring data and skills the MOD is short of, and a partisan environment that may seek to influence the outcome. This is one of the more difficult problems the MOD faces in procurement. We believe that internal improvement would be continually strengthened and reinforced through independent assurance of the realism of the MOD budget, free from these internal pressures. Our proposals for an arm's length body, which we call the SSRO, are set out in Part 3.
185. The benefit of a more realistic and stable budget is not just financial. In our consultations with industry, the negative impact on contractors of frequent change was often highlighted. In particular it makes planning and optimisation very difficult, and can reduce morale by creating uncertainty and nugatory work. We consider the stability that would be encouraged by stronger assurance would thus be of significant benefit to industry.

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35. One of the main issues is so called 'entryism', defined as 'the incentive and practice of deliberate underestimation of project costs and timescales and overestimation of performance capability, by both the MOD and industry, to support the initiation and continuation of projects in the knowledge that they are unlikely to be terminated once reality becomes evident.'

**Key Recommendation 6:** The SSRO should provide an independent review of the realism of budgets allocated to single source contracts to provide assurance to the MOD that single source contracts are in financial control.

## Commercial Constructs

186. The commercial construct, or commercial model, refers to the contractual elements that are not a direct description of the requirement. For example, the commercial construct specifies the duration of the contract, whether it is fixed price or subject to pain and gain share, the use of performance measures (such as Key Performance Indicators), and whether it is a contract for a specific output or a framework contract that can be called off as required.
187. Selection of the right commercial construct can make a substantial difference to contractor incentives, including efficiency incentives. This is appreciated in the US, where the Under Secretary for Acquisition recently released a directive<sup>36</sup> that requires the commercial construct for all contracts over \$100m to be justified.
188. Commercial constructs must be fit for purpose, with the best commercial construct depending on many factors. For example a fixed price on a design contract might pressure a contractor to rush the design, adding substantial cost risk later in the programme which they may not bear. On the other hand a fixed price for a maintenance contract on an established platform should encourage efficiency.
189. The recommended commercial construct could be part of the SSPRs. On balance, however, we consider that guidance on the best construct should be a question for commercial policy rather than part of the single source regulatory framework.

**Recommendation:** There are clear situations where certain constructs are not appropriate. There is limited guidance on this in MOD commercial policy. We recommend that the MOD should establish clear rules on the permitted commercial constructs in various situations, and that for large contracts the chosen model should be independently reviewed prior to contract signing.

190. One issue we wish to focus on is the use of pain and gain share contracts, known as Target Cost Incentive Fee (TCIF), as opposed to firm/fixed price and cost-plus contracts<sup>37</sup>. Currently firm/fixed price contracts represent approximately 60% of single source contracts by value, with TCIF representing 40%, and cost-plus contracts being very rare<sup>38</sup>.
191. TCIF provides a half-way-house between firm/fixed and cost-plus pricing. It is used when a contract is too risky for a contractor to accept all the risk without including a prohibitively expensive contingency. It also encourages a culture change towards productive joint working, allowing the MOD and contractors to deal in the round with requirement change, failures in the government provided elements of the solution, poor performance, and cost increases. However, these benefits come at a price.

36. Ashton Carter Directive, Nov 2010.

37. In MOD procurement, firm price contracts have payments that are not adjusted for either inflation or actual costs. Fixed price contracts are similar; however the payments are pegged to agreed inflation indices - transferring inflation risk to the MOD. TCIF contracts have a target cost and any cost over- or under- run is shared between the MOD and the contractor according to an agreed share. Finally, cost-plus contracts mean the MOD pays contractor costs, with a profit element added on top.

38. UK Defence Statistics 2010, Table 1.15, MOD.

192. As discussed previously, the desire for increased profit provides contractors with the strongest incentive to be efficient. Despite including 'incentive' in its name, TCIF provides contractors with less incentive to be efficient than firm/fixed price contracts. This is because any saving they make must be shared with the MOD rather than flowing straight to their bottom line. Firm and fixed priced contracts will always provide a stronger efficiency and cost control incentive.
193. In the case of firm and fixed price contracts, the efficiency gain is not translated into value for money until such time as the new lower cost base is reflected in contract amendments or a subsequent contract. TCIF, whilst providing an incentive for contractors, can deliver value for money benefits more immediately to the taxpayer by sharing in the cost reductions during the current contract. There is thus a balance to be struck between the desire to share possible benefits, and the effect of this on reducing efficiency and cost control incentives.
194. In extreme cases, efficiency incentives can be wholly undermined. We are aware of one major TCIF contract where the cost was agreed at several billions of pounds, and publicised as such. This TCIF contract transferred 90% of any cost overrun to the MOD. This means that costs can almost double before the contractor makes a loss. A 90% MOD share arrangement almost frees the contractor from the need for tight cost control and efficiency measures.
195. This is compounded by another negative impact - the significant cost risk it places onto the MOD is not always recognised in budgets. TCIF contracts have on occasion been used and abused as a means to camouflage the real costs of contracts by transferring cost into unrecognised risk contingencies. Continuing the previous example, an independent estimate at the time of pricing, prepared by CAAS, estimated costs at more than 50% above the agreed price. This was subsequently shown to be much more accurate, and the MOD had to bear the substantial cost increases.
196. A further issue with TCIF contracts is that the pain and gain share is, in practice, usually only calculated at the end of a contract. In long term projects, often subject to considerable changes to specification, the analysis of the contract gets immensely difficult. Also, the potential for a large pain or gain cash transfers ten years hence provides little incentive to those at the beginning of a contract.
197. The complexity of TCIF reconciliations places a substantial reliance on MOD and industry analytical resource, reliance often inconsistent with current resource constraints particularly on the MOD side. To work well, progress against TCIF targets must be continuously monitored by both parties. There is a substantial overhead associated with the setting, managing, and reconciling of TCIF contracts. We are aware of arrangements where there has been inadequate consideration of the ability to assess the gain and pain, leading to an unacceptable loss of control.
198. Given these issues, should TCIF be abolished, as in the French approach of only allowing fixed price contracts? The short answer is no - there are situations where neither a firm/fixed price, nor a cost-plus contract, is appropriate. However, it would benefit from simplification and from mitigating potential abuse. If there are significant risks that are hard to estimate then we suggest that either such costs should be removed from the TCIF contract (for example through specific terms and conditions) or an alternate commercial construct should be used. A 90/10 approach is not appropriate. Any significant deviation from equality in sharing of risks and rewards leaves the mechanism open to abuse.

**Recommendation:** TCIF should be fixed to a 50/50 share between the MOD and contractors, mitigating the misuse of TCIF to meet unrealistic budgetary constraints, and balancing the incentivisation of efficiency with the benefit of value for money for the taxpayer.

**Recommendation:** Review of the commercial construct, and the quantification of the risk that the MOD takes on, should be included in the independent commercial due diligence.

199. Cost-plus contracts were once the default MOD approach to procurement. Since the late eighties there has been a shift away from cost-plus<sup>39</sup>; current commercial policy is to use cost-plus only by exception. There were, and still are, very good reasons not to use cost-plus. Under cost-plus there is no direct incentive for contractors to control their costs; indeed, the higher the costs the greater the profit, so there may even be a perverse incentive to increase costs.
200. Notwithstanding the reservations, there are situations where cost-plus is the most appropriate commercial construct. Getting the design right can make a huge difference to manufacture costs and subsequent maintenance costs, yet accounts for only a small fraction of the total costs of equipment. A fixed price contract might save a few hundreds of thousands at the design stage, yet end up costing many tens of millions later. In general terms, the closer to the research and development phase, the less appropriate a fixed/firm or TCIF contract will be, and the more a cost-plus contract will be appropriate. The proviso here is that, for cost-plus to work, the MOD must be an 'intelligent customer' to provide constructive oversight of the contractor's performance. There is no alternative to the MOD being an intelligent customer.
201. Once a project is in the manufacture or support phase, the costs can be very high and a cost-plus contract which provides contractors with little incentive for cost control is no longer an appropriate commercial model. Particular difficulties arise in a first of class manufacture or maintenance contracts, where costs are both substantial and highly uncertain. Fixed price and TCIF contracts, which transfer much of the estimating risk to the contractor, will result in cost contingencies within the contract price that may offer poor value for money. On the other hand, a cost-plus contract is also not appropriate. The most effective compromise may be to carry these contingencies within the MOD, compensating contractors for outturn variances using a specified methodology, while still using a fixed price or TCIF model.

**Recommendation:** In the specific area of concept, assessment, and design contracts, the MOD should reconsider its policy on not using cost-plus contracts. Use of cost-plus should be coupled with strong MOD oversight, supported by appropriate provisions in the contract, to ensure quality and mitigate the risk of waste.

202. Following the Defence Industrial Strategy in 2005<sup>40</sup>, MOD procurement policy moved towards long term contracts which recognised the need to sustain certain capability and capacity requirements within defence contractors. This has taken the form of commercial constructs that guarantee a contractor long term volumes of work in return for reductions in their cost base and flexibility for MOD to change its requirements. The benefit to

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39. Under the No Acceptable Price No Contract (NAPNO) regime.

40. Defence Industrial Strategy, December 2005, ISBN 0-10-166972-0.

contractors is exclusivity and certainty; the benefit to the MOD is security of supply, strategic capability and simplified cost management.

203. These arrangements come at a price to the MOD. The MOD becomes liable for future rationalisation costs and the implications of demand fluctuations. Rationalisation costs in the past have rarely been budgeted for<sup>41</sup>, and hence have caused affordability issues at the time of realisation. Following the SDSR, specific budgetary contingencies were made. We recommend that this should remain a feature of future planning rounds and budget settlements.
204. One other implication of these long term agreements, which by their very nature concern themselves with major programmes and platforms, is that they have the effect of removing short term budget flexibility as the cost of major contract amendments or cancellations is significant.

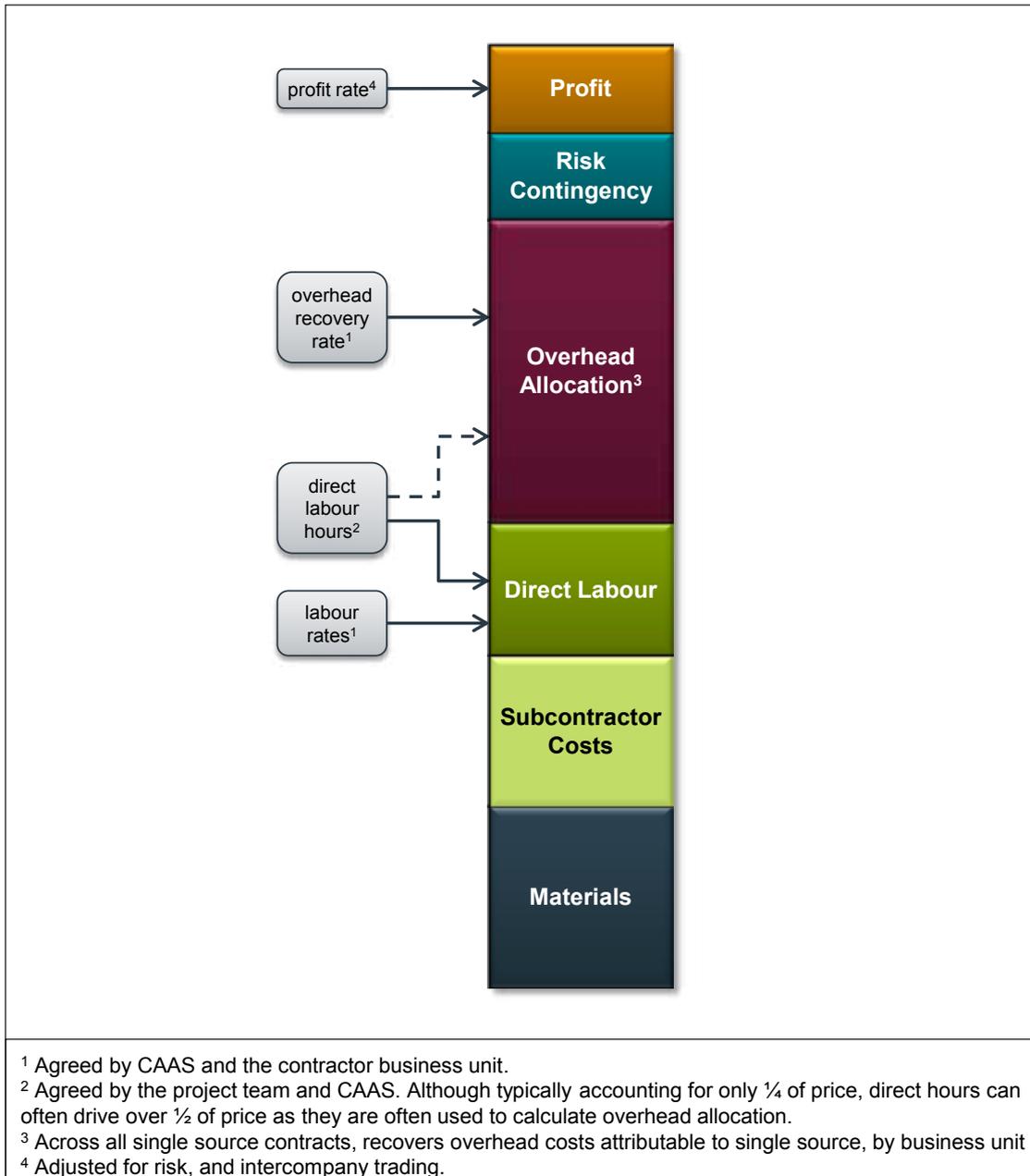
**Recommendation:** Long term capacity and capability contracts should be used sparingly and be under particularly close scrutiny. They should only be entered into if a strong case can be made that the strategic capability requirement will remain under all likely future scenarios for the full duration of the arrangement.

## Overhead Recovery

205. Most MOD procurement processes are the same whether competitive or single source. For example, the approaches to assurance and risk allocation are rightly the same regardless of the procurement approach. There is one major exception, however, which is the agreement of the unit rates (such as labour rates) used in single source pricing; this process is unique to single source pricing.
206. Unit rates include direct costs, for example, engineers' salaries, and an allowance for overheads, such as site maintenance. In single source procurement, all overhead costs are currently recovered in this way (see 'Pillar 2' in Annex B). Total contractor overheads recovered in this way represent a significant element of contract prices, estimated at approximately £3bn per annum. How the MOD scrutinises the appropriateness of costs charged is thus worthy of investigation. A typical contract price breakdown is shown in Figure 4.

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41. A positive example is the Maritime Change Programme, where rationalisation liabilities were considered in the budget.



**Figure 4 - Typical Contract Price Breakdown**

- 207. The two scandals that led to the original 1968 Yellow Book involved contractors achieving high profit by double counting overheads. This resulted in some controls on overhead recovery being put into place. The resulting overhead recovery method has remained largely untouched since then.
- 208. In single source contracting, overheads are normally recovered as a loading expressed as a percentage or an amount, on top of direct costs, typically labour. For example, a typical direct labour rate of £30 per hour could, after overheads have been loaded on top, be increased to £80 per hour. The scale of this uplift is a reflection of overhead costs now

being substantially greater than direct labour costs. This was not always the case: in 1968 labour typically accounted for three quarters of contractor total costs, whereas now it is less than a quarter<sup>42</sup>.

209. Contractors operate a variety of overhead allocation and recovery methodologies. Some contractors also use a range of methodologies across their business units. Business units may be recovering overheads over a range of contracts, and possibly with more than one customer. This makes overhead recovery a complex and technical task.
210. Recovery rates for overheads are reviewed by a team of over 80 full time accountants within CAAS. Perhaps many more are involved in the process within contractors' costing functions. The approach to validating the appropriateness of contractors' recovery rates is long standing and reasonably robust<sup>43</sup>.
211. The issues with overhead recovery are not around the technical solution but with how recovery rates are agreed and used. Agreement of recovery rates is a negotiation between contractors and the MOD. It is not a contractual agreement; agreed rates are communicated to commercial staff on both sides but there is no compulsion to use them. In general these agreed rates are used; however, failure to reach an agreed rate is not uncommon, which undermines the whole process.
212. The recommendation outlined in Part 1, namely that the SSPR includes monitoring adherence to single source regulations, should include a review of rate negotiation and usage. Equality of Information principles and processes, which provide the MOD with cost investigation rights under single source procurement, do not currently extend to the agreement of overhead rates.

**Recommendation:** The open book and Equality of Information provisions recommended in Part 1 should extend to rates agreements.

213. Despite the robust approach, there are still ways that overhead can be over, or under, recovered. Firstly, forecasting hours and overhead costs is not always easy and estimates can be wrong. Secondly, overhead costs are typically fixed but the direct costs they are loaded onto are variable. Any change in the requirements/timescales will change direct costs, and add volatility to overhead recovery. Lastly, changes to any one contract within a business unit will have a knock-on impact on the overhead to be recovered from any contracts which are not yet priced. The net result is that overhead recovery can be inaccurate. To address this we have recommended, in Part 1, that large single source contractors provide an annual overhead report that allows the MOD to compare actual overhead costs with the total recovered.
214. The technical complexity and scope of the overhead recovery process has been expanded in recent years. TCIF contracts require estimated rates to be used when placing the contract and actual rates to be agreed for all the years a contract is in place, rather than just agreeing forecast rates when pricing a new contract and reconciling the final costs. Long contract durations, requirement change, and contractors reconfiguring their business units each make TCIF reconciliations more difficult. In addition, some long term

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42. Labour currently accounts for approximately 17% of costs, and continues to decline.

43. Contractors have to allocate overheads between single source, competitive, and non-MOD work using a consistent formula which is reported to the MOD, known as the Questionnaire on the Method of Allocation of Costs (QMAC). Actual overhead costs and labour hours are based on the accounts of each business unit and are thus subject to internal due diligence as well as MOD challenge.

capacity and capability contracts identify and pay for overheads in a different way, so these overheads have to be tracked separately. Over the same period, the MOD resource available to perform rates agreements has reduced. There is a risk that, without the right resource, the overhead recovery process may fail.

**Recommendation:** If the MOD wishes to retain the current single source overhead recovery approach, it should continue strengthening the CAAS resource engaged in rates agreements and TCIF reconciliations.

215. An alternative option would be to give up the current single source overhead recovery system. For example, overhead allowances could be based on a simple percentage of costs, with guidance on when a given percentage was appropriate. Another alternative would be to use a method which includes efficiency targets, similar to the 'RPI-X' system used by utility regulators.
216. Although these options are simpler, they do not have the protection afforded by the current approach and the risk of significant over or under recovery of overhead would increase.
217. Industry is likely to be wary of this kind of change. A simpler approach, such as using a percentage of costs, would lead to winners and losers. Evidence would be needed to negotiate a particular percentage or efficiency target, and this would need significant resource.
218. A full consideration of the costs and benefits associated with moving to a new method for recovering overhead has not been undertaken. Whichever approach is used for overhead recovery, there is the opportunity for the MOD to price in efficiency targets - but setting these targets requires management information that is not currently available to the MOD. Our view is that the most important issue is transparency and the timely reporting and monitoring of overheads, rather than the detailed recovery methodology.

## Commercial and Financial Controls

219. Like other parts of the public sector, and in contrast to the private sector, within the MOD financial performance is not the paramount driver of policy and behaviour. The role of the MOD is not to make a profit, but rather to defend the nation and strengthen peace and stability. This requires military capability supported by the right equipment and infrastructure. The culture in the MOD procurement is, unsurprisingly, dominated by the need for capability.
220. The consequence of commercial and financial failure is also not as severe as in the business world, resulting in political embarrassment rather than possible criminal charges or business failure. Policies and guidance are in place, often based on good practice that can be found within the private sector, but the dominant culture within the MOD places finance and commercial in a more peripheral role than would be acceptable within business. Although this is understandable, many billions of pounds are being spent and without the right commercial and financial controls, both value for money and a balanced budget are at risk. The key point is that capability, financial, and commercial controls need to be in more appropriate balance.
221. The analysis that follows highlights the consequences of having capability, financial and commercial controls out of balance. In commenting on these issues, we are very

aware that much has been, and is being, done by the senior MOD leadership to improve matters. Our comments are intended to highlight the vital importance of achieving this better balance if value for money is to be achieved, and to provide the rationale for the reforms to single source procurement regulations that we propose. We see these reforms as complementary to the management and organisational changes that are underway, and see both as critical in achieving value for money for taxpayers.

222. DE&S is responsible for delivering equipment-based capability requirements. It is organised into project teams who each deliver specific projects and who have significant autonomy. The total DE&S budget is decided by head office, but once transferred to DE&S it is then divided and subdivided into low level budget lines drawn upon by project teams.
223. In line with standard private sector (and government) practice, a project team needs an approved business case in order to spend its budget. The bigger the project, the greater the assurance and scrutiny applied to the business case. The largest projects, which are our focus, go to the IAC for approval. The IAC is responsible for ensuring value for money, and approving most project-level financial and commercial boundaries. If approved, projects are given approval limits against key performance requirements, cost and time (known as the PCT envelope). Any breach of these limits results in projects having to seek re-approval at the IAC.
224. Projects need an approved business case prior to starting contractual negotiations, so the IAC reviews business cases rather than contracts. IAC approval of a business case is therefore contingent on later commercial due diligence. This commercial due diligence is a relatively new process, and there is limited resource available for the task. This puts the MOD at significant risk, particularly where there is not enough resource to conduct in-depth reviews on all large projects. There are also some specialist areas, such as tax, where civil service salaries do not attract sufficient expertise.
225. The need for in-depth review on all multi-million pound projects is clear. Analytical skills are required when the MOD takes on financial risk. For example, a TCIF contract may pass 50% or more of the cost risk onto the MOD. Unless this risk is evaluated, there is no way of knowing whether or not the project has breached its approval limits; the cost is not limited to the headline price of the contract but also needs to include an assessment of MOD cost risk. Without this protection, there is no way of knowing if a contract represents value for money.

**Recommendation:** Large contracts should be subject to independent commercial due diligence and legal review prior to contract signing. There should also be an evaluation of the financial risk taken on by the MOD. The MOD should ensure that a realistic provision for this risk has been made within the department's budget.

226. Each year the MOD engages in a process called the 'Planning Round' (PR) to reset the overall budget and project requirements. In most cases it also resets the lower level budgets, although there is discretion within DE&S to re-allocate at this level. The PR starts by comparing the total MOD budget set by HM Treasury with current cost forecasts to evaluate the shortfall. A whole series of possible 'options', typically delays or scope reductions, are sent to project teams who send back the likely savings of each option. There is then a very difficult prioritisation process where each Service argues the case for its projects, which is overseen by DG Fin, Deputy Chief of Defence Staff - Capability, and other groups within head office. In the last PR, over 500 options were considered.

227. The staff within project teams typically wish their project to survive and thrive. Project team leaders have often been in post for a short period, such as two years (though this is changing), have looked to their service for future promotion, and have not wanted the project to fail under their stewardship. They also understandably believe in the value of their project. Large projects have historically been under threat from centrally driven saving measures, often coupled with an unrealistic budgetary provision. Project team leaders have found themselves in the difficult position of having to balance supporting centrally driven attempts to balance the overall MOD budget at the same time as supporting their customer (capability), their project, and their career.
228. Unfortunately, it has been a negative sum game. With each Project Team (PT) competing for scarce resource, the outcome is that projects have been delayed rather than curtailed or cancelled, both pushing costs into the future and as a result escalating costs rather than controlling them. As a consequence, long-term financial and commercial risks have increased, costs have risen, and the pressure on future resources has increased. The repetition of this vicious cycle meant the MOD has received less capability for the money it had available than it could have. Looking at the overall equipment programme, the dominance of capability over commercial and financial controls at the PT level actually reduced the total capability available to the MOD.
229. This is not to put most of the blame onto PTs. It has been the combination and interaction between an over-heated central budget and the survival behaviour of PTs that has created this vicious cycle. What have been needed are the hard choices required to create a realistic overall budget, so that PTs no longer face the dilemma of having to choose between capability and commercial and financial factors. This process is underway with the current organisational changes being implemented. We strongly support these changes and have focused our primary recommendations to support and strengthen them. However, we also believe that there are improvements that could be made to the financial and commercial controls that apply to PTs, and that these would benefit overall equipment capability.
230. As we have noted, there is currently considerable change underway within the MOD in this area. In this, it is important that the PTs have adequate support and access to the skills of appropriately qualified financial and commercial people, who themselves have access to senior management within the finance and commercial functions. Such access and support is essential to ensuring that appropriate consideration is given by the PTs to the input from these functions when taking procurement decisions.

## **Requirement Change**

231. Both industry and sources within the MOD have advised us that requirement changes have typically occurred very frequently. This has been particularly the case in large single source contracts (see Annex C). Delays and reductions in scope have arisen from past attempts to bring costs in line with budget. Other requirement changes have come from a constant desire and/or need to improve on a project's originally specified capability. In some cases change has been absolutely necessary; however, it is a generally expressed view that far more change has occurred than was essential. Possible reasons given for this have included insufficient clarity in the original specification, and 'entryism': deliberate under-specification to bring the initial price in line with available budget, followed by scope-creep to bring it back in line with requirements.
232. A desire for improved project capability is understandable but it has come at a cost greater than the simple increase in the price. This additional cost is not felt immediately by the project, but affects the project in the long-term and creates negative impacts across the overall equipment programme.

233. Requirement changes have usually increased costs disproportionately to the increase in capability. More design work has been needed to incorporate the change into the whole system than there would have been had it been specified earlier. Perhaps more significantly, change has also introduced delay. Given that most projects have high fixed costs, delay substantially increases the final cost of the project even if in-year costs remain relatively unaffected.
234. Constant change also seriously undermines commercial leverage, which increases prices further. In contracts where the costs were substantially higher than originally forecast, there have been cases where contractors have attributed the bulk of this to MOD changes, and the MOD did not have enough information or available skills to challenge this. Large changes have occasionally triggered a complete re-opening of the contract. The MOD has then been locked into using a particular contractor, with substantial sunk costs, and without any real threat of walking away. This is hardly the best position from which to negotiate a good price, and there is evidence of contractors having increased their original cost estimates as part of the new deal.
235. Unless requirement change is restricted to the essential, the MOD will find it difficult to control its budget. The only way of doing this is to have controls in place to limit the freedom of PTs to make changes. Changes must be better assessed for value for money and their impact on the overall costs of the project.
236. In theory, these controls can be applied through the IAC process. If requirement change means the project breaks its approval threshold, it needs to seek IAC re-approval. A business case for the change would then have to be either approved or the change would be stopped. Ironically, one reason why this has not always happened has been the frequent delays and reductions in scope initiated to balance the budget, as explained below.
237. Multiple delays and de-scopes mean the original business case becomes less relevant. If a project is given an approval limit of £300m for 10 units, and is subsequently asked to halve this to 5 units, what should the new cost approval limit be? It is not £150m as the contractor has substantial fixed and transitional costs. There is limited resource available to do a proper assessment and re-set the limits for all options across all projects. The project can be left with its original £300m approval limit despite only needing to provide half the number of units. In this hypothetical example, although the project still needs to find enough budget to pay for requirement changes, it no longer needs to justify value for money at the IAC.
238. The French have a more rigorous approach to technical change than the UK. All material specification changes require a business case to be approved. The impact on the project-level budget lines, set annually in law through the 'Loi de Programmation Militaire', is assessed over the life of the project.

**Recommendation:** Any technical change (or batch of changes) above a certain materiality level is subject to a separate investment appraisal, regardless of whether or not the project is still within its overall approval threshold.

## Risk

239. The relationship between profit and risk has already been discussed. This section looks at allowances for risk that are included within the costs, rather than the impact of risk on a fair rate of return.

240. The standard approach to agreeing a price in single source procurement is to add up all the estimated costs, add an allowance for risk, and then add profit on top. These risk allowances, known as 'risk contingencies', typically account for between 5%-10% of the total cost or circa £1bn per year across the whole equipment programme. Risk is thus material enough to warrant careful consideration.
241. The process of risk identification, quantification and modelling is usually undertaken by the contractor to produce an estimate of cost risk. This is a complex process with considerable judgements involved. Those judgements can have a very significant impact on the quantum of risk the model produces. Considerable expertise needs to be available to the MOD to understand these risks and to negotiate with the contractor. We judge there is insufficient expertise within the MOD, and that value for money will inevitably suffer when the contractor has both greater knowledge of the data and greater expertise.
242. One of our primary recommendations, namely consistent and regular contractor reporting, will help with this process. Contractors will report on drawdown from risk contingency. Over time, and over a wide portfolio of projects, this will allow the MOD to benchmark total risk as a percentage of price and build a picture of the most material risks. This needs to be supplemented, however, with increased skills and experience.
243. We have been advised that the MOD is evaluating its risk management processes, including the possibility of recruiting a Chief Risk Officer. The approach to risk management would benefit from development, including creating the ability to have an overview of the cost exposures that exist throughout the portfolio of procurement contracts, not least of which is rationalisation costs. Risk on the scale that exists in single source contracts would benefit from quantification and management on a portfolio basis.

## **Internal Audit**

244. The main audit function within the MOD is the Defence Internal Audit directorate which reports to the Defence Audit Committee and the Accounting Officer. It is not currently involved in the process of evaluating DE&S' performance in managing procurement contracts, nor in reviewing the financial outcome of projects. One reason for this is likely to be the complex and technical nature such an evaluation requires, and the fact that the NAO together with the PAC performs a similar audit function, albeit external. Nonetheless, there is currently a gap in the MOD's internal audit capability.
245. The post-costing reviews performed by CAAS provide some of the financial and commercial assessments that would be expected from an internal audit of DE&S procurement. However, because CAAS sits within DE&S, there is potential for a conflict of interest which ill fits an internal audit function.
246. Later on we recommend the setting up of a Single Source Regulations Office (see Key Recommendation 7) which would have both the skills and access to the right information to provide assurance regarding efficiency and value for money in procurement outcomes. This additional independent assurance and scrutiny over MOD's single source procurement would help mitigate the risks arising for limited internal scrutiny of this area.
247. We also propose that the Defence Audit Committee should ensure that there is adequate coverage of DE&S' activities in its plan, including contract monitoring and post-costing activity.

# Part 3: Independent Assurance

## Introduction

248. We have evaluated extensively the consequences of the single source market imperfections, and considered whether the recommendations we have made in this report so far are adequate to restore an acceptable balance between industry and the MOD, and whether they address behavioural issues arising from imperfections in the market. We believe restoring the balance is essential to providing incentives for increasing efficiency, and aligning MOD incentives, to ensure there is value for money for the UK taxpayer.
249. The imbalance occurs for the following reasons:
- a. for key capabilities, particularly where freedom of action needs to be maintained, there is often only one contractor in the UK defence market;
  - b. the current framework does little to replicate the drivers for efficiency that would exist in a market with effective competition;
  - c. the prioritisation of capability over financial and commercial within the MOD has undermined the MOD's commercial leverage with industry;
  - d. the current arrangements do not provide adequate disclosure of costs during a contract for the MOD to evaluate whether it is receiving value for money;
  - e. the MOD cannot compete on an equal footing with contractors for key skills, such as financial and commercial, and will always operate at a disadvantage;
  - f. there is a significant asymmetry of bargaining positions, with an information advantage on the part of industry, and of the power to impose change on the part of the MOD.
250. We have concluded that these forces are significant and the recommendations that we have made so far would not, of themselves, be sufficient to create an environment for single source defence procurement where taxpayers can be assured that they are receiving value for money.
251. We do not consider it accidental that in all the other major NATO member countries with significant single source procurement there is a legal framework in force, designed to address the issues associated with ensuring a fair deal for taxpayers. Notably, in France and the US, there are legal frameworks that strictly cover both aspects of the procurement process and defence budgets.
252. In the US, the Department of Defense (DoD) budget is controlled through the Defense Subcommittee on Appropriations and the House Committee on Appropriations. The DoD budget allocates funds down to each individual DoD agency and to each branch of the military. Funding in each agency is defined down to individual programme level.
253. In France, in addition to strict laws governing the process and pricing of single source procurement, there is oversight and approval of multiannual defence budgets by the Assemblée nationale. These budgets are binding, though in-year breaches of limits may

be authorised by the President. Although aspects of the French regime were attractive to us, it is underpinned by elements that would be difficult and slow to incorporate within the UK<sup>44</sup>.

254. The independent assurance of MOD procurement processes is comparatively less rigorous and consists largely of reports by the National Audit Office, and parliamentary approval of annual budgets. We have concluded that the approach to independent assurance of defence procurement needs to be augmented, and we have evaluated a number of alternative solutions to the problem of compensating for the quite pronounced imperfections in the market. These alternative approaches, which were all proposed to us during our discussions with relevant stakeholders, are considered in the follow sections.

## **Our Preferred Solution**

255. The Review Board primarily oversees the calculation of the profit element in single source procurement, manages the GACs, and provides arbitration in specific circumstances. We see considerable advantage in transforming the Review Board into a new body which we have called the Single Source Regulations Office (SSRO).
256. The purpose of the SSRO would be to define and maintain a framework that encourages efficiency and value for money in MOD single source procurement, compensating for the absence of competitive market pressures. The roles of the SSRO would include taking on the functions of the current Review Board (with the exception of arbitration), but would also fulfil a wider remit in line with this purpose. The SSRO would not have executive powers, but would enhance the information available to the MOD. The following roles are proposed:
- a. ensuring consistent and high quality cost information flows from contractors to the MOD through appropriate access rights and regular reporting;
  - b. analysing this information to help the MOD agree prices that incorporate strong but realistic efficiency targets;
  - c. reporting to the MOD Accounting Officer on the realism of MOD budgets allocated to major single source projects;
  - d. providing assurance of MOD's adherence to procurement practices that help ensure value for money and supplier efficiency;
  - e. monitoring and ensuring compliance with the single source pricing regulations, and managing their change over time;
  - f. overseeing and setting the profit rate mechanism and the GACs, taking over these functions from the Review Board. This would include making provision for an appropriate relationship between profit and risk;
  - g. monitoring and encouraging the use of SMEs within single source procurement.
257. The single source pricing framework we propose in our earlier recommendations would allow the SSRO to fulfil the above roles. For details of the activities that would be required to meet these roles, see Annex E, paragraph E185. The SSRO would not have executive powers - for example it would not price contracts or set budget levels - but it would create transparency through data collection, analysis and reporting. The SSRO would provide independent assurance and would report to the relevant branch of the

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44. For example the French equivalent of DE&S, known as the DGA, is staffed by primarily by engineers who come primarily from specialist polytechniques, sponsored by the government. They have substantial technical experience and are independent from any one service.

executive. Given the SSRO will be focused on single source defence procurement we propose that this should be the MOD. We see advantage in some of the information generated by the SSRO being provided to HM Treasury; however this is a matter for agreement between MOD and HM Treasury. Given the commercial sensitivity of the information (such as supplier cost forecasts and MOD budget data), the reports generated by the SSRO would not be publicly available.

258. To fulfil its function, the SSRO would need to deploy high-level financial and cost estimating expertise.
259. We see the existence of the SSRO as helping to reinforce the important changes in financial and commercial controls referred to in Part 2 that are aimed at overcoming the culture within the MOD for capability needs to prevail over long-term financial planning. It would provide effective mechanisms for scrutinising single source defence contractors, alongside strengthened external scrutiny of the MOD budgetary provision allocated to single source contracts, to help ensure value for money for taxpayers. Such enhanced assurance would strengthen the position of those within the MOD seeking to ensure proper financial and budgetary control is in place, and therefore would reinforce, rather than cut across, the organisational and decision-making changes currently being undertaken.
260. The SSRO would accelerate the time it would otherwise take the MOD to become an intelligent customer. We note that government procurement processes in other major defence spending countries, such as the US and France, are governed by laws that provide important alternative means of external scrutiny and budgetary constraints. We have considered this alternative, but have concluded that the SSRO is a preferable approach which builds on UK experience and practice.
261. The one role of the Review Board we recommend discontinuing is that of arbitration. Arbitration requires highly specialist skills yet is likely to be fairly rare (the Review Board has performed a single arbitration in the last twenty years). It would not make financial sense for the SSRO to pay for and maintain this capability. Furthermore the SSRO would be a Government body which, unlike the Review Board, is not primarily designed to be a mediator between the MOD and industry. As such it may not be regarded by contractors as being sufficiently impartial.
262. We recommend replacing the current arbitration role of the Review Board with the general dispute resolution terms that would already be included within MOD single source contracts. Where this is not possible we recommend a professional arbiter takes on the role.

## **The Alternatives**

263. We have considered a number of mechanisms through which external scrutiny could be enhanced, all of which were proposed to us in our consultations with relevant stakeholders. Options included:
  - a. the creation of an external regulator along the lines of a utility regulator overseeing control of essential facilities;
  - b. external control of the MOD budget;
  - c. greatly enhanced HM Treasury, NAO and PAC oversight;
  - d. our recommendation, for the creation of the SSRO.
264. The first two involve giving powers over MOD spending to an outside body; the last

two involve no such transfer of powers, but increase the degree of external scrutiny and challenge.

265. We do not believe that the answer is to give an outside body powers over MOD spending. The argument for an external regulator along utility lines is that some of the key facilities involved with single source defence contracting are monopoly facilities developed in public ownership and since privatised. In contrast, the utilities are private monopolies supplying a multitude of private sector customers, and a principal function of regulation is to prevent the exercise of monopoly power to the detriment of those customers. In the case of defence spending, the customer is the MOD, which has considerable purchasing power of its own. An independent regulator would also, in effect, need to have powers over the decisions of government, which raises both constitutional and practical problems. It is the wrong answer to require an independent external regulator to provide a substitute for intelligent contracting by the MOD.
266. The idea of external control of the MOD budget is equally problematic. Whichever body controls the defence budget would need considerable technical expertise and would be subject to the same pressures and lobbying as the MOD is at present.
267. An alternative to the enhanced external scrutiny and challenge that we see the proposed SSRO providing would be to enhance the current scrutiny by HM Treasury, the NAO and the PAC. This would require HM Treasury and/or the NAO greatly to enhance their defence industry technical skill base, particularly in financial analysis and cost estimating. We do not favour this option because it would be beyond the remit of these bodies to scrutinise contractor performance and efficiency. We see considerable advantage in giving one body responsibility for scrutiny of value for money issues, with the ability to examine both contractor efficiency and MOD processes. We also consider that the SSRO should report to the executive, highlighting issues as they arise to the MOD.
268. At the heart of our proposals is the need to ensure a much more effective flow of information on MOD projects on a forward-looking, realistic basis. Without that, it will be impossible to achieve effective budgetary control of the processes involved in complex defence procurement. Our judgement is that the SSRO, receiving data both from the MOD and the contractors in the way described in detail in Annex E, provides the best mechanism for achieving this.
269. We anticipate at least two objections to our proposal for an independent SSRO. Firstly, it means that the MOD would be subject to scrutiny both by this Office and by the NAO and HM Treasury, which might be seen as unduly duplicative. However, we do not think this objection has weight. We expect that the SSRO would develop such expertise and authority that HM Treasury and the NAO would come to use its analysis in their scrutiny roles. While respecting commercial sensitivities, the SSRO would provide whatever information the NAO required for it to fulfil its duty to scrutinise public spending. The NAO may well wish to use SSRO expertise when reporting to the PAC. We do not see the SSRO as in any way cutting across, or diminishing the NAO's key role of oversight of public expenditure answerable to the PAC.
270. Secondly, it may well be said that the SSRO would lack teeth. We have already spelt out why we think formal powers to determine MOD spending would be inappropriate. However, we do think that more powerful, independent scrutiny and challenge, together with the considerably enhanced information flows on multi-year budgets that will result from this, would work together with the organisational and decision-making changes already underway in the MOD to put future single source procurement on a sounder basis. There is a useful analogy with the approach the Government has taken to enhance

macroeconomic fiscal stability through the creation of an independent scrutiny body in the form of the Office of Budget Responsibility.

271. To fulfil its role, the SSRO would require powers to gather information on single source defence contracts from the MOD and contractors (in line with our recommendations concerning the new SSPRs). It is expected that these powers would be agreed with industry, so that industry and MOD sign up to a joint code of conduct. This code of conduct would be incorporated into single source contracts through a special condition that we envisage would be mandated in MOD commercial policy.
272. In the event that such agreement is not forthcoming, we could then see the need to resort to legislation to formalise such powers (following the example noted above of other leading defence procurement countries and the Gray Report's recommendation for legislation). We would be concerned that legislation in this area would sit uncomfortably with the UK's processes and practices for controlling government spending, and would prefer that recourse to legislation is avoided, not least because it may result in a more cumbersome and bureaucratic system. In the event of a failure to agree on the voluntary arrangement we have outlined here, recourse to legislation may well be necessary to improve current arrangements.

## **Funding and Skills**

273. Since the inception of the current Yellow Book regime, the MOD has, in effect, funded the imbalance of skills and information between the MOD and industry, through payments to contractors for overhead recovery that include the cost of specialist financial and commercial expertise. Alongside the erosion of MOD skills, the resulting informational imbalance is one of the underlying issues the SSRO would address.
274. The SSRO should be funded by a levy upon the profit rate applicable to future single source contracts. It is expected that this levy would be less than ten basis points (i.e. 0.10%). The shortfall in funding during the transition to the new arrangements should be funded by the MOD.
275. The SSRO would require a range of analytical skills in order to undertake, inter alia, validation and analysis of the contract and contractor information provided to it, evaluation of contractor efficiency metrics, determination of the annual profit rate, etc. We see these skills as being additional and complementary to those in CAAS.
276. These strong analytical skills would give the SSRO the necessary capabilities to provide independent assessments of cost and risk forecasts and comparison with the MOD budget allocated to single source projects. SSRO activities and outputs are summarised within Annex E.
277. The size of the SSRO needs to be consistent with its roles and activities. With the suggested materiality thresholds, we have estimated that the SSRO would be monitoring and analysing circa 100 contracts and 20 suppliers<sup>45</sup>, although there will be a transition period before this volume is reached. The annual SSRO budget is estimated to be less than £7m, representing less than 0.1% of current annual single source procurement, based on the SSRO employing between 30 and 40 staff.

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45. SSPR review team estimate based on MOD commercial data.

## Conclusion

278. We have considered this recommendation at length, as we are aware that this is central to several of the key issues for this review. In bringing balance and changing behaviours, we aim to ensure that industry receives an appropriate return, with rewards for managing risk and improving efficiency, thereby ensuring continued participation by companies operating in the UK defence market and potentially encouraging new entrants. Equally, we re-iterate our firm recommendation that the MOD must focus on reducing the total cost of projects, not on reducing the margins or camouflaging the true scale of financial risks and associated costs.

**Key Recommendation 7:** The Review Board should be replaced by a Single Source Regulations Office (SSRO) with a remit to scrutinise single source defence procurement. The SSRO would define and maintain a framework that encourages efficiency and value for money in MOD single source procurement. It should be an independent Non-Departmental Public Body, sponsored by the MOD. After appropriate consultation, the SSRO should draw up a code of conduct and an associated special condition for inclusion within MOD single source contracts, and should monitor compliance by both industry and the MOD. It should have appropriate information gathering powers to enable it to assess the efficiency of contractors. It should also be charged with assessing whether the MOD is conducting its single source procurement so as to promote value for money for the taxpayer.

# Part 4: SMEs and Exports

## Small and Medium Enterprises

279. The coalition Government has stated that it will promote procurement from small business, in particular by introducing an aspiration that 25% of government contracts should be awarded to SMEs. The MOD is considering a number of ways to incentivise SMEs. It is not our intent to consider these initiatives in this report (further details are at Annex H).
280. We have been assisted in our discussions by A|D|S<sup>46</sup> who facilitated meetings with SMEs to discuss their experience of contracting directly with the MOD and also contracting with prime contractors, as subcontractors on MOD projects. We were encouraged by Government's recognition of the importance of SMEs within the defence industry. Our recommendations are designed to encourage greater participation as another tool to increasing efficiency in industry.
281. We have made recommendations regarding contractor reporting that are designed, as part of our open book approach, to provide greater transparency to costs. These recommendations require regular reporting on contract performance; submission of a company overhead plan; and reporting on overhead recovery.
282. At lower contract values, the right balance between the costs and benefits of improved transparency and increased reporting changes. For contracts with a low financial value, exemptions from our recommended reporting requirements are appropriate to avoid what could otherwise be a potentially disproportionate administrative burden.

**Key Recommendation 8:** Single source contracts in excess of £5m in value but less than £50m should be exempt from a number of SSPP reporting requirements, for example, Quarterly Contract Reports. Below £5m, no specific SSPP reporting should be required, minimising the administrative burden for SMEs.

283. We have earlier recommended a new approach to determining the profit rate for single source contracts. Similar to the reporting thresholds, we also believe that a simplified methodology for determining the profit rate of lower value contracts should apply.

**Recommendation:** For single source contracts below £5m in value, a simplified flat-rate level of profit should be applied.

284. Taken together, the reduced reporting requirements and simplified profit rate will considerably ease the application of our recommendations on direct contracts with SMEs.
285. We recognise that another significant means of SME engagement with MOD procurement is through subcontracts with large primes. In our discussions with the large contractors, we were told of the extensive use made of subcontractors and SMEs. To promote increased SME participation in defence, encouraging primes to make more use of SMEs may be of greater benefit than increasing direct MOD procurement with SMEs.

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46. A trade organisation for advancing the UK Aerospace, Defence, Security and Space industries.

286. Subcontractor costs often represent a significant element of large contracts. To ensure value for money for the UK taxpayer, it is important that prime contractors make sure subcontractors are selected in a way that delivers value for money to the MOD. Maximising the use of competition is likely to support this.
287. There is recognition that SMEs are the source of much innovation and can often compete at lower cost levels than primes. SMEs can make a significant contribution to innovation and improving efficiency by working with prime contractors.
288. The MOD has a role to play in encouraging the use of subcontractors on major contracts at the time of negotiation, and ensuring there is adequate consideration of SMEs and other subcontractors prior to letting contracts.

**Key Recommendation 9:** Contractors with single source contracts totalling above £100m in value should produce an annual statement on their contracting with SMEs. It should explain how relationships with SMEs are managed and the processes that the prime contractors have in place to support and foster SMEs in their role as subcontractors.

289. To support efficiency and value for money throughout the supply chain, where a subcontractor to a single source contract is itself selected on a single source basis, then the SSPR requirements upon the prime contractor should also be flowed down, by the prime, to the subcontractor using appropriate contract terms and conditions. Such flow-down should recognise similar exemption thresholds to those in the SSPR. We foresee practical and commercial difficulties in applying this principle throughout the supply chain, where the commercial relationship between the MOD and contractor becomes increasingly diluted through each tier. Therefore, we recommend that this flow-down should only apply from the first tier to the second tier of the supply chain - i.e. one level down from the first contractor.
290. We judge that this principle of flowing down SSPR requirements to the second tier of the single source supply chain is important in achieving value for money in single source procurement, as we believe a significant value of subcontract activity is let on a single source basis. Currently, this activity is largely opaque to the MOD<sup>47</sup> and consistent flow-down will ensure that a wider scope of single source procurement activity is included in the new SSPR arrangements.

**Recommendation:** SSPR requirements should be flowed down from the first tier to the second tier of single source contractors.

## Innovation

291. Innovation was not included in the terms of reference of this report, though it is clearly relevant to the performance of the defence sector, both primes and SMEs, and therefore to efficiency and value for money, which are central to this report. Through its single source procurement, the MOD supports a considerable level of innovation, driven either on the demand side by the constant aim to enhance capability or on the part of contractors (both prime contractors and SMEs) devising new products and processes. We note, for example, the continual advances in materials research to produce lighter and stronger materials to enable ever-higher performance of jet fighter planes. Such innovation can have wider application in industry beyond the defence sector. Similarly,

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47. Existing MOD contract terms (DEFCONs) provide for flow-down of terms, though in practice this is not enforced.

research in other sectors may have application in the defence sector: for example, lightweight alternatives to the use of hydrocarbons for electricity generation could well have important battlefield applications.

292. In other parts of Government, much has been done, through the work of the Technology Strategy Board under the auspices of the Department for Business, Innovation and Skills, to encourage collaboration between government departments to use government procurement more effectively to promote UK innovation, with benefits to the government as purchaser, to economic performance more widely, and therefore ultimately to the taxpayer. This collaboration has involved the main procuring departments, namely the Department of Health, the Department of Transport and the Department of the Environment. The MOD has not been part of this initiative. Clearly there are important national security issues involved in innovation in the defence industry, and many innovations may need to remain classified. However, we do see benefit in the MOD exploring with other departments and the Technology Strategy Board how greater joint collaboration could help innovation with benefits over time to the MOD procurement budget and value for money, as well as more broadly to the Government innovation agenda.

## Exports

293. Acquisition of defence equipment across the world is generally based on a trade between cost and capability. We consider that in most defence export markets, the primary drivers are geopolitical relationships between nation states, and the capability of the equipment. Cost is often a consideration only after these primary aspects have been satisfied.
294. Exports are heavily sector specific. For example, there is a no export market in nuclear submarines, whilst the markets for medium weight armoured vehicles are substantial and more competitively driven. Consequently, the level of UK defence exports varies considerably by sector, with the export of fast jets being the most significant in recent years.
295. There are two broad means of enabling UK industry to compete better in global defence markets - defining capability that has a potential market beyond the UK MOD, and further improving the cost competitiveness of UK industry.
296. Firstly, in specifying capability, we observe that in France the potential for export orders is evaluated at the specification stage of projects, whereas in the UK the focus is upon the specific requirements of the MOD (being the body specifying the requirements). These requirements may often restrict, either on cost and/or technology terms, the potential export market. Export orders for equipment also required by the MOD could have a direct benefit on value for money to the taxpayer by generating economies of scale. Other indirect benefits may include wider future service and supply options, and greater obsolescence and supply chain resilience.

**Recommendation:** As in the French system, export potential should be formally considered as part of the MOD capability requirement specification process.

297. Secondly, further increasing the efficiency of UK contractors will make their equipment more cost competitive in international markets, where these are open. We have made several recommendations to measure and improve the efficiency of equipment procured on a single source basis for the MOD. These recommendations are driven by the desire to improve value for money to the UK taxpayer; however, they will also have an indirect benefit to export potential.

# Transition

## Transition from Yellow Book Regulations to Single Source Pricing Regulations

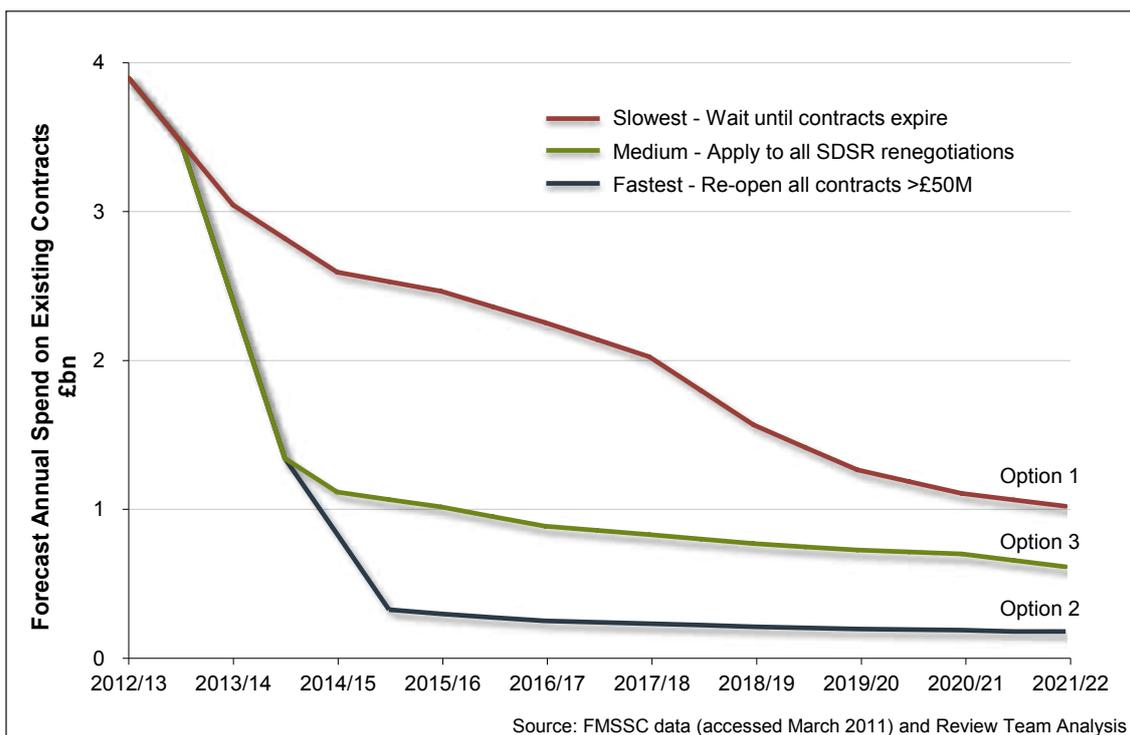
298. Current Yellow Book regulations are enacted in two ways: through terms and conditions included in contracts, and through custom and practice. The use of custom and practice is unsatisfactorily vague - where there is a claim for costs that the MOD is expected to pay, such as rationalisation and redundancy costs, this should be underpinned by commercially agreed conditions rather than relying on reasonable expectation. The MOD should be able to identify the extent of such potential liabilities to which it is exposed.
299. The revised single source pricing regulations should be enacted through a code that is given legal force through a special condition that will be mandated through MOD commercial policy. The inclusion of this special condition will determine that single source pricing regulations will apply. For future contracts, the absence of this special condition will indicate that there can be no reasonable expectation that SSPR protections and provisions (or indeed the old Yellow Book regulations) should apply to either party.
300. For existing single source contracts there are 3 issues:
  - a. how quickly we can move from existing arrangements to new arrangements;
  - b. existing DEFCONs that will need to be changed given new arrangements;
  - c. reasonable expectations based on the current system.

### Moving from the existing arrangements to new arrangements

301. The slowest implementation option is to wait until current single source contracts expire and apply the SSPRs only to new contracts. Our analysis, based on a limited but readily available dataset, shows that the annual value of existing Yellow Book contracts declines from £4bn in 2012 to £2bn by 2017. There is then a long tail that continues for approximately a further 10 years.
302. The fastest implementation option would be to re-open all the most material single source contracts, say those above £50m representing roughly 75 contracts<sup>48</sup>. This would account for roughly three quarters of the value of current single source contracts. If we assume that the renegotiation takes roughly six months, the number of Yellow Book contracts would decline significantly faster. By 2014 there would be £0.4bn per annum worth of the current portfolio.
303. A third option exists, namely implementing the new arrangements both in new contracts and in any contracts that are already being re-negotiated as a consequence of the SDSR and other recent announcements. The MOD is currently planning to re-open a number of their largest single source contracts, including foundation contracts. This will accelerate the transition when compared with simply waiting for existing contracts to expire.
304. Figure 5, based on MOD data, shows the value of existing single source contracts under the three different options discussed. The indicative profiles shown assume that negotiations to bring legacy contracts under the new regulations could begin mid 2012/13. The SDSR renegotiations would take priority and be made in one year, with other contracts renegotiated in the following year, reflecting commercial capacity constraints.

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48. There is not the resource to re-open all single source contracts, and most of our recommended changes (such as contract reporting and budget risk assessment) only apply to contracts over £50m in value.



**Figure 5 - Value of Legacy Contracts on Current Yellow Book Regulations, Under 3 Transition Options**

- 305. It should be noted that there is an inherent risk in re-negotiating contracts, namely that it allows both parties to make contract amendments and agree to a new price. The party initiating the re-negotiation will typically have the lesser commercial leverage. The benefit of faster implementation of new SSPRs may be outweighed by this risk.
- 306. We consider that option 3 is the best, and the MOD should focus on incorporating the new arrangements on new contracts and those within its renegotiation programme.

**Existing DEFCONs that will require amendment given new arrangements**

- 307. There are a number of standard MOD conditions in existing contracts that provide referral rights to the current Review Board for Government Contracts (the Review Board). These are embodied in DEFCONs: 650, 650A, 651, 651A, and 652<sup>49</sup>.
- 308. Our recommendations include the replacement of the Review Board with the SSRO. The role of the SSRO does not include providing independent arbitration, as discussed in paragraph 261. It is suggested that a blanket contract amendment is made, through contractor-level agreements, to make the DEFCONs consistent with the role of the SSRO.

**Reasonable expectations based on the current Yellow Book**

- 309. For new contracts, and for overheads, the recommended SSPRs require contractors to report cost forecasts to the MOD. Any significant forecast cost deviations will then alert the MOD and specific arrangements, including duties of mitigation, can be arranged. This will not, however, apply to existing contracts where there is little that can be done to

49. See the MOD Acquisition Operating Framework (AOF), Commercial Toolkit, DEFCONs for more details.

remove the 'reasonable expectations' in place when they were signed. We recommend that the MOD engages with contractors where possible to introduce processes in existing contracts that will highlight costs that are material prior to their being incurred (both direct costs and overheads).

### **Transition from the Review Board to the SSRO**

310. Our recommendations include transforming the current Review Board into a new Non-Departmental Public Body (NDPB): the Single Source Regulations Office. The SSRO would subsume the current functions of the Review Board, except their role in arbitration. The SSRO will take over the Review Board's current role in the management of the GACs and in profit rate setting.
311. The SSRO will not be in a position to take over profit rate setting and GAC reviews before April 2012, so the Review Board should remain at least until the end of the 2012 Annual Review. It is intended that the code and associated special condition incorporating the SSPRs would be ready for inclusion into new and renegotiated contracts by mid-2012, and that the SSRO would be in a position to perform the profit calculation from 2013 onwards.

# Conclusions

312. Much has changed since the Yellow Book regulations were introduced over forty years ago. Then there was considerable financial and cost estimating expertise within the MOD, a skill base within the department that gave an insight to costs, and extensive use of cost plus contracts. So, not surprisingly, profit was the issue on which the single source regulations concentrated. However, the landscape has changed radically in the ensuing decades. The MOD has withdrawn from manufacturing on its own account, has outsourced significant amounts of maintenance, and industry has consolidated, creating a challenge for the MOD in sustaining its expertise in financial management and cost estimating - a challenge exacerbated by the shrinkage of CAAS. The challenge is now being addressed but it will take time to develop the capabilities to be an intelligent customer in the new landscape.
313. The existing regime focuses almost exclusively on the profit element of single source pricing, in part because of the expertise in costing that used to reside in the department. The regime has little to say on the subject of costs and ensuring that there is an incentive for companies to focus on efficiency, thereby driving down costs, for the benefit of the taxpayer and industry.
314. Consolidation within the industry, and the inevitable advantage that contractors have in understanding costs, has placed the MOD at an increasing disadvantage in recent years in understanding the appropriate level of costs for contracts. The changes we have proposed, in particular the open book accounting and standardised reporting on contracts by contractors, are designed to ensure that the MOD can develop the information to become an intelligent customer over a period of time. Without such data, the aim of becoming an intelligent customer will remain beyond the department's grasp. There is no avoiding the need for intelligence (information) if the MOD is to improve as an intelligent customer.
315. Incentivising efficiency is at the centre of our review. The new approach will require a more transparent approach to cost reporting and will enable the MOD to understand contractors' costs more readily. In this environment, contractors need to be rewarded for their efforts in driving down costs. In commerce, profit is the key driver of performance. There needs to be sufficient financial reward for industry to deliver a good deal for taxpayers. Our proposals increase the reward available to companies that deliver improved value for money for the taxpayer.
316. Much of the current impairment in value for money that occurs in procurement is the result of weak financial processes and controls within the MOD, as documented in the Gray report. There are encouraging signs that the new senior executive team within the MOD is gripping the problem of the over-heated budget, but there is a great deal to be achieved. Accurate information on the costs and risks of existing and new projects is essential if the wasteful process of renegotiating contracts as a result of budgetary problems is to be avoided in the future. We recognise that CDM is addressing many of these areas in his current review of DE&S, and we have made recommendations which we hope will be helpful in the development of his Materiel Strategy.
317. Ensuring that industry is being incentivised to be efficient, and is being financially rewarded for success in this regard, is not an activity that it is appropriate for the MOD as a monopsony customer to control without appropriate checks and balances. The

independent assurance provided by our proposed SSRO is essential to ensuring both that industry complies with the open and transparent approach to contracting contained in this report, and also that industry is rewarded for success in delivering efficiency. Its other main role is accelerating the process of the MOD becoming an intelligent customer, and providing assurance that the department has developed sound financial controls and will avoid a repeat of the over-heated budget. Achieving these major changes will be of considerable ongoing benefit to the MOD, the Armed Forces, the taxpayer and industry.

# Summary of Recommendations

## Key Recommendations

**Key Recommendation 1:** Open book<sup>50</sup> accounting should be mandated on all single source contracts as a supplement to the Equality of Information provisions that exist under the current single source arrangements.

**Key Recommendation 2:** All contracts above a threshold value of £50m should be reported on regularly by the contractor, using a standardised format, with annual certification by the contractor's Board.

**Key Recommendation 3:** DEFCON 648A should be modified from what is currently an overly protective regime to one that more strongly encourages contractors to reduce their cost base. We propose that the current 5% threshold, above which MOD receives automatic sharing, should be increased to 10% or 15%. We also recommend that the 75% MOD sharing arrangement might be better set at a lower percentage, such as 50%. We welcome views on these options, and alternatives, in the consultation phase.

**Key Recommendation 4:** An Overhead Report should be submitted annually by all contractors with aggregate single source contracts in excess of £100m total value. The report should have two distinct sections - Forward Planning, detailing planned overhead expenditure that will impact the prices of single source contracts; and Overhead Recovery, detailing under/over recovery of overheads on single source work during the reporting period.

**Key Recommendation 5:** The implicit starting point for the contract profit allowance should be a 'risk free' profit rate. Commercial leads should have to justify any movement away from the 'risk free' rate using an assessment of the contractor's risk. The MOD should develop guidance for commercial negotiators to follow in assessing the extent of the allowance that should be added for risk in the profit allowance.

**Key Recommendation 6:** The SSRO should provide an independent review of the realism of budgets allocated to single source contracts to provide assurance to the MOD that single source contracts are in financial control.

**Key Recommendation 7:** The Review Board should be replaced by a Single Source Regulations Office (SSRO) with a remit to scrutinise single source defence procurement. The SSRO would define and maintain a framework that encourages efficiency and value for money in MOD single source procurement. It should be an independent Non-Departmental Public Body, sponsored by the MOD. After appropriate consultation, the SSRO should draw up a code of conduct and an associated special condition for inclusion within MOD single source contracts, and should monitor compliance by both industry and the MOD. It should have appropriate information gathering powers to enable it to assess the efficiency of contractors. It should also be charged with assessing whether the MOD is conducting its single source procurement so as to promote value for money for the taxpayer.

50. As defined in Annex E, paragraph E152

**Key Recommendation 8:** Single source contracts in excess of £5m in value but less than £50m should be exempt from a number of SSPR reporting requirements, for example, Quarterly Contract Reports. Below £5m, no specific SSPR reporting should be required, minimising the administrative burden for SMEs.

**Key Recommendation 9:** Contractors with single source contracts totalling above £100m in value should produce an annual statement on their contracting with SMEs. It should explain how relationships with SMEs are managed and the processes that the prime contractors have in place to support and foster SMEs in their role as subcontractors.

## Ancillary Recommendations

**Recommendation:** The current adjustment to the profit allowance for intercompany trading should be removed, and contractors should be required to record costs charged to the MOD at their original cost to the group.

**Recommendation:** The GACs should include the general provision that costs charged to the MOD should be both reasonable and appropriate. This should be included in the contractors' annual Board certification (Key Recommendation 2).

**Recommendation:** There are clear situations where certain constructs are not appropriate. There is limited guidance on this in MOD commercial policy. We recommend that the MOD should establish clear rules on the permitted commercial constructs in various situations, and that for large contracts the chosen model should be independently reviewed prior to contract signing.

**Recommendation:** TCIF should be fixed to a 50/50 share between the MOD and contractors, mitigating the misuse of TCIF to meet unrealistic budgetary constraints, and balancing the incentivisation of efficiency with the benefit of value for money for the taxpayer.

**Recommendation:** Review of the commercial construct, and the quantification of the risk that the MOD takes on, should be included in the independent commercial due diligence.

**Recommendation:** In the specific area of concept, assessment, and design contracts, the MOD should reconsider its policy on not using cost-plus contracts. Use of cost-plus should be coupled with strong MOD oversight, supported by appropriate provisions in the contract, to ensure quality and mitigate the risk of waste.

**Recommendation:** Long term capacity and capability contracts should be used sparingly and be under particularly close scrutiny. They should only be entered into if a strong case can be made that the strategic capability requirement will remain under all likely future scenarios for the full duration of the arrangement.

**Recommendation:** The open book and Equality of Information provisions recommended in Part 1 should extend to rates agreements.

**Recommendation:** If the MOD wishes to retain the current single source overhead recovery approach, it should continue strengthening the CAAS resource engaged in rates agreements and TCIF reconciliations.

**Recommendation:** Large contracts should be subject to independent commercial due diligence and legal review prior to contract signing. There should also be an evaluation of the financial risk taken on by the MOD. The MOD should ensure that a realistic provision for this risk has been made within the department's budget.

**Recommendation:** Any technical change (or batch of changes) above a certain materiality level is subject to a separate investment appraisal, regardless of whether or not the project is still within its overall approval threshold.

**Recommendation:** For single source contracts below £5m in value, a simplified flat-rate level of profit should be applied.

**Recommendation:** SSPR requirements should be flowed down from the first tier to the second tier of single source contractors.

**Recommendation:** As in the French system, export potential should be formally considered as part of the MOD capability requirement specification process.

318. Further details of the working practices flowing from all of the above recommendations can be found in Annex E - Recommended Solution.

# Next steps

319. Once published, this report will be followed by a consultation period with industry and across wider Whitehall, led by the MOD. This consultation will run until the 6th January 2012. Responses to this report should be provided using the website [www.defenceconsultations.org.uk](http://www.defenceconsultations.org.uk) (comments visible by all), the email address [DGDCDCC-Comms@mod.uk](mailto:DGDCDCC-Comms@mod.uk) (if you wish comments to remain confidential), via industry trade bodies (such as the CBI, A|D|S, Northern Defence Industries, and the Federation of Small Businesses), or by post to:

**Single Source Pricing Regulations team**  
**Zone 5.N.13**  
**MOD Main Building**  
**Whitehall**  
**London SW1A 2HB**

320. For further details on the consultation terms, including on confidentiality disclosure, please see the above website.
321. Consultation on all matters within this report is welcome. However, there are two recommendations where we outline options, shown below, and comments on these would be appreciated:
- a. the approach for relating profit and risk. We have recommended the SSRO publishes a risk-free rate, together with a profit range. The actual profit rate to apply will depend upon the project-level cost risk taken on by contractors and be based on a consistent approach. We invite comments on the nature of this approach;
  - b. the automatic pain and gain share provisions to be applied to firm and fixed contracts (currently implemented via DEFCON 648a). We have recommended that automatic pain and gain share should apply if actual profit rates differ from the intended rate by more than either 10% or 15%, and that the MOD share should be either 75% or 50%.
322. Once consultation is complete, it is expected that a final report will be published in early 2012. The content of this report will depend upon matters arising from the consultation process. At this stage, should our recommendations be accepted, it is anticipated to cover the items listed below:
- a. a high level implementation plan;
  - b. detailed SSRO duties and activities, governance, reporting lines, staffing, cost, funding, and set up;
  - c. the scope to which the single source pricing regulations are expected to apply (e.g. considering contract amendments and implementation down the supply chain);
  - d. how single source pricing regulations will be implemented and enforced, for example, specifying the legal terms and conditions that are expected to be included within single source contracts, and the contractor-level agreements covering matters not well suited for inclusion within individual contracts, expected to be signed by contractors and the MOD;
  - e. templates for the quarterly contract reports, annual overhead reports, and annual SME reports that contractors will provide to the SSRO and the MOD;

- f. an assessment of the impact on MOD and Industry policy and processes, and identified training needs;
- g. the transition from the current Review Board to the SSRO and existing single source regulations to the new single source pricing regulations;
- h. the impact on legacy single source contracts.

# Annex A - Terms of Reference and Review Process

## Introduction

- A.1 This annex sets out the Terms of Reference of the review and the Written Ministerial Statement that accompanied Lord Currie's appointment, and a brief description of the process that has been followed during this first phase of the review.
- A.2 In the course of the review, the views of stakeholders have been sought, alongside a public consultation process. A list of those whom Lord Currie has met in preparing this report is provided (paragraphs A14 to A16).

## Terms of Reference

### Key Objectives / Outputs

- A.3 To produce an independent report containing proposals for the creation of a framework for modern, fit-for-purpose commercial arrangements for single source contracts between Her Majesty's Government (HMG) and MOD contractors from the defence industry.
- A.4 The recommendations must deliver Value for Money (VFM) to the taxpayer, foster a culture of efficiency within the defence industry, and provide a fair return for industry.
- A.5 Recommendations will be considered by HMG and discussed in detail with stakeholders. This will result in an implementation plan, and then implementation itself.

## Scope

- A.6 Topics covered include, but are not limited to:
  - a. Establishing an appropriate price for contracts - ensuring VFM for the taxpayer and a fair return to industry.
  - b. How to provide an on-going incentive to improve or enhance efficiency - ensuring governance replicates the competitive pressures that may be absent in single sourcing.
  - c. Costs HMG should and should not pay - how to deal with rationalisation, pensions, marketing etc.
  - d. Protection for both parties - e.g. dispute resolution mechanisms, protection from fraud.
  - e. Regulatory models, their strengths and weaknesses, and their appropriateness within this context.
  - f. HMG investigation and audit rights.
  - g. Legal constraints - including 'state aid', European Union (EU) procurement law, EU regulations etc

- h. Lessons identified from mechanisms in other industries; and single source approaches used by other governments.
- i. Assessing the appropriate balance of risk and reward.
- j. Incentives under the regime (Small and Medium Enterprises (SME), exportability, overhead reduction, encouraging moving to competition, HMG incentives).
- k. Management information and reporting.
- l. How change should be managed.
- m. Implementation issues (resources, skills, simplicity).
- n. Transition from current regime to new proposed regime.

## Timescale

- A.7 The work will be carried out in three phases.
- a. Phase 1 - Publication of Independent Report - Consideration of all the options and the production of a recommendation for the future pricing of HMG single source procurement, together with supporting arguments and discussion: Report by end of July 2011<sup>51</sup>.
  - b. Phase 2 - Consultation on Implementation - Discussions with industry and with stakeholders in the MOD regarding implementation of an agreed framework. Implementation plan by end December 2011.
  - c. Phase 3 - Implementation - Implementation of agreed framework and training of MOD staff to operate the new system. By end June 2012.

## Written Ministerial Statement

- A.8 On 26 January 2011, the Minister for Defence Equipment, Support and Technology (Peter Luff) made the following statement on the appointment of the Chairman for the review.

*I am today announcing that Lord Currie of Marylebone is to Chair an independent review of the regulations used by the Ministry of Defence (MOD) when pricing work to be procured under single source conditions without reference to competition. The existing framework is described by the Government Profit Formula and Associated Arrangements (GPFAA) - the so-called 'Yellow Book' - of which the MOD is the sole user.*

*The GPFAA stems from an Agreement between HM Treasury and the Confederation of British Industry in 1968. Operational aspects have been reviewed since that time but successive governments have left the underlying principles in place. Getting single source pricing right is of great significance to all stakeholders, not least taxpayers: the MOD typically places annually around 40% by value of work on this basis.*

51. The review was extended, with publication delayed until October 2011. Subsequent timescales have been adjusted accordingly, with phase two delayed until early 2012, and phase 3 by the end of 2012.

*The formula sets out profit rates allowed as addition to costs, as recommended by the Review Board for Government Contracts; my predecessor announced acceptance of the Board's last report to Parliament on 30 March 2010 (Official Report, column 98WS). The GPFAA also includes Government Accounting Conventions setting out what costs are allowed when pricing single source work.*

*This review implies no criticism of the Review Board for Government Contracts, which is a valued part of the existing framework and whose remit has been to maintain the profit formula and examine only those issues set before it by the MOD and industry.*

*The Defence sector has evolved beyond recognition since the inception of the 1968 Agreement. At that time, labour constituted over three-quarters of costs within the Defence sector. Now it is less than one quarter. The government owned many more of the assets than we do now. Furthermore, the sector is facing an era of consolidation and restructuring. The government inherited a fiscal situation that makes it more important than ever that industry is incentivised to reduce costs through the use of modern, fit for purpose commercial arrangements (including for small and medium sized enterprises), additionally making UK industry more competitive on the world market. Therefore, I believe the time is right to carry out this review and have asked that an MOD team, working with the CBI, be established to support Lord Currie's investigation.*

*Lord Currie will be consulting widely with other stakeholders and will present his initial recommendations to me by July 2011, after which there will be further consultation with stakeholders to agree an implementation plan, at which time I will report back to the House. In parallel, the MOD has requested that the Review Board for Government Contracts continue its work to maintain the existing processes through completion of its 2011 Annual Review of the Profit Formula, due to conclude in April 2011, and thereafter until the outcome of this review is known and a way forward agreed.*

## **Process**

- A.9 Lord Currie has been assisted in preparing this report by a review team made up from external consultants and MOD staff. The team has provided a range of information, 'think pieces', and potential options.
- A.10 To ensure the review has considered as wide a range of issues and potential options as possible in formulating its recommendations, a structured process of research and assessment has been followed.
- A.11 This process has included:
- a. Background Research - the current Government Profit Formula and its Associated Arrangements (GPFAA), the legal setting in which the arrangements operate, general economic principles, and the historic landscape of single source expenditure.
  - b. Specific Research - research into arrangements in other comparable industries and government departments, other UK regulators, and other allied countries' arrangements for managing single source contracts.
  - c. Options Generation - a range of papers ('think-pieces') focussing upon specific

areas of single source contracting, to provide a summary of the issues and potential options for each area. These papers covered a number of areas, including efficiency incentives, profit rate setting, overhead recovery and reporting, SMEs etc. Nearly 150 options were presented for consideration by the review.

- d. Recommendation Development - Following from the options generation stage, a series of workshops was held to agree the most appropriate individual options and formulate these into a consistent and coherent recommended solution.

## Interviewees

A.12 In the course of our review, Lord Currie met with a number of stakeholders (senior executives of contractors, senior MOD executives, senior Government executives, trade bodies and the Review Board). Their views have been taken into consideration in the preparation of the report. Stakeholders are invited to participate in the consultation stage of the review (see Next steps).

A.13 We have also gained considerable insights from visits to contractor factories and construction sites, and from review of related reports including those published by Bernard Gray (now Chief of Defence Materiel) on Defence Procurement, Lord Levene on the MOD's organisation and structure, and Review Board reports and decisions.

A.14 A number of senior staff from within the MOD were interviewed, including:

- a. Minister for Defence Equipment, Support and Technology
- b. MOD Permanent Secretary
- c. Defence Equipment and Support (DE&S) - Chief of Defence Materiel
- d. DE&S - Chief Operating Officer
- e. Deputy Chief of Defence Staff (Capability)
- f. Director General Finance
- g. Chair of the Defence Reform Unit
- h. DE&S - Commercial Director
- i. DE&S - Director Corporate Commercial
- j. DE&S - Director Submarines
- k. DE&S - Head of CAAS

A.15 In addition to MOD staff, senior staff from central Government, Other Government Departments (OGDs) and other public bodies were interviewed, including:

- a. No. 10 Downing Street
- b. Cabinet Office
- c. Her Majesty's Treasury
- d. Department for Business, Innovation and Skills
- e. Office for Budget Responsibility
- f. Intellectual Property Office
- g. The Review Board for Government Contracts

- A.16 From industry, a number of companies and trade bodies were interviewed, targeting those who have significant single source contracts, including:
- a. A|D|S (Aerospace, Defence, Security trade association) – who also facilitated our meeting a number of smaller companies
  - b. Babcock International plc
  - c. BAE Systems plc
  - d. Boeing Defence UK Ltd
  - e. The CBI
  - f. Finmeccanica SpA
  - g. KPMG
  - h. Lockheed Martin UK Ltd
  - i. National Endowment for Science, Technology and the Arts
  - j. PricewaterhouseCoopers
  - k. QinetiQ Group plc
  - l. Rolls-Royce plc
  - m. Thales UK Ltd
- A.17 Finally, international views were sought; in particular interviews were conducted with the French Ministère de la Défense and the US Department of Defense.
- A.18 We would like to thank all those who have kindly taken time out of their schedule to speak to us.

# Annex B - Current Arrangements

## Introduction

- B.1 This annex describes the arrangements currently used by the MOD when pricing goods or services to be contracted on a single source basis. The term 'single source' refers to the award of a contract to a contractor after negotiation, but in the absence of a competitive bidding process (hence single source is also referred to as 'non-competitive contracting').
- B.2 MOD policy is to compete the procurement of requirements whenever it can, and to flow this requirement to compete down to its prime contractors. A single source approach must be fully justified and legally compliant. The decision to compete or not takes place within a legal framework, currently the Public Contracts Regulations 2006<sup>52</sup> (the 'Regulations'). Moreover, a new EU Defence and Security Procurement Directive<sup>53</sup> (DSPD) covering the procurement of military and sensitive equipment, services and works was adopted in 2009 and the UK Regulations implementing it, the Defence and Security Public Contracts Regulations 2011 came into force on the 21st August 2011, strengthening the requirement to compete.
- B.3 Legally justified exemptions will remain albeit that use of exemptions is likely to come under much closer scrutiny and it is envisaged that MOD will continue to place a significant value of new contracts and amendments on a single source basis. The department also has a significant legacy of single source contracts which will remain in force for many years ahead. On average over the last 5 years the MOD has contracted approximately £8.7bn per year on a single source basis<sup>54</sup>.
- B.4 The current single source regime used by the MOD is best described as a set of 'arrangements', as opposed to 'regulations'. There is an external, independent body involved in the process - the Review Board for Government Contracts - but it is not a body vested with regulatory powers. The Review Board exists by virtue of an Agreement made in 1968 between government and industry and its recommendations are only enacted by joint agreement of the MOD and the defence industry (or in very limited circumstances through contract conditions).
- B.5 Single source pricing is sometimes referred to by the MOD as 'Yellow Book' pricing. Strictly speaking the Yellow Book is a report of the Review Board and is primarily about setting profit rates. However, the MOD tends to use the term to encompass the totality of the arrangements, not just profit.
- B.6 The 1968 Agreement has been carried forward into an agreement called the GPFAA. A key principle of the GPFAA is that the parties have a right to 'Equality of Information' at the time of pricing although there is no agreed definition of this term. The presumption underpinning Equality of Information is one of good faith between the parties to bring one another's attention to any information which is material to the agreement of a fair and reasonable price.
- B.7 Another key principle is the right of either party to call for the 'post-costing' of a single

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52. The Public Contract Regulations - <http://www.legislation.gov.uk/uksi/2006/5/contents/made>

53. EU Directive 2009/81/EC

54. UK Defence Statistics 2010, Table 1.15, MOD. <http://www.dasa.mod.uk/modintranet/UKDS/UKDS2010/c1/table115.php>

source contract, to compare the actual costs incurred with the cost estimated and agreed at the time of pricing. This comparison allows the costs incurred and true profit earned on a contract to be revealed. In certain circumstances the parties may negotiate a re-pricing of a contract following post-costing, although this is unusual. In other circumstances contract conditions may be invoked to bring about a price adjustment following revelation of an excess profit or loss. Currently the MOD selection of contracts for post-costing is sporadic, although some additional resource is currently being directed towards re-energising the process.

- B.8 Many of the existing mechanisms for pricing single source work, including Equality of Information and post-costing rights, are intended to be flowed down by the MOD's prime contractors to first tier subcontractors, enabling the MOD to post-cost a major subcontract. It is unclear how consistently this happens and the extent to which the MOD makes use of the rights flowed down.
- B.9 The Government Profit Formula (GPF) used in pricing single source contracts is overseen by the Review Board for Government Contracts, in accordance with its terms of reference. The GPF has been adapted over time but is still considered by all parties to be weak in terms of its scope to flex profit rates in line with the risk being undertaken by contractors. In essence, some minor adjustments aside, the GPF has only 2 rates to apply to single source contracts: a 'risk rate' that is intended to be comparable to the rate of return earned by a wide-range of companies in other sectors of the UK economy (the GPF is founded on this 'comparability principle'); and a 'non-risk' rate which is arbitrarily set at 75% of the 'risk rate'.
- B.10 All 'Yellow Book' reports are heavily focussed on profit rates rather than total costs, even though costs typically make up 90% of the price to the taxpayer. This concentration on profit detracts from attention on matters such as the cost efficiency of contractors, and what are fair and reasonable costs for the taxpayer to bear in the price of military capability. The onus appears to be squarely on the MOD to show why any direct costs and overheads claimed by a contractor should be excluded, rather than on contractors to demonstrate they are fair and reasonable.
- B.11 There is no consistent requirement for real-time, open book reporting (bespoke reporting may occur on a contract-by-contract basis, but is not a standard requirement). Contracts awarded on the basis of settling a price based on the ascertained cost may involve annual cost certification but the reporting of incurred costs on a firm or fixed price contract is much less systematic. This only really occurs when the MOD selects a contract for post-costing investigation and, for various reasons (including levels of resourcing) this has become much less frequent in recent years. It only tends to happen, when it happens at all, at the very end of a contract by when it may be too late to make use of the data and lessons identified on the contract or follow-on contracts.

## **When Is Single Source Procurement Undertaken?**

### **Competition policy**

- B.12 The MOD operates within a legal framework when determining to seek competitive tenders or to adopt a single source approach. Statistics show that the MOD places the majority of its contracts through competition, when measured by number of contracts. However, when measured by contract value, non-competitive procurement at prime contract level is significant, averaging over the past 5 years approximately £8.7bn per year, approximately 40% of annual procurement. It should be noted that within this value there will be some subcontracted work

awarded by MOD primes on the basis of competitive tenders, and that it includes the value of any contract amendments made to competitive contracts.

- B.13 All major United Kingdom (UK) defence contractors, whether UK owned or UK subsidiaries of overseas owned companies, use the current arrangements for pricing single source work undertaken in the UK. These companies include BAE Systems, Rolls-Royce, AgustaWestland, Lockheed Martin, Thales, General Dynamics, QinetiQ, MBDA, Babcock and others. Further details about the current single source contractor landscape are at Annex D.
- B.14 This section summarises current public procurement law - more detailed information about the regulations and procedures can be found in the MOD Commercial Toolkit<sup>55</sup>, in particular the topics headed 'Choosing a Competitive or Non-Competitive Approach' and 'EC Public Procurement Regulations'.
- B.15 MOD policy is to maximise competitive tendering, a position summarised in the department's 'Commercial Toolkit':

*You will buy goods, works and services for the MOD under an open and fair procurement process, which maximises the use of competition in order to seek best value for money. You will use a competitive approach to procurement in all but exceptional cases where there are justifiable and legally compliant reasons not to do so.*

- B.16 The MOD operates in many different industry markets that have each have different characteristics. For example, contractors in the information technology sector operate in a highly competitive environment, the scope for competition is more limited (or may not exist) in other parts of the defence sector where industry has consolidated. There may be other reasons why the MOD would choose to take a single source approach - but in all cases, that choice must comply with the legal framework within which the department operates.

## **EU procurement law**

- B.17 MOD requirements must be competed in accordance with EU public procurement regulations and procedures. These are set out in the Regulations which place a legal requirement on the UK government to advertise and compete its requirements in all but exceptional cases. Where the Regulations apply single source procurement (or any limitation on open and fair competition) is only permitted using the 'Negotiated procedure without prior publication of a contract notice' in the 'exceptional cases' set out at Regulation 14.
- B.18 The Regulations cover public procurement across government. A new set of procurement regulations specifically designed for defence procurement has come into force in the UK from 21 August 2011, to implement the DSPD. The European Commission's rationale for adopting the DSPD is that too often in the past EU Member States have relied inappropriately on exemptions from the Regulations to avoid competitive tendering, stifling the development of an open EU defence market.

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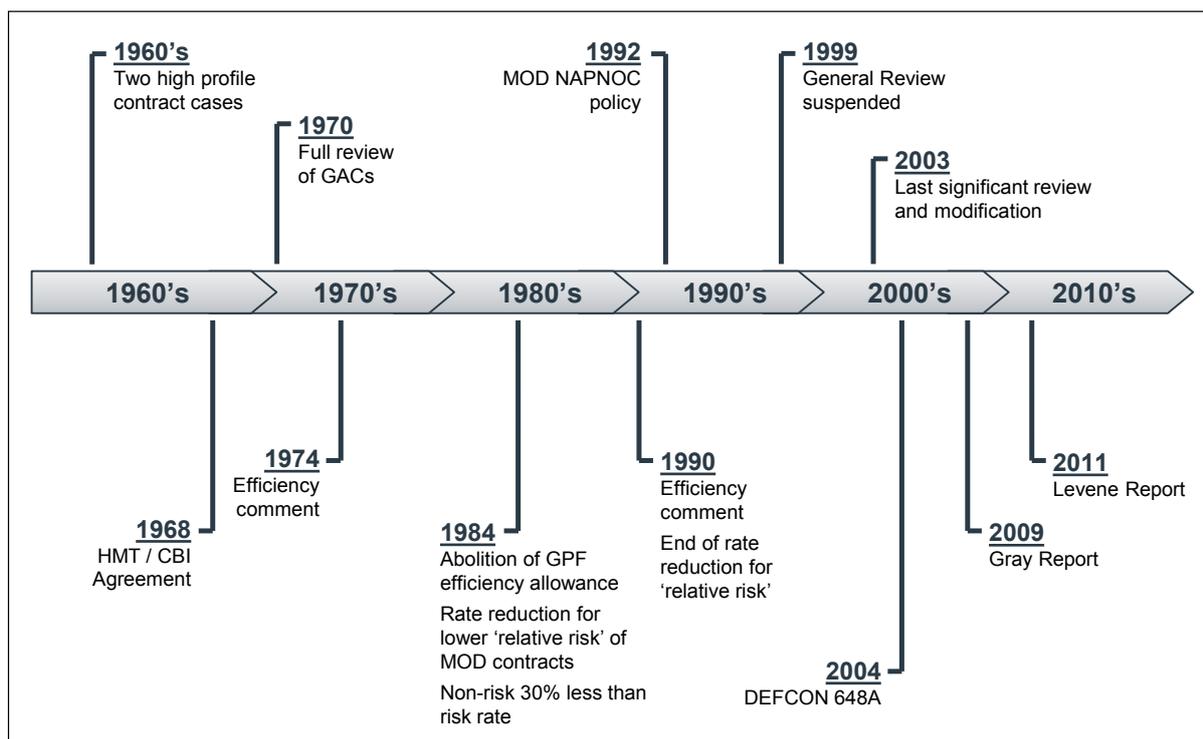
55. MOD Acquisition Operating Framework, Commercial Toolkit - <http://www.aof.mod.uk/aofcontent/tactical/toolkit/>

- B.19 Some of the arguments previously used to justify the application of exemptions are no longer available under the DSPD (the main exemptions from the requirement to compete are set out at Appendix 1 to this Annex). Member States will have to go further in fully justifying exemptions that can still be applied. Infraction proceedings are already in the pipeline on Member States' use of exemptions under the existing regulations and such proceedings are expected to increase once the DSPD comes into force. Nevertheless, as indicated at Appendix 1, exemptions from the requirement to compete are still available.
- B.20 In summary, under EU procurement law and the coalition Government's own transparency agenda, the pressure to avoid single source public procurement is increasing, with more stringent justification required to claim exemptions from the legal requirement to compete. Nevertheless, under the regime for permitted exemptions, the MOD is likely to continue to place a significant value of contracts on a single source basis, and has a legacy of single source contracts which will remain current for many years ahead (see Annex D).

### **Current Single Source Arrangements: the 'Yellow Book' Framework.**

#### **Yellow Books and the Review Board for Government Contracts**

- B.21 The 'Yellow Book' is published by the Review Board for Government Contracts, a non-departmental public body sponsored by the MOD. The main role of the Review Board is to oversee and maintain the profit formula used by the MOD and their contractors when pricing single source contracts. While the profit formula is available to all government departments it is only used by the MOD, because of the volume of the department's single source pricing.
- B.22 The Review Board for Government Contracts was established by Memorandum of Agreement between HM Treasury and the CBI in February 1968. A simultaneous agreement established the new profit formula and announced new contractual conditions giving the government, "the right to Equality of Information and post-costing of individual contracts". Figure 6 provides a summary of past key events.



**Figure 6 - Summary Timeline of the History of the Yellow Book Framework**

- B.23 The 1968 agreements were a consequence of episodes in the 1960s when public attention was drawn to weaknesses in the arrangements for pricing single source contracts. The government discovered it had paid levels of profit several times greater than it had intended when agreeing prices on a number of contracts. This led to an inquiry which in due course led to the 1968 Agreement - further background is at Appendix 2 to this Annex.
- B.24 The term 'Yellow Book pricing' has come to indicate not just the profit formula but the wider arrangements used in single source pricing. These include the categories of cost that are allowed and disallowed, and the rights and processes the parties have pre-contract to obtain information (to be in a position to agree a fair price); and post-contract to know what the actual costs of the contract were (to compare with the estimated cost agreed at the time of pricing and, in certain defined circumstances, share any 'excess' profit or loss arising).

### **The Government Profit Formula and Associated Arrangements**

- B.25 Another document often referred to in the context of single source pricing is the GPFAA. The GPFAA is effectively a pull-forward of the original 1968 Agreement, modified to reflect changes agreed since that time<sup>56</sup>.
- B.26 The GPFAA describes the arrangements from first principles through to operational use so is a better starting point for a new user than the front end of a Yellow Book (which just describes the outcome of that year's review of the profit formula). Even so, the GPFAA

56. Copies of the GPFAA and some of the more recent Yellow Books (2003 onwards) can be downloaded from: <http://www.mod.uk/DefenceInternet/AboutDefence/CorporatePublications/FinanceandProcurementPublications/ReviewBoardGovContracts/>

does not capture the full picture of single source pricing - these are better described as the 'Three Pillars' of single source pricing (see paragraph B33).

### **Yellow Book reviews of the Government Profit Formula**

- B.27 The primary purpose of the Yellow Book is to report the outcome of the Review Board's periodic reviews into the operation of the GPF. The underpinning principle of the GPF is 'comparability': the principle that the profits earned on government single source work should be comparable with the average return earned by relevant sectors of the rest of British industry. The Review Board annually recommends revisions to GPF allowances that are required for the principle of comparability to be maintained.
- B.28 The Review Board makes its recommendations in Annual Reviews; and every 3 years it conducts a more comprehensive General Review. The MOD and industry agree with the Board the terms of reference of each review. Industry views on the GPF and wider arrangements are represented by a trade committee, the Joint Review Board Advisory Committee (JRBAC). JRBAC membership is drawn from a spectrum of defence equipment and service contractors, from small companies through to major, single source providers.

### **Government Accounting Conventions**

- B.29 Although the Review Board's Annual and General Reviews are primarily concerned with reviewing and maintaining the profit formula, the MOD and industry sometimes agree other matters within the Review's terms of reference. These often concern the GACs for single source contracts which set out what costs and capital are allowable. For example, the 2007 General Review (2007GR) considered pension deficit contributions, a contentious item of cost that had started to delay pricing. In the most recent Review (the 2011 Annual Review, effective from 1 April 2011) the parties agreed changes to some GACs (e.g. the GAC dealing with contractor site closure costs).
- B.30 In addition, Yellow Book reports may contain a number of Annexes related to wider single source pricing arrangements e.g. the full text of existing GACs; previous guidance of the Review Board still relevant to future pricing; and a summary of previous decisions of the Review Board concerning the pricing of an individual contract which had been referred to the Board under contract conditions.
- B.31 The 2003 General Review (implemented 1 July 2004) was the most substantial review in recent years and followed a number of studies into the formula (the rationale for change is well described in the 2003GR Yellow Book report). However, in line with its terms of reference, the 2003 overhaul was principally about the profit formula, not contract costs.
- B.32 Examining past Yellow Books it is apparent that the focus of each Review has been on modifications to the operation of the profit formula. Although occasionally touching upon issues of cost and efficiency, Yellow Books do not appear to have examined in any great depth how wider arrangements dictate the overall level of costs that are accepted into government single source contracts, or whether single source contractors incurring those costs were operating efficiently.

### **The 'Three Pillars' of Single Source Pricing**

- B.33 The term 'Yellow Book' has come to mean the wider arrangements that the MOD and industry have developed since 1968, for pricing single source work. A useful way to think of these arrangements is that single source pricing comprises 'Three Pillars' (see also Appendix 3 to this Annex):

- a. **Pillar 1** - the framework of underlying principles and conventions established by the 1968 Agreement and developed since that time, by agreement between the MOD and its contractors, both through the Review Board's annual and general review process, and in other forums for example, the joint MOD/industry DEFCON Working Group (DWG), which acts to agree new and amended contract conditions. The current suite of DEFCONs relating exclusively to single source contracts (albeit some are also included in competitively awarded contracts to cover subsequent single source contract amendments) are listed at Appendix 4 to this Annex.
- b. **Pillar 2** - the 'contractor recovery rates' process by which an MOD organisation (the Cost Assurance and Analysis Service (CAAS)) recommends labour/overhead recovery rates with individual contractor pricing units. CAAS recommendations are made to MOD commercial leads who alone can agree rates with contractors. In making their recommendations, CAAS apply the GACs which govern what costs are allowable and disallowable in single source pricing. As indicated by their title, GACs are conventions, not statutory regulations. The agreement of rates is a non-contractual process (at the time of agreement); although those same recovery rates may subsequently be used in pricing contracts and gain contractual force.
- c. **Pillar 3** - the pricing of individual contracts, frequently using the contractor labour/overhead recovery rates agreed in the Pillar 2 process, and deploying agreed 'pre-contract' pricing processes (joint MOD/Contractor signature of 'Equality of Information Pricing Statements'<sup>57</sup> (EIPS) and contract conditions (DEFCONS), all based upon the principles originally established by the 1968 framework (Pillar 1).

### What Information does the MOD get to aid Single Source Pricing?

- B.34 The MOD gets information to aid the pricing of single source contracts from all of the 'Three Pillars'.
- B.35 **Pillar 1** - Information about Profit - Pillar 1 provides, through the Review Board process, an agreed rate of profit to apply to the costs that are agreed between the parties (either on the basis of forward estimated costs built into a firm, fixed or target cost contracts, or in the case of an 'ascertained cost' contract, on the basis of the profit to be applied to actual costs). The fact that the Review Board recommends a profit rate for future pricing, agreed at Ministerial level and by industry, means that for the majority of single source contracts (by number), profit is largely taken out of the negotiation. This does not preclude that there may be some subsequent negotiation around profit on some contracts, when that is agreed to be appropriate.
- B.36 There is some minor scope for flexing the published GPF allowances, to take account of the risk in the contract, although evidence suggests it is a mechanism very little used. The permitted adjustment is +/- 10% of the published rate (e.g. if the profit rate for a 'normal risk' contract was, say, 10%, then the permitted rate to reflect a high/ low risk contract would be 11% or 9%). Additionally, MOD contract teams do have flexibility not to use GPF rates at all, although they would need to justify why they had deviated from the agreed rates and would, of course, need to negotiate the non-application of agreed GPF rates with their contractor.
- B.37 **Pillar 2** - Information about contractor labour/overhead 'recovery rates' - The information obtained here leads in time to a CAAS recommendation of each contractor's individual labour/overhead recovery rates used in contract pricing. It covers a critical process by

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57. MOD Acquisition Operating Framework, Pricing - Equality of Information - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pricequa/full\\_pricequa.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pricequa/full_pricequa.pdf)

which the MOD obtains information from contractors. CAAS investigation of the claimed rates of many contractors is an annual process (certainly for larger contractors like BAE Systems and Rolls-Royce) and not driven by any one contract requirement. It is only relatively small contractors where the need for a CAAS rates investigation might be driven by a specific contract pricing requirement. Some contractors who have relatively low values of single source pricing are unlikely to be fully investigated, although CAAS will assist MOD pricing teams with a 'desk-audit' when they can.

- B.38 Given the CAAS rates investigation is not contractual and is often not tied to a specific pre-contract price proposal from a contractor, under what rights does the MOD obtain information from contractors? The implicit answer assumed by both parties - implicit because it is not formally recorded anywhere - appears to be a mutual recognition between the MOD and industry that the Equality of Information principle (see paragraph B50) that is a key feature of the 1968 Agreement would be meaningless if it was not also applicable to the process by which the MOD agrees labour/overhead recovery rates with its single source contractors.
- B.39 The 1968 Agreement clearly links Equality of Information to post-contract award activities, but that was at a time when contracts were often priced provisionally, so access to a contractor's records post-contract award (through contract condition SC43, now DEFCON 643<sup>58</sup>) was valuable to the MOD, since it helped inform the eventual agreement of a firm or fixed price for the work.
- B.40 In 1992, the MOD introduced a NAPNOC<sup>59</sup> (No Acceptable Price, No Contract) policy, which required an acceptable price to be agreed prior to placing a contract, substantially reducing the incidence of provisionally priced contracts. In this scenario, DEFCON 643 becomes less relevant, and the MOD and industry have to agree pre-award 'Equality of Information' processes (see Pillar 3). These NAPNOC processes do not explicitly mention the CAAS rates investigation process.
- B.41 The CAAS investigative process is 'custom and practice' - there is a presumption of good faith reflecting a recognition that the MOD needs to investigate a contractor's labour/overhead recovery rates ahead of any bid, let alone contract, for pricing purposes. The investigation also covers agreement of contractor specific CP:CE ratios (Cost of Production:Capital Employed), which are needed for application of the GPF<sup>60</sup>. The CAAS investigative process is non-contractual at the time of investigation, and is not explicitly covered by NAPNOC Equality of Information processes. The statement of what information single source contractors need to submit to the MOD is set out by the GACs (Appendix 6 to this Annex).
- B.42 The opening paragraph of the GACs state that:

*"the GACs set out the basis for computing a contractor's capital employed, cost of production and overheads for the purpose of pricing non-competitive government contracts".*

58. MOD Acquisition Operating Framework, Pricing - Price Fixing DEFCON 643 [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr\\_fix/full\\_prfix.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr_fix/full_prfix.pdf)

59. MOD Acquisition Operating Framework, Pricing - No Acceptable Price, No Contract - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/napnoc/full\\_napnoc.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/napnoc/full_napnoc.pdf)

60. This financial ratio is used in determining the profit rate applicable to individual contractor business units, taking into account the level of capital employed, and therefore the corresponding capital allowances.

- B.43 The GACs are relatively short (in comparison to, say, US Federal Acquisition Regulations (FAR)) and are conventions, not regulations; in many of the more contentious areas of cost they appear vague, indicating that many costs are neither allowable nor disallowable, but are 'partially allowable'. What precisely is 'partially allowable' then becomes a matter of negotiation based more on indicators rather than tightly defined regulations.
- B.44 The GAC obligation on contractors is to provide information that is available from their "normal accounting systems" to the MOD to support their claimed rates and CP:CE ratios. The contractor is obligated to disclose its cost accounting practices to the MOD and to apply them consistently - this is achieved through a disclosure statement known as the Questionnaire on Method of Allocation of Cost<sup>61</sup> (QMAC). There is an implicit assumption that the MOD should not ask for information which is not available from a contractor's "normal accounting system".
- B.45 The MOD has the scope within the GACs to exclude costs that it regards as "unnecessary, wasteful or extravagant", provided that it gives the contractor a "full written explanation" of any such exclusion. Given this, contractors do generally accept that there is a requirement on them to justify the reasonableness of the expenditure that is recorded in their "normal accounting systems", if asked specific 'reasonableness' questions by MOD staff. The key point is that the MOD must ask the questions - the rates claim itself is not routinely accompanied by any justification of the costs (although some contractors are more forthcoming than others).
- B.46 In the recent 2011 Annual review, some changes were made to the GAC statements on these matters. These changes put more explicit onus on cost justification by contractors, but retained the requirement on the MOD to request information. The 2011 Annual Review GAC amendment also introduced the idea of a third party to resolve disputes about the 'justification' of claimed costs (see GAC extract at Appendix 5 to this Annex). This third party has not yet been identified by the parties although a footnote to the GAC says it "may be the Review Board for Government Contracts".
- B.47 **Pillar 3** - Information about a specific price proposal - Finally, there is the information provided by contractors in connection with the pricing of a specific contract. When the MOD invites a contractor to submit a single source price proposal, it expects the bidder to provide a full breakdown of the price. This will include the cost of all materials and services, the direct labour cost analysed by number of hours and charging rate(s) (usually claimed as combined labour/overhead rates), any machine hour rates, any other overhead recovery uplifts, and the profit percentage applied to cost. Material costs should be analysed between raw materials and subcontracted work.
- B.48 During the negotiation of these elements of cost, the MOD will expect to understand and negotiate the level of risk contingency that has been included within the price proposal.
- B.49 The MOD pricing team (usually commercial and project technical officers from the procuring Project Team) will call on the services of investigative cost engineers and accountants from CAAS (at least for larger contracts, say £20m and above) who will examine the contractor's proposal and make recommendations concerning the CAAS view of the most likely cost of the procurement. With the contractor's proposal and the CAAS opinion, as well as their own views, the MOD pricing team will enter into negotiation with the contractor to agree a price.

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61. MOD Acquisition Operating Framework, Questionnaire on Method of Allocating Cost - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/pr\\_chrat/prchrat\\_annb.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/pr_chrat/prchrat_annb.pdf)

## **Equality of Information Pricing Statements**

- B.50 An important part of this process is the EIPS which records the facts and pricing assumptions underpinning agreement of the contract price, which is signed by the MOD and the contractor. A specimen EIPS 'checklist', setting out the information required in support of the contractor's estimate, is at Appendix 6 to this Annex. The list is not necessarily comprehensive, and the actual content of each EIPS will be agreed by the negotiators. MOD policy is that an EIPS is required on all single source contracts over £1m.
- B.51 The MOD has accepted that the Equality of Information principle is mutual and has agreed a statement about the release of information to contractors. Within the constraints of government policy, the MOD is expected to be as open as possible about any pending procurement decisions that may affect the usage of a company's capacity and its overhead rates. The key point is that the EIPS and its annexes should set out, however briefly, the assumptions that have been recognised and agreed by both parties and used to arrive at the negotiated price.
- B.52 The EIPS is signed before the contract is let with a period of up to a fortnight allowed to enable both parties to check the validity of the information that they have provided, before they sign the statement. This period is not an opportunity to re-open the pricing but rather to check that the data is sound.
- B.53 The EIPS is linked to the contract by the use of DEFCON 652<sup>62</sup> - Remedy Limitation. In the event of a dispute (e.g. following post-costing of the contract, when one party reaches the conclusion that it was not given Equality of Information at the time of pricing) then each party's course of redress will be limited by this condition to a reference to the Review Board for Government Contracts, using DEFCON 650<sup>63</sup> - Reference to the Review Board of Questions Arising Under the Contract.

## **Post-costing of single source contracts**

- B.54 Post-costing is the activity whereby the contractor certifies the actual costs incurred on a firm, fixed or target price contract, which the MOD then reviews and compares with the estimated costs included within the agreed price. Any variance between the actual cost and the estimated cost becomes an increase or decrease in the profit to the contractor. Post-costing of a single source contract should be considered as a part of the arrangements for pricing such contracts, because in certain scenarios post-costing can lead to a renegotiation of the contract price, or an adjustment through the application of contract conditions.
- B.55 The MOD carries out post-costing for the following purposes:
- a. in pricing follow-on contracts, as an essential element in Equality of Information;
  - b. to enable the department to check the accuracy of its estimating procedures;
  - c. to provide the information for a selective scrutiny of the outcome of particular contracts so that a reference can be made by either side to the Review Board;
  - d. to provide verification of outturn costs for fixed or firm prices where contract terms require a sharing of the outcome of a cost over-run or under-run by means of an adjustment to the contract price. A reference may be made by either side to the Review Board where a party considers that the sharing outcome is inequitable.

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62. MOD Acquisition Operating Framework, DEFCON 652 - <http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/defcons/pdf/652.pdf>

63. MOD Acquisition Operating Framework, DEFCON 650 - <http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/defcons/pdf/650.pdf>

- B.56 Currently the MOD's stated policy is to post-cost all single source contracts over £10m, unless there is no benefit in doing so. However, over the past decade resource constraints coupled with competing priorities have seen a decline in the number of post-costings.
- B.57 The decline in post-costing activity has been noted and commented upon by the Review Board, who use the information as one of the sources of data for assessing whether the profit formula is working (i.e. whether contractors are broadly achieving the target rate of return that is 'comparable' with the rest of British industry, or whether the formula is routinely giving them more or less).
- B.58 The MOD reports a summary of the outcome of its post-costing investigations annually, to the Public Accounts Committee<sup>64</sup> (PAC) and to the Review Board. The MOD's assessment of post-costing results over the past 10 years is that, on average, contractors beat the target rate of return by around 3%. On one hand, this could be reasonable: the point of NAPNOC pricing is to incentivise the contractor to bear down on the costs and so increase his profit margin. Provided the lessons are learned by the MOD, the benefits are taken forward when the reduced costs are factored into the pricing of follow-on contracts. On the other hand, the fact that contractors on average appear to be beating the target rate and making greater profits might be an indicator of selectivity in the contracts the MOD chooses to post-cost. In addition, the average variance of around 3% masks some significant incidences of large additional profits being returned on some contracts and, in some cases, losses by contractors.
- B.59 The possibility of contractors earning excessive profit is a concern for the public sector: the 1968 Agreement, including the establishment of a profit formula, was founded on incidences of excess profits on single source defence contracts. Although post-costing can reveal such profits, it cannot correct them. For this, until 2004 the parties relied upon either negotiating a price adjustment or referring the contract to the Review Board, under contract condition (SC50 and then DEFCON 650). Neither of these routes led to many contract price adjustments because, in order to justify re-pricing, it had always been necessary to demonstrate that one party or the other had not received Equality of Information at the time of pricing.
- B.60 Accordingly, the 2003 General Review agreed a revised contract condition (DEFCON 648A<sup>65</sup> - Availability of Information) which provided for the 'automatic' price adjustment of single source contracts, where post-costing reveals an excess profit or loss has occurred (as defined by the DEFCON - see clause extract at Appendix 7 of this annex). The clause still allows a referral to the Review Board if one party believes the 'automatic' sharing to be inequitable. Although the new DEFCON 648A might be seen as a helpful protection for the taxpayer, an alternative view is that it destroys firm/fixed NAPNOC pricing and undermines the incentive on the contractor to bear down on costs and increase margins (hence in the long run the taxpayer pays more).
- B.61 The only way to determine with a degree of certainty the level of overall variance on MOD single source contracts (between actual and estimated costs and hence actual profit earned) would be to obtain on a more routine, consistent basis, information from contractors concerning the outturn costs of single source contracts. This does not happen under the current arrangements other than through post-costing, which is sporadic and has until recently been in decline.

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64. Public Accounts Committee - <http://www.Parliament.uk/business/committees/committees-archive/committee-of-public-accounts/>

65. MOD Acquisition Operating Framework, DEFCON 648A - <http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/defcons/pdf/648a.pdf>

## Summary - Issues With the Existing Arrangements

- B.62 Yellow Book reports have been historically focussed on determining the 'right' profit rate to be used for single source MOD contracts. This focus is not surprising given the profit formula was first established in 1968 when much of MOD contracting was on a cost-plus basis (i.e. the cost was the cost and the issue was how much profit it was reasonable to add on top). Profit has remained the focus despite the fact that the MOD has moved away from cost-plus contracting and now aims to agree firm/fixed contract prices on the basis of costs estimated at the outset.
- B.63 Despite this focus on profit, the GPF is still considered by all parties to be weak in terms of its scope to flex profit rates in line with the risk being undertaken by contractors. Some minor adjustments aside, the GPF has only two rates to apply to single source contracts: a 'risk rate' that is intended to be comparable to the rate of return earned by a range of companies in other sectors of the UK economy (the GPF is founded on this 'comparability principle'); and a 'non-risk' rate which is arbitrarily set at 75% of the 'risk rate'.
- B.64 Yellow Book reports have said very little about the cost efficiency of contractors undertaking single source work, despite cost constituting approximately 90% of the price of a single source contract. The GPF document includes past Review Board pronouncements thought to be relevant to future pricing but has only 2 references to statements about efficiency, from profit formula reviews in 1990 and 1974.
- B.65 Allowable/disallowable costs are set out in the GACs. Whilst there are some clear 'allowable' and 'disallowable' costs, significant areas of cost (e.g. site rationalisation and closure costs) fall into a category of 'partially allowable' costs. However, the onus appears to be on the MOD to justify any exclusion of costs on grounds of them being 'unnecessary, wasteful or extravagant', and not on the contractor to demonstrate they are necessarily and efficiently incurred.
- B.66 The reporting of actual costs incurred on single source contracts is known as post-costing, and is enabled by contract conditions. However, despite scope to carry out 'interim' post-costing as the contract proceeds, this rarely happens. Most post-costing is done, if it is done at all, at or near the end of a contract. There is no real-time or open book reporting of the costs of single source contracts. If such disclosure does occur, it is sporadic and on the basis of bespoke arrangements, not because single source pricing arrangements require it.

## Appendix 1 to Annex B

### EU procurement regulations: principal exemptions from the requirement to compete

- B.67 Article 346 of the Treaty on the Functioning of the European Union (TFEU) provides a derogation from the EU treaty itself and, therefore, internal market rules in relation to measures which a Member State considers “necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material” and in relation to “information the disclosure of which it considers contrary” to those interests.
- B.68 However, recourse to Article 346 is expected to be limited to exceptional circumstances which will have to be considered on a case-by-case basis. The EC has listed the following as examples of types of procurement that it considers may fall under Article 346:
- a. the purchase of equipment/services which is strategically so important that any dependence on authorisation by another Member State is considered as a risk for essential security interests;
  - b. the activity has to be executed on the purchasing Member State’s territory and only by a national contractor;
  - c. the contract has to be awarded to a national contractor to maintain or establish a national industrial capability considered necessary for its essential security interests.
- B.69 Articles 36, 52 and 62 TFEU contain specific exceptions to the application of the principles set out in the TFEU on the grounds of, amongst other things, public security. It should be noted that the “secrecy and security” exemption in current Regulations<sup>66</sup> will be significantly reduced in scope under article 13(a) of the DSPD. It is now limited to the same extent as Article 346(1)(a) TFEU where the supply of information would be contrary to the essential interests of national security.
- B.70 Article 12(c) of the DSPD provides a specific exclusion for contracts awarded pursuant to the “specific procedural rules of an international organisation purchasing for its purposes, or to contracts which must be awarded by a Member State in accordance with those rules”. The Directive does not define the term “international organisation”, but the Commission has defined it in its Guidance as “a permanent institution with separate legal personality, set up by a treaty between sovereign states or intergovernmental organisations and having its own organisational rules and structures”. If any such organisation is purchasing “for the purpose of its members”, either acting as an intermediary or reselling supplies procured at the request of a member, then the Commission is of the view that the DSPD will apply to such purchases.
- B.71 Article 13(c) of the DSPD provides a specific exclusion for contracts awarded in the framework of a cooperative programme based on Research and Development (R&D), which are:
- a. conducted jointly by at least two Member States;
  - b. for the development of a new product;
  - c. where applicable, for the later phases of all or part of the life-cycle of the product.

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66. Article 14 of the current procurement directive FN44 2004/18/EC.

- B.72 The key condition of this exclusion is that the R&D is aimed at the development of a new product. The Commission maintains that common purchases of off-the-shelf equipment cannot come under this exclusion, even if technical adaptations are made to customise the equipment. The cooperation must be genuine. This means that it must include some proportional sharing of technical and financial risks and opportunities and participation in management and decision making in the cooperative programme.
- B.73 Article 13(f) of the DSPD excludes certain contracts for R&D from its scope, namely contracts for R&D services “other than those where the benefits accrue exclusively to the contracting authority/entity for its use in the conduct of its own affairs, on condition that the service provided is wholly remunerated by the contracting authority/entity”. The exclusion is principally aimed at service contracts awarded for co-financed R&D activities where the contracting authority and the contractor share costs and/or benefits.

## Appendix 2 to Annex B

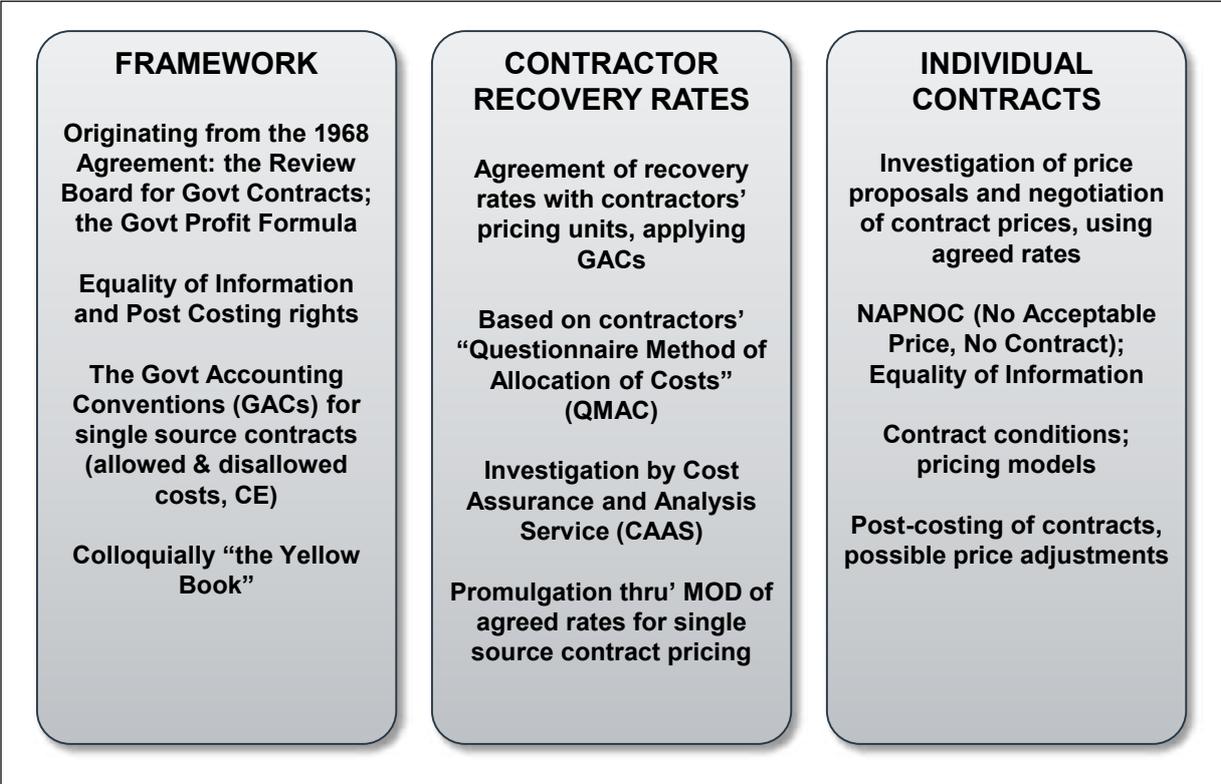
### Background to the 1968 Agreement<sup>67</sup>

- B.74 **Para 105.** A common profit formula for government departments based on capital employed was established before the Second World War and, with a change in 1941, remained until the late 1960s. The formula was intended as a guide to departments and settlements were generally below the maxima set for the formula. The amount of profit allowed by the formula had for many years been considered in industrial circles to be inadequate.
- B.75 **Para 106.** The establishment of the Review Board was a consequence of two episodes during the 1960s in which public attention had been drawn to weaknesses in the then existing arrangements for pricing non-competitive contracts. The first of these cases, involving the supply of Bloodhound guided weapons to the Ministry of Aviation, led to the appointment of Sir John Lang to conduct an Inquiry. The facts of the case were, briefly, that Ferranti was found to have made a profit on 40 contracts several times greater than the profit level allowed for by the Ministry when agreeing prices. Besides criticising the Ministry's practices the Inquiry found that Ferranti had included in the price an estimate of production man-hours far higher than they might have been expected to incur. The Inquiry found that the pricing methods used by the Ministry resulted in the contractor knowing more about the likely pattern of costs than the Ministry. The Inquiry recommended, amongst other things, that the Ministry should try to secure the right of 'Equality of Information' by means of a contract condition, that the profit formula should be reviewed and that, exceptionally, post-costing might be undertaken.
- B.76 **Para 107.** As a consequence of the Ferranti case, and a subsequent similar case involving Bristol Siddeley Engines, new arrangements for the pricing of non-competitive contracts were agreed between the government and industry. These arrangements were reflected in two formal agreements which were announced to Parliament by the Chief Secretary, HM Treasury, on 26 February 1968.
- B.77 **Para 108.** One of the formal agreements between government and the CBI in February 1968 concerned the establishment of the Review Board, under the terms of the Memorandum of Agreement. The other, which took effect from 26 February 1968, was a new formal Profit Formula Agreement, the principal effects of which were to:
- a. extend the scope of information available to the Ministry in price negotiation through the introduction of contract terms covering the principles of Equality of Information and post-costing;
  - b. achieve a more equitable pricing basis by a revised profit formula the aim of which was 'to give contractors a fair return on capital employed; that is to say, a return equal on average to the overall return earned by British industry'.
- B.78 This agreement also contained a term by which the parties agreed to the future establishment of a Review Board for Government Contracts to review the effect of these new arrangements and to adjudicate in future pricing disputes.

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67. Review Board for Government Contracts, 2003 General Review (from the 2003GR 'Yellow Book', paragraphs 105-108) - [http://www.mod.uk/NR/rdonlyres/BDA54836-6E5F-4FD0-812A-8CBDE643D82/0/profit\\_formula\\_general\\_review\\_03.pdf](http://www.mod.uk/NR/rdonlyres/BDA54836-6E5F-4FD0-812A-8CBDE643D82/0/profit_formula_general_review_03.pdf)

**Appendix 3 to Annex B**



**Figure 7 - The Three Pillars of the Current Arrangements**

## Appendix 4 to Annex B

**Table 1 - Defence Contract Conditions Particularly Relevant to Single Source Contracts**

DEFCON	SCOPE
DEFCON 127	Price Fixing Condition for Contracts of Lesser Value
DEFCON 176A	MOD Requirements For Competition In Subcontracting (Non Competitive Main Contract)
DEFCON 631	Interim Certified Cost Statement
DEFCON 643	Price Fixing
DEFCON 648/648A	Availability of Information
DEFCON 650/650A	Reference to the Review Board of Questions Arising Under the Contract
DEFCON 651/651A	Reference to the Review Board of Questions Arising in Relation to Relevant Subcontracts, Including Those With a Subsidiary Company or Firm
DEFCON 652	Remedy Limitation
DEFCON 653	Pricing on Ascertained Costs
DEFCON 653A	Costed Contracts - Contractor's Certified Cost Statement
DEFCON 695	Interim Summary Cost Certificate - Post-Costing
DEFCON 696	Provisions in Relation to a Final Cost Summary Statement - Post-Costing

## Appendix 5 to Annex B

### Amendment to the aim of the GACs<sup>68</sup>

#### Aim of the Government Accounting Conventions

- B.79 The GACs are those accounting conventions agreed from time to time, between the MOD acting on behalf of the government and the CBI acting on behalf of industry, for pricing single source government contracts. These Conventions are applicable to both direct contract costs and indirect costs. These GACs are available for use by all other government departments.
- B.80 The aim of the GACs is to set out the basis upon which a contractor includes direct costs in a contract price proposal and computes their capital employed, cost of production and overheads for a rate claim submission to the government department concerned, for the purpose of pricing single source government contracts. Wherever possible a contractor's normal accounting systems will be used. The contractor is to disclose his cost accounting practices and apply them consistently.
- B.81 At the request of the government department considering the direct labour and overhead costs submitted in accordance with paragraph B80 the contractor will give access to the department to information that it holds adequate to justify the direct labour rates and specific elements of the burden rates claimed.
- B.82 The government department concerned will examine the information described in paragraphs B79 to B80, with the aim of reaching agreement with the contractor concerning those rates. Where costs are disallowed a written explanation will be provided to the contractor by the government department. In cases where the government department concerned is not persuaded by the justification of costs provided and consequent disallowances mean that an agreement cannot be reached, then the dispute over claimed costs may be referred to a 3rd party<sup>69</sup> for an expert opinion.

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68. Review Board for Government Contracts, agreed at the 2011 Annual Review, effective 1 April 2011 - [http://www.mod.uk/NR/rdonlyres/A3A5959A-EDC4-49AF-BE03-1C2FBE6EF276/0/2011\\_annual\\_profitformula\\_noncompetitive\\_contracts.pdf](http://www.mod.uk/NR/rdonlyres/A3A5959A-EDC4-49AF-BE03-1C2FBE6EF276/0/2011_annual_profitformula_noncompetitive_contracts.pdf)

69. Which may be the Review Board for Government Contracts.

## Appendix 6 to Annex B

### Specimen Equality of Information Check List

#### Information Required In Support Of The Contractor's Estimate

- B.83 A definition of the scope and standard of the estimate by reference to:
- a. the contract task as defined in drawings, specifications, test schedules, service requirement etc. at a given date;
  - b. the methods of manufacture it is proposed to employ, defined wherever possible by reference to plant operational layouts, plans for jigs, tools, etc;
  - c. the QMAC extant at the date of the estimate and any proposed changes thereto;
  - d. the agreed quality plan for the contract in accordance with the specified Allied Quality Assurance Publications 2000 series and Defence Standard 05-61 series extant at the date of the estimate.
- B.84 A statement of the type of estimate prepared (i.e. synthetic (detailed), synthetic (broad), comparative, parametric etc. and of the rationale by which it has been compiled, including the data used to develop it and the calculations made).
- B.85 A statement of main assumptions made in preparing the estimate, including:
- a. the period of manufacture;
  - b. batch sizes;
  - c. the extent of subcontracting;
  - d. the basis of payment to operatives (e.g. time rates, bonus scheme etc.);
  - e. any significant change in overhead rates as compared with the latest agreed rates.
- B.86 Details of any other factors that might arise which could affect the estimate and the probable extent of their impact, for example:
- a. a change in the basis of payment to operatives; or
  - b. changes in production or procurement volume; or
  - c. impending management decisions.
- B.87 Appropriate details of the make-up of the estimate for each item for which a separate price is expected to be agreed including:
- a. the amounts included for materials, bought-out parts, subcontracts, direct labour and overheads - for each year in which work is expected to be carried out and for the contract as a whole;
  - b. the direct labour, overhead and other rates used in compiling the estimate.
- B.88 Details of allowances and contingencies:
- a. any allowances included in the estimate (e.g. for scrap, rectification, learning/experience etc.);
  - b. any contingencies which apply to the estimate (supported in each case by evidence of both the need for the contingency and its likely magnitude).

- B.89 Where the estimate is subject to a Variation of Price provision, details of:
- a. the date from which the Variation of Price provision would apply;
  - b. the elements to which it is to be applied;
  - c. the formula;
  - d. the indices.
- B.90 Where the estimate could form the basis of a firm fixed price, details of:
- a. the 'date point' of the estimate;
  - b. the average Direct Labour Rate actually paid up to the 'date point';
  - c. that part of the estimate for materials, supplies, subcontracts, etc. for which firm prices have been included or possible cost variations have been taken into account;
  - d. the Direct Labour Rate current at the 'date point'.
- B.91 Records of the cost of production of the goods (or parts thereof) including details of times taken and of wage rates paid:
- a. under the contract;
  - b. under earlier contracts.
- B.92 Particulars relating to subcontractor's and contractor's prices.

## Appendix 7 to Annex B

### Clause 4 of DEFCON 648A

B.93 Clause 4 details the 'automatic' excess profit and loss sharing provisions.

4. If it is established by reference to the records maintained in accordance with Clause 1 and summarised in a DEFFORM 648A statement that either:

[sub-Clause 4(a)] - the outturn profit exceeds the profit allowance applicable to the Contract Price in accordance with the relevant Government Profit Formula by a sum greater than five percent of the Contract Price; or

[sub-Clause 4(b)] - the outturn costs exceed the Contract Price by a sum greater than five per cent of the Contract Price;

(or those percentages that are agreed between the Authority and the Joint Review Board Advisory Committee and issued by the Review Board in the annual and triennial review Reports on the Profit Formula for Non-competitive Government Contracts published by the Stationery Office at the date of Contract);

then –

if sub-Clause 4.a) applies, the Authority shall reduce the Contract Price by an amount equivalent to seventy five per cent of the sum greater than five per cent of the Contract Price but only if that amount exceeds £250,000 and not otherwise, and the Contractor shall pay to the Authority any sum then due;

if sub-Clause 4.b) applies, the Authority shall increase the Contract Price by an amount equivalent to seventy five per cent of the sum greater than five per cent of the Contract Price but only if that sum exceeds £250,000 and not otherwise, and the Authority shall pay to the Contractor any sum then due;

unless either the Authority or the Contractor notifies the other party in writing of their intention to refer the circumstances of the outturn to the Review Board in accordance with DEFCON 650A, and does refer the matter within 30 days of that notice.

# Annex C - Cost of Project Delay

## Background

- C.1 This annex draws upon information available in the public domain to provide real-world examples of the cost of delay.
- C.2 As highlighted by the Gray Report<sup>70</sup> the MOD has had a substantially overheated equipment programme, with too many types of equipment being ordered for too large a range of tasks at too high a specification. The Strategic Defence and Security Review (SDSR) and subsequent work in the department aims to address this unaffordable programme - however, behaviours in the department that contributed to the situation may remain, and the Levene report addresses these from an organisational perspective.
- C.3 When this over-large and inflating programme has met the hard cash planning totals that the MOD can spend each year, the department has been left with no choice but to slow down its rate of spend on programmes across the board. This has been achieved through 3 broad types of change:
- to delay, or slow down, projects - reducing the rate of spend per annum, though increasing the total spend due to increased overheads incurred as duration lengthens;
  - to de-scope, or reduce the output, of projects - a reduction in capability that increases the cost per unit as fixed costs are spread over fewer units;
  - to cancel projects, a difficult option with capability and political consequences.
- C.4 The MOD raises a portfolio of these changes through an annual 'Planning Round' process - this process aims to make amendments to programmes (known as options) in order to balance the MOD's capability requirements with the budget available.
- C.5 The result of previous annual planning rounds has been the introduction of a range of options that have either delayed, de-scoped, or cancelled programmes in order to help meet the department's budgetary commitments.
- C.6 Analysis of the initial SDSR equipment options<sup>71</sup> has revealed that approximately 70% were to either defer or de-scope programmes. In typical planning rounds this would be expected to be higher (the SDSR had a higher proportion of cancellation options than was typical).

## Issue

- C.7 Some of the actions taken to balance the budget, represented through delays and reductions in scope for equipments, necessarily have an impact upon value for money by increasing the cost per unit of output.
- C.8 On average, acquisition projects face a delay of two and a half months each year (20% delay) between Main Gate and In-Service Date (ISD). These delays have a range of

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70. Review of Acquisition for the Secretary of State for Defence, An independent report by Bernard Gray, October 2009 - <http://www.mod.uk/NR/rdonlyres/78821960-14A0-429E-A90A-FA2A8C292C84/0/ReviewAcquisitionGrayreport.pdf>

71. MOD Renegotiation Strategy Team, 26 May 2011.

impacts, all of which reduce the efficiency of providing equipment. These impacts include:

- a. further fixed costs as activity is spread over an extended period, both within the MOD and industry;
- b. potential capability gap costs, for example additional Urgent Operational Requirements (UOR) expenditure to maintain capability during delays, and run-on costs of maintaining existing equipments;
- c. consequential costs, such as reducing opportunities for implementing cost reduction measures, or increased requirement changes (as the longer the acquisition takes, the more new requirements and technology changes occur);
- d. other consequential costs, such as increased costs due to inflation and additional capital costs.

C.9 In addition to these costs of delay, to maintain costs within budget requirements the output may be reduced, either through removing specific capability or reducing platform numbers - this has a further impact on value for money by increasing the unit costs as design and fixed costs of manufacture are spread over fewer units.

C.10 These impacts, and an assessment of their cost, are discussed in length in the Gray Report, and the situation has not changed since. The National Audit Office (NAO) Major Projects Report (MPR) 2010<sup>72</sup> highlights further costs of delay and reductions in units since 2009.

## Impact

### General Impact

C.11 The Gray Report and NAO MPRs estimate potential costs associated with delay.

C.12 Gray estimates the general cost of delay for acquisition projects (between Main Gate, when a manufacture project is given approval, and In-Service) to be between £0.9bn and £2.1bn per annum, being 4% to 10% of total equipment spend<sup>73</sup>.

C.13 The NAO MPRs for 2009 and 2010 report a range of specific examples of impacts associated with delay and reductions in scope, including:

- a. £1.3bn attributed to slowing production on Queen Elizabeth Class carriers;
- b. £0.4bn for slowing production on Astute;
- c. 23% reduction in Lynx Wildcat numbers producing 12% reduction in cost (representing a significant increase in unit cost per helicopter).

C.14 These estimates and examples focus upon the acquisition of equipment, primarily from Main Gate to In-Service - i.e. for the Demonstration and Manufacture (Migration) stages of the CADMID/T<sup>74</sup> cycle. They do not cover the in-service phase, normally at least as costly as earlier stages and equally prone to delay and output reduction - for instance the Lynx Wildcat in-service flying hours have also been reduced by over 30%, with a resulting increase in the proportion of fixed cost per flying hour.

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72. NAO, The Major Projects Review 2010, ISBN 978-0-10-296550-6 - [http://www.nao.org.uk/publications/1011/major\\_projects\\_report\\_2010.aspx](http://www.nao.org.uk/publications/1011/major_projects_report_2010.aspx)

73. DE&S resource and capital budgets (RDEL+CDEL) for 2008/09, MOD Annual Report and Accounts Volume One 2008-09 - [http://www.mod.uk/NR/rdonlyres/0981769C-D30A-469B-B61D-C6DC270BC5C5/0/mod\\_arac0809\\_vol1.pdf](http://www.mod.uk/NR/rdonlyres/0981769C-D30A-469B-B61D-C6DC270BC5C5/0/mod_arac0809_vol1.pdf)

74. The MOD's equipment life-cycle definitions - Concept, Assessment, Demonstration, Manufacture (Migration), In-service, Disposal / Termination.

- C.15 Therefore the full cost across the equipment lifecycle will be significantly higher than the estimates of the acquisition impacts.

### **Single Source Impact**

- C.16 Whilst the NAO and Gray reports cover both competitive and single source contracts, the majority of major projects covered are single source - including for example Astute, Lynx Wildcat, Nimrod MRA4, and Queen Elizabeth Class carriers.
- C.17 Following the SDSR, over 350 contracts have been identified for renegotiation as a result of SDSR options<sup>75</sup>. Of these contracts, 90% are single source contracts, despite single source contracts accounting for 40% of defence procurement by value over the last 5 years.
- C.18 This shows that the impacts of the planning round process are heavily skewed towards single source contracts, as the majority of larger programmes that tend to be impacted by options are delivered through single source contracting.

### **Conclusions**

- C.19 Reducing the MOD practice of delaying and de-scoping equipment programmes in order to balance the budget will provide substantial cost savings and significantly improve the efficiency of equipment procurement and support. It will also provide industry with greater certainty and stability of requirements.
- C.20 To do so requires a balanced programme to be achieved and then maintained as part of normal MOD business. Past experience suggests that behaviours are too entrenched for this to be achieved without changes to the environment in which these decisions are made.
- C.21 One of our central recommendations is to create the SSRO which will provide independent assurance of compliance with the new SSPR processes by both industry and the MOD.
- C.22 The SSRO Budget Report (paragraph E93) is a key part of MOD assurance, highlighting for programmes contracted through single source contracts whether there is realism in the budget for those programmes.
- C.23 Highlighting whether single source programmes are in budgetary balance will assist the MOD to maintain a balanced programme overall, and provide early visibility of budgetary issues with specific programmes.

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75. MOD Renegotiation Strategy Team, 26 May 2011.

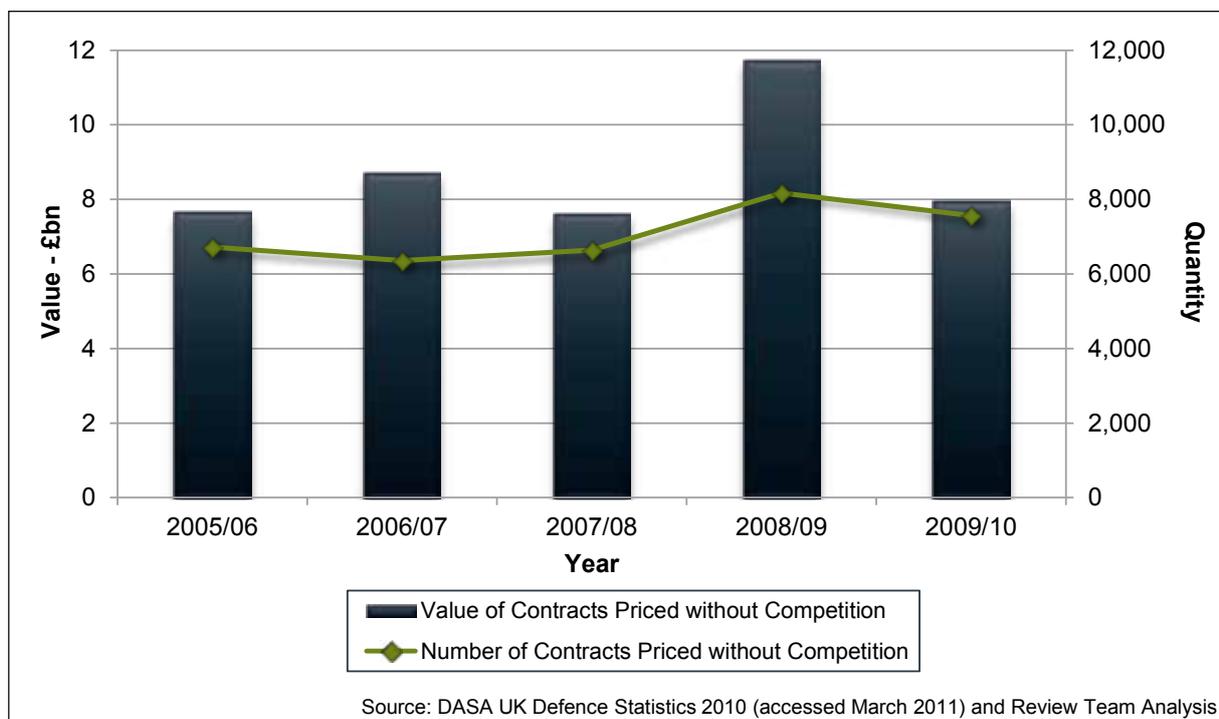
# Annex D - Current Landscape

## Introduction

D.1 This annex details the current landscape of single source contracts awarded by the MOD to contractors. The majority of analysis has been drawn from Defence Analytical Services and Advice (DASA) UK Defence Statistics 2010 which is based on data from the Financial Management Shared Service Centre (FMSSC), who are responsible for the payment of the majority of MOD contracts. The latest verified data available is for Financial Year (FY) 2009/10<sup>76</sup>.

## Value of Contracts Placed

D.2 Figure 8 illustrates the number and value of single source contracts (and amendments) awarded over the last 5 years.



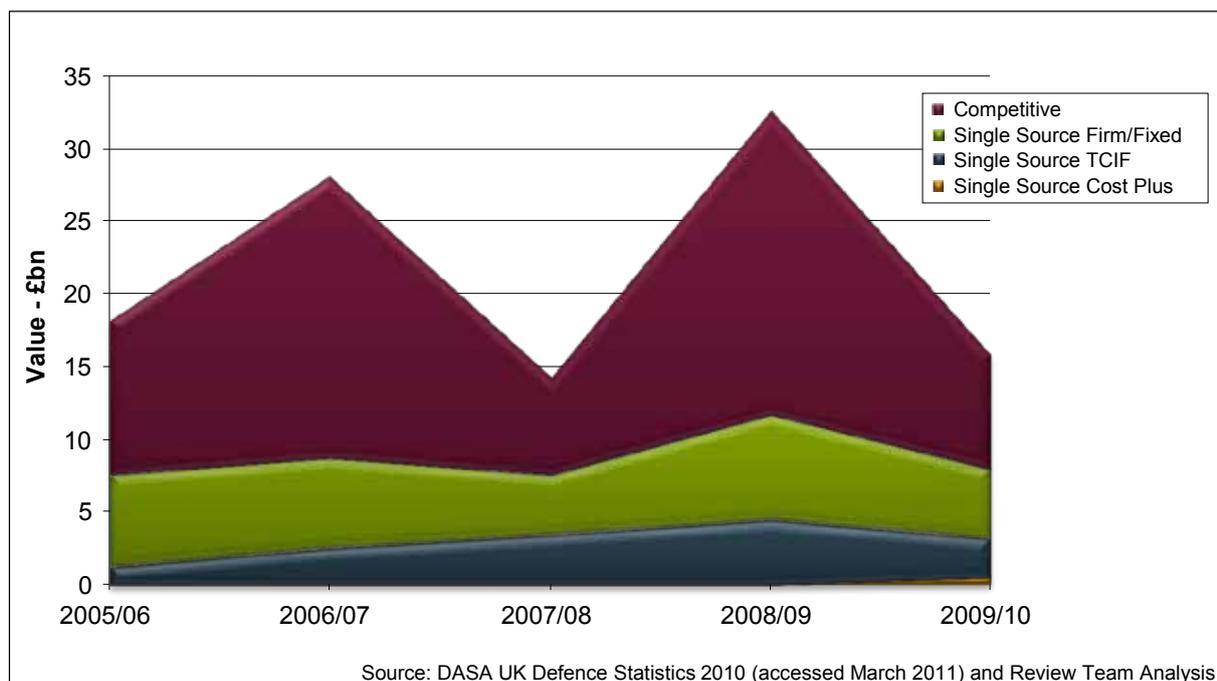
**Figure 8 - Quantity and Value of Single Source Contracts Placed Over the Last 5 Years**

D.3 The increase in the value and quantity of contracts during 2008/09 is due to a number of new high value equipment contracts and contract amendments. The highest value new single source contract in 2008/09 related to the manufacture of the QEC carriers at some £3.1bn. Excluding the value of spend in FY08/09 on the QEC carriers, the annual spend on single source contracts has been relatively stable, between £7.5bn and £8.5bn, averaging approximately £8.1bn<sup>77</sup>, representing just under 40% of acquisition costs.

76. CSB 1 Quarterly Publication, Non-Competitive Contracts by Pricing Marker and Value FY2009-10 Qtr 1-4 (FINAL).

77. Including QEC, the average is £8.7bn representing 40% of acquisition costs, as per the Executive Summary.

- D.4 Figure 9 illustrates the split of contract value by the type of pricing mechanism. The increase in the overall value of MOD contracts in 2006/07 and the subsequent fall in value in 2007/08 can be attributed to the placing of a £9bn competitively let contract in 2006/07.
- D.5 The increase in the overall value of MOD contracts in 2008/09 is due to a number of new high value equipment contracts and amendments to the value of existing contract arrangements. The most notable new contract in addition to QEC carriers in 2008/09 was the Future Strategic Tanker Aircraft with a contract valued at some £10.4bn<sup>78</sup>.

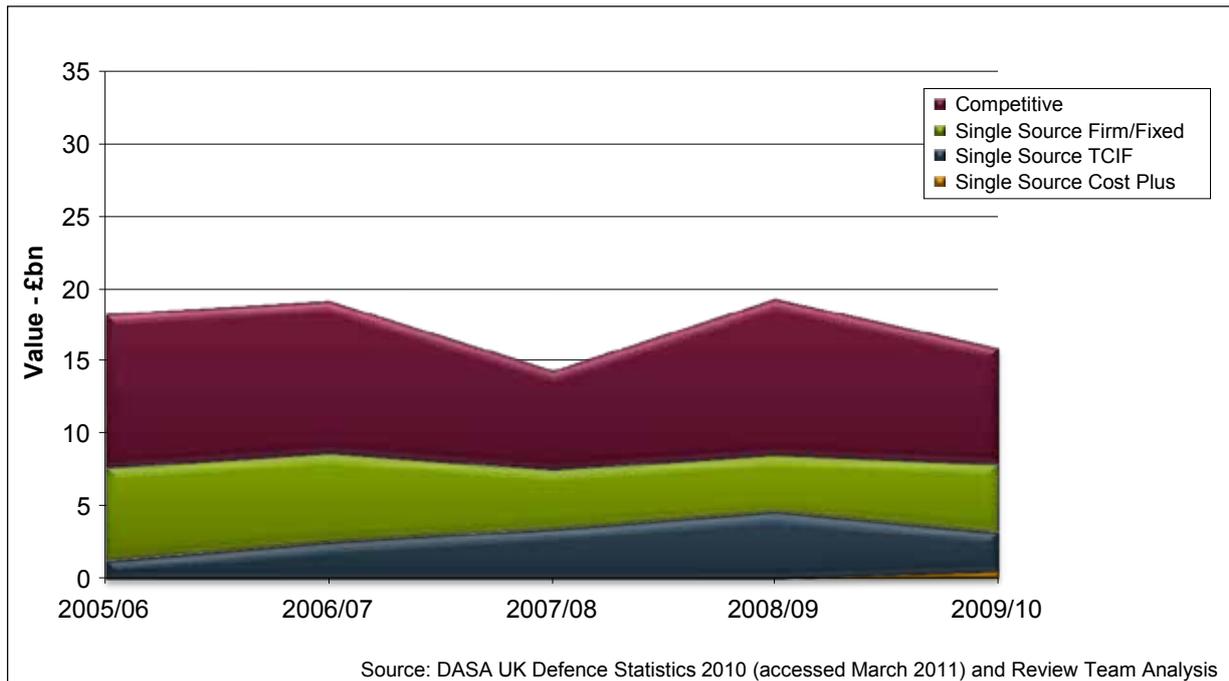


**Figure 9 - Contracts by Type<sup>79</sup>**

- D.6 Figure 10 illustrates contracts placed by type, with the 3 largest contracts (2 previously discussed) removed. This leads to a much less volatile profile and would mean single source spend represents 47% of overall spend.

78. It should be noted that the start date for this latter contract was 28 March 2008, but full details of the contract were not formally recorded on MOD financial systems until after 1 April 2008. This contract has therefore been counted in financial year 2008/09.

79. Competitive contract spend includes Contracts Priced by Reference to Market Forces which includes the use of informal competitive tendering procedures and commercial price lists.



**Figure 10 - Contracts by Type Excluding the 3 Largest Contracts**

- D.7 In 2009/10 the MOD placed just over 24,400 contracts with a collective value of around £15.9bn. The value of the newly placed contracts has fallen considerably from the 2008/09 figure, though this had been inflated by the inclusion of 2 particularly high value contracts which were let in that year. Note that these figures are the value of future committed spend, not what has been paid in this year. Thus a £9bn figure for single source procurement does not mean that £9bn was spent in that year, but that the level of future committed spend related to new single source procurement has increased by £9bn.
- D.8 The number of contracts placed in 2009/10 has increased slightly (by just over 1.5%) compared to that reported for 2008/09.
- D.9 Of the total value of MOD contracts placed in 2009/10 around 50% were priced by competition.
- D.10 Analysis of new single source contracts placed in 2009/10 shows that over 5,700 new single source contracts were placed with a total value of just over £6.5bn<sup>80</sup>.
- D.11 It was identified that there were 473 contracts, valued at nearly £237m, which had no indication of whether they were competitive or single source. Nearly all of these contracts (by value) were placed with the Defence Science and Technology Laboratory (DSTL), a MOD Trading Fund.
- D.12 Figure 11 illustrates the spread of single source contracts by value bands and includes the number of contracts within each band. This figure indicates how many contracts will be impacted by setting the SSPR reporting requirements at different value thresholds. For example in FY2009/10 with a threshold of £50m there would have been 19 contracts that qualified for the full set of SSPRs, covering 68% of the total value of single source

80. The difference between this value and the £8bn in Figure 9 for FY2009/10 is due to contract amendments being included in the Figure 9 data.

contracts placed that year. Lowering the threshold to £10m would have encompassed a further 50 contracts, making 69 in total subject to the full set of SSPRs, and covering 84% by value of contracts.

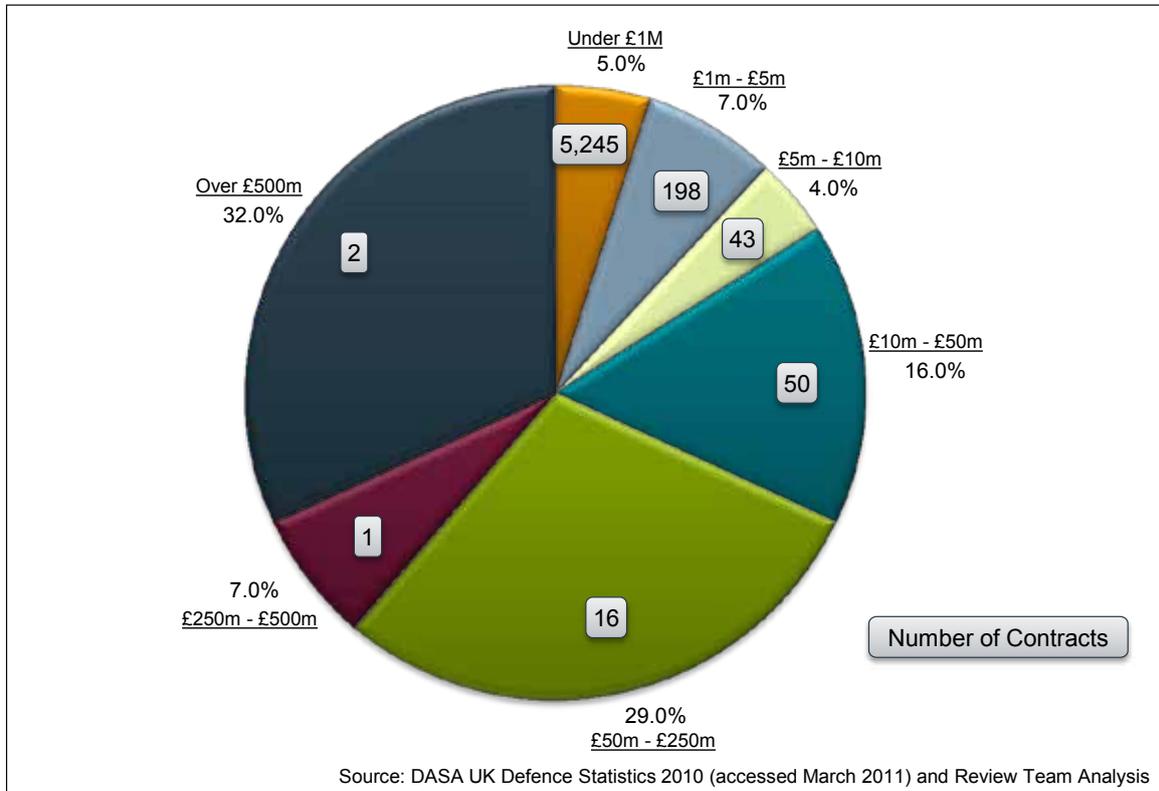


Figure 11 - Value of Single Source Contracts in FY09/10 by Value Band and Quantity

## Key Contractors

D.13 Table 2 lists the contractors with which the MOD had live single source contracts worth over £50m (based on 2010 data), let in the last five years. The current thresholds proposed by this review will mean that it is these contractors (or at least a list very similar to this) that would be impacted by the recommended SSPRs<sup>81</sup>.

Table 2: Contractors with Single Source Contracts Worth Over £50m<sup>82</sup>

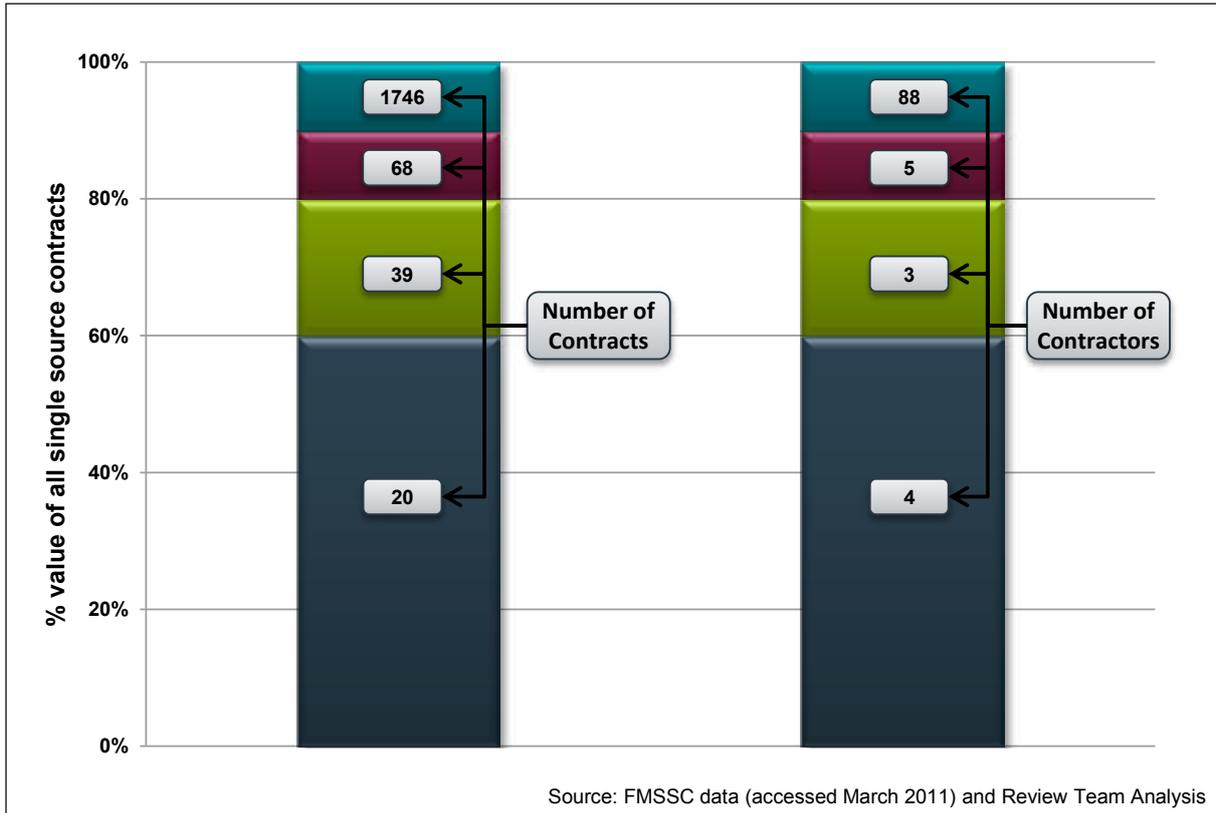
Babcock International Group	GE - Aviation	Met Office
BAE Systems	Guy's and St Thomas' NHS Foundation Trust	Microsoft
Boeing	AWE plc	NATS Holdings
Cranfield University	IBM	Northrop Grumman
David Brown Gear Systems	Lockheed Martin	QinetiQ
Defence Support Group	Marshall Aerospace	Rolls-Royce
EADS	MAAS Consultants	Snecma Services
Finmeccanica Group	MBDA	Thales
		Ultra Electronics

81. Overseas companies will need particular consideration.

82. SSPR review team analysis based on MOD commercial data.

## Contractor Consolidation

D.14 Over the last 2 decades, significant consolidation has occurred with the UK and global defence industry. The result is that MOD expenditure is dominated by large contractors, a situation even more apparent in single source contractors. For single source contracts, over the last 5 years just 7 current contractors<sup>83</sup> have accounted for 80% of the value of contracts let, with 17 contractors accounting for 95%. This concentration is shown in Figure 12.



**Figure 12 - Concentration of Value in Contracts and Contractors**

- D.15 The top 7 contractors are: BAE Systems plc, QinetiQ Group plc, Finmeccanica SA, Rolls-Royce plc, MBDA Missile Systems, Marshall Group, Babcock International Group plc.
- D.16 Significant consolidation has taken place across industry and within these contractors, with the exception of Marshalls which has not followed an acquisitive strategy. Examples of consolidation include:
- BAE Systems**
    - 2004: Acquired Alvis Vickers (UK's main manufacturer of armoured vehicles).
    - 2005: Acquired United Defense Industries.
    - 2007: Acquired Armor Holdings.
    - 2008: Acquired Detica Group, and Tenix Defence (major Australian contractor).

83. Companies who now hold contracts, in many cases these were let with other companies since acquired.

- 2010: Acquired ETI (cyber and intelligence) and Atlantic Marine.
- b. **QinetiQ Group plc**
- 2004: Acquired Westar Corporation and Foster-Miller (U.S. defence companies).
- 2004: Acquired HVR Consulting Services Ltd (UK engineering consultancy).
- 2005: Acquired Apogen Technologies Inc. and Broadreach Networks Limited.
- 2006: Acquired Graphics Research Corporation Ltd (marine design tools).
- 2007: Acquired Analex Inc, ITS Corporation, 3H Technology LLC, and Boldon James Holdings Limited.
- c. **Finmeccanica SA**
- 2000: Finmeccanica and GKN plc merge their respective helicopter subsidiaries (Agusta and GKN-Westland Helicopters) to form AgustaWestland.
- 2004: Acquired GKN share of AgustaWestland.
- 2007: Acquired BAE Systems share of SELEX Sensors and Airborne Systems.
- 2008: Acquired DRS Technologies (U.S. defense contractor).
- d. **Rolls-Royce plc**
- 1994: Acquired the Allison Engine Company.
- 1999: Acquired Vickers plc
- 2006: Optimized Systems and Solutions LLC became a wholly owned subsidiary (previously a joint venture with SAIC).
- e. **MBDA Missile Systems**
- 1996: Parts of Matra Defense and BAe Dynamics merged to form Matra BAe Dynamics (MBD).
- 1998: GEC-Marconi Radar and Defence Systems and Alenia Difesa combined their missile and radar activities to form Alenia Marconi Systems (AMS).
- 2001: MBD and the Missile and Missile Systems activities of AMS merged, creating MBDA.
- 2005: LFK, a unit of EADS Defence and Security Systems, agreed to be merged into MBDA.
- f. **Babcock International Group plc**
- 2002: Acquired Service Group International Ltd (support services).
- 2004: Acquired Peterhouse Group plc.
- 2006: Acquired Alstec Group Ltd (nuclear and airport services).
- 2007: Acquired Devonport Management Limited, Appledore Shipbuilders, and International Nuclear Solutions plc.
- 2008: Acquired Strachan & Henshaw.
- 2009: Acquired UKAEA Ltd.

# Annex E - Recommended Solution

## Introduction

E.1 This annex provides further description of each of the elements of the recommended solution. These are likely to be subject to refinement in the next phase of the review. Our proposed solution represents the distillation of approximately 150 individual options across the different aspects of the review, and has 4 broad areas:

- a. contractor assurance;
- b. MOD assurance;
- c. pricing information and process;
- d. rights and remedies.

E.2 Figure 13 shows the elements described in subsequent sections:

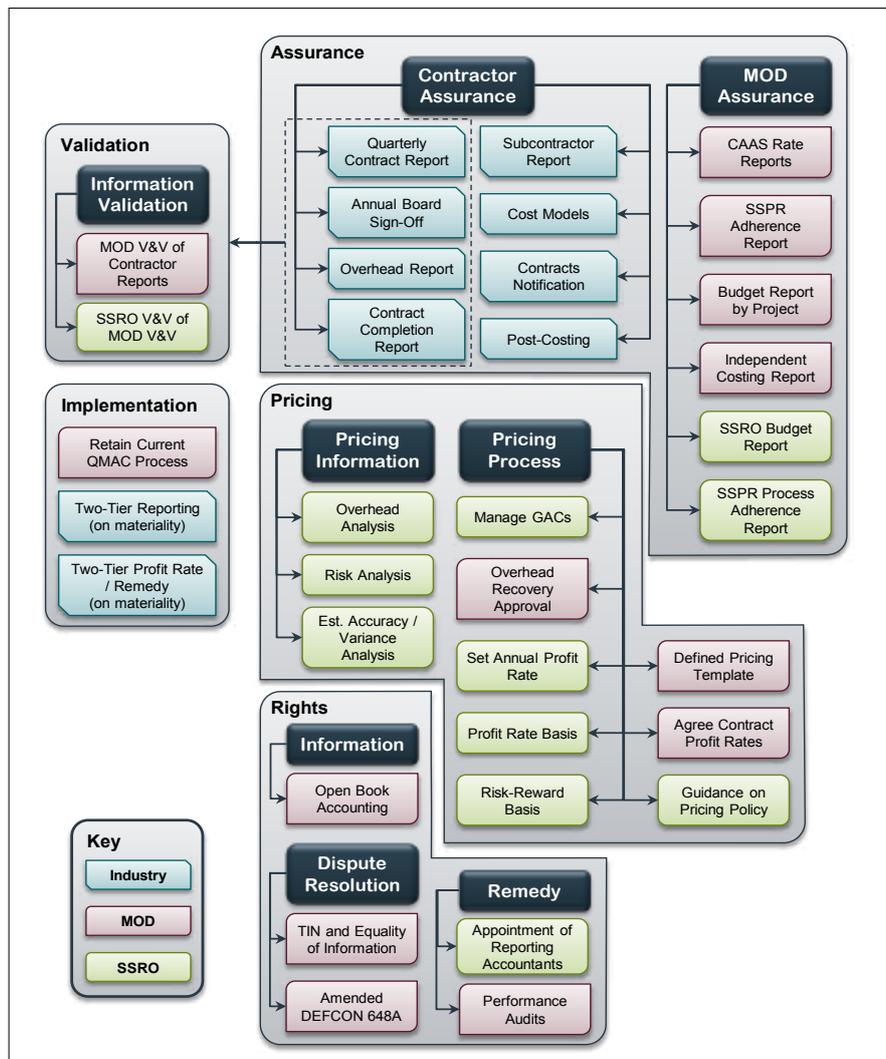


Figure 13 - Summary of Recommended Regulations

- E.3 The recommended solution contains a number of reports that are generated by the SSRO to support the MOD in getting efficiency and value for money within single source procurement. We see advantage in some of these reports also going to HM Treasury; however this is a matter for agreement between HM Treasury and MOD.
- E.4 The SSPRs work to increase efficiency and value for money primarily through greater transparency. Although this will potentially highlight shortfalls, it will also highlight good practice by both industry and the MOD. The SSPRs will help ensure that there is more evidence available to assess both strengths and weaknesses.

## **Contractor Assurance**

### **Quarterly Contract Report**

- E.5 The length of single source contracts varies from a few months to over 30 years. Whilst the average contract length is less than 4 years, this is skewed by many short and low-value contracts. For contracts over £50m, the average contract length is over 5 years, and for contracts over £100m the contract length is typically over 10 years<sup>84</sup>.
- E.6 For single source contracts over £50m, the MOD and SSRO would require visibility of interim progress through the life of the contract. Interim reports between the points of contract pricing and contract close will allow for early sight of contract variations both in terms of cost and time, enabling greater budgetary control by the MOD and the contractor.
- E.7 Therefore, a Quarterly Contract Report (QCR) should be completed for all single source contracts above the reporting threshold of £50m. These QCRs should provide a range of information, to include:
  - a. spend incurred to date, in the format of a pricing template (paragraph E143), including breakdown of subcontractor costs;
  - b. estimate of cost (by year) to completion, in the format of the pricing template;
  - c. items drawn from the risk contingency, value and reason;
  - d. non-financial metrics, including estimated time (date) at completion and overhead recovery metrics (e.g. man hours, machine hours);
  - e. significant changes in specification.
- E.8 The QCR should be submitted to the relevant MOD Project Team and to the SSRO, in time periods to be aligned to calendar quarters;
- E.9 QCRs should be subject to annual sign-off by the contractor's Board (paragraph E11) and the MOD should have the right to undertake selective validation and verification of QCRs (paragraph E57);
- E.10 There should be remedy for repeated non-submission (paragraph E157).

### **Annual Board Sign-Off**

- E.11 In relation to the QCR contractors should be required to sign at Board level (for the relevant Business Unit) that the QCRs give a fair view of the contract position at the time

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84. SSPP Review Team analysis.

that the report was submitted. The exact form and content of the Board certification should be defined in the implementation phase.

- E.12 The annual Board sign-off of QCRs should be submitted to both the MOD and the SSRO.
- E.13 The annual certification is designed to ensure that the contractor's Board takes responsibility for the validity of information presented to the MOD and the SSRO.

### **Overhead Report**

- E.14 Industry overheads are a significant proportion of expenditure that is recovered through single source contracts, estimated by the MOD to represent approximately £3bn<sup>85</sup> of defence expenditure per annum. Currently industry overhead costs are subject to significantly less scrutiny at senior levels in the MOD than other comparable levels of expenditure.
- E.15 Therefore, industry overhead costs require greater visibility, approval, and management, above the level of individual contracts through which they may be recovered - i.e. at the business unit level at which they are incurred.
- E.16 To achieve this, an Overhead Report is recommended. The Overhead Report should cover 2 aspects - forward planning, and reporting of recovery relative to costs incurred. This report does not replace the existing detailed overhead claim currently provided and used in the rate setting process (paragraph B37).
- E.17 The Overhead Report should (by the nature of overheads and their recovery method) be a contractor level report, not a contract level report. The report should be completed at contractor group level (i.e. the highest level required to capture all MOD single source contracts) with supporting schedules for relevant business units.
- E.18 Contractors with aggregate live single source contracts worth over £100m should be required to submit the Overhead Report on an annual basis. The sections should cover:
  - a. **Forward planning:** detail of planned overhead expenditure related to single source contracts, whether paid directly or allocated indirectly, with further details of significant initiatives or movements that will impact overheads in future years.
  - b. **Overhead recovery:** details of overheads recovered through single source contracts, and relevant overhead costs incurred with a breakdown between MOD and non-MOD contracts and MOD competitive and single source contracts.
- E.19 The Overhead Report would allow greater visibility of departmental planning assumptions, and visibility of fair recovery of overheads incurred. It would be an essential component of the overhead recovery approval (paragraph E128) and the CAAS rate report (paragraph B37).

### **Contract Completion Report**

- E.20 All parties should be striving for continuous improvement in estimating accuracy and pricing for single source contracts. Understanding the position at completion of contracts relative to that envisaged at contract signature is an essential part of the feedback process to improve the cost estimating accuracy of future single source contracts. A final report is therefore recommended at completion of all single source contracts over £5m.

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85. SSPR Review Team analysis.

- E.21 For smaller single source contracts between a threshold of £5m and the full reporting threshold of £50m, the Contract Completion Report (CCR) would be important as it will be the first comprehensive cost report submitted for independent review since contract signature (because QCRs are recommended only on contracts over £50m).
- E.22 The report should be submitted within 6 months of contract completion. If any issues are still in negotiation or dispute at this point, the CCR should note these, but submission should not be delayed.
- E.23 The CCR should include:
- a. significant issues encountered, significant specification changes, and lessons identified;
  - b. final costs, in the format of the pricing template, including breakdown of subcontractor costs (as documented in the Equality of Information Pricing Statement (EIPS));
  - c. for TCIF<sup>86</sup> contracts, the proposed final fee after share-lines and adjustments should also be reported;
  - d. variance relative to the position at time of pricing, with commentary on significant variances;
  - e. final risk-contingency position and key risks occurring.
- E.24 This information would support industry, the MOD and the SSRO in improving many areas of single source acquisition, from requirements setting through to trend analysis, risk assessment, and pricing.

### **Subcontractor Report**

- E.25 Subcontractors make up a significant element of the cost of many contracts. It is necessary that prime contractors ensure that subcontractors are selected in a way that ensures value for money. MOD policy is to compete wherever possible and maximise the opportunities for SMEs, and prime contractors should follow this approach.
- E.26 Prime contractors will need to record details of all significant subcontractors, including how they have been selected. The CAAS investigation into the price build-up will review these details, and validate the approach.
- E.27 If the subcontractor is selected on a single source basis then the regulations and access requirements, stipulated in the single source regime, should be flowed down by the prime contractor to the subcontractor using appropriate contract terms and conditions.
- E.28 The onus should be on the prime contractor to ensure that the subcontractor delivers VFM, which may require investigations similar to those conducted by CAAS on the prime contractor. Reports on prime contractor's investigations under open book<sup>87</sup> (paragraph E152) accounting should be made available to the MOD on request. If the subcontractor is not prepared to allow the investigation by the prime contractor, the prime contractor should still be responsible for ensuring VFM in the subcontract. The prime contractor could request the MOD or a suitable 3rd party to undertake the investigation.

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86. MOD Acquisition Operating Framework, Pricing - Target Cost Incentive Fee - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr\\_tcif/full\\_prtcif.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr_tcif/full_prtcif.pdf)

87. MOD Acquisition Operating Framework, Openness in Business - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/openinbus/openinbus\\_cps.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/openinbus/openinbus_cps.pdf)

## Cost Models

- E.29 Cost models and the associated modelling documentation is an integral component of Equality of Information/Truth In Negotiation (paragraph E167) and open book (paragraph E152). The contractor should share with the MOD any cost model(s) and the appropriate documentation used in the build-up of the contract price leading up to the point of pricing (and beyond if appropriate).

## Contractor Contracts Notification

- E.30 The SSRO is recommended to report across the single source landscape of contractors and contracts. Identification of all single source contracts is an essential step to ensuring completeness so that all parties understand which contracts and contractors are subject to the SSPRs.
- E.31 Two routes of identifying contracts to the SSRO exist - from MOD commercial information (for example that obtained via DEFFORM 57<sup>88</sup>) and from contractor commercial information. Both sources should be used to ensure that the SSRO has a complete view of single source contracts subject to the SSPRs.
- E.32 Contractors should, on signature of each single source contract, notify the SSRO of that contract with a précis of the main features of the contracts including the DEFCONs and profit rates applied. Contract changes should also be notified to the SSRO by both parties in précis form. If requested, a full copy of the contract should be made available to the SSRO.

## Post-Costing

- E.33 Post-costing<sup>89</sup> is the certification by the contractor of the outturn costs of a single source contract, and its subsequent investigation by the MOD, comparing the outturn costs of a single source contract with the costs agreed at the time of pricing. Post-costing certificates are only produced when required by one of the parties to the contract.
- E.34 Current MOD policy is to post-cost all single source contracts over £10m along with a sample of single source contracts below £10m. The MOD is currently under an obligation to report post-costing results to the PAC.
- E.35 Post-costing should identify and explain variances between estimated and actual costs and is undertaken for the purposes of:
- a. pricing follow-on contracts as an essential element in Equality of Information;
  - b. enabling the MOD to check the accuracy of its estimating procedures;
  - c. providing information about the outturn of individual contracts to enable the application of single source pricing DEFCONs.
- E.36 Under the SSPR all single source contracts should contain a post-costing contract condition and no value should be specified above which a post-costing investigation will take place.

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88. MOD Acquisition Operating Framework, DEFFORM 57 - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/defforms/exp\\_not/57\\_57a.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloads/defforms/exp_not/57_57a.pdf)

89. MOD Acquisition Operating Framework, Pricing - Post-Costing - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/postcost/full\\_postcost.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/postcost/full_postcost.pdf)

- E.37 For SSPR contracts over £5m that provide CCRs (paragraph E20) the MOD may consider the information provided in the CCR equivalent to a final cost certificate. Contracts which are not required to provide CCRs, but which are selected for post-costing, should provide a final cost certificate in the format specified by the MOD.
- E.38 Copies of MOD final post-costing reports should be provided to the SSRO.

#### **Retain Current Questionnaire on the Method of Allocation of Costs (QMAC) Process**

- E.39 The QMAC is a document which describes the method used by a contractor to allocate costs in its accounting system (for the purposes of recording and estimation). The company's overall cost structure is laid out, and each individual type of cost and activity is assigned as either 'direct' or 'overhead', as per the practice of the contractor in question.
- E.40 The QMAC is completed annually by every contractor fulfilling single source contracts, and is reviewed by CAAS to ensure that it is accurate and reasonable. Both parties sign the document when they are satisfied with its contents. It may then be used to substantiate contract prices and rates agreements for the financial year to which it relates.
- E.41 The contractor should adhere to the agreed QMAC in its preparation of cost-based documents, such as contract price proposals, cost certificates and recovery rate submissions. The main purpose is to ensure that the costing methods employed by the contractor are both reasonable and consistent, thereby eliminating the possibility of the 'double charging' of costs as both direct and indirect. Consequently the QMAC is a vital document for the MOD in its review of contractor submissions. A valid QMAC is required to be in place prior to the signing of any contract or the agreement of any rates.
- E.42 The QMAC was jointly reviewed by the MOD and industry in 2011, and both parties agreed that it was an essential document. It was also recognised that the document template is in need of updating.
- E.43 In our review we believe that the QMAC and its related procedures should be retained as it provides valuable information in assessing costs.

#### **Two-Tier Reporting (on materiality)**

- E.44 The SSPR would add new activities to the management of some contracts. For large contractors this should be a manageable change to current MOD and contractor management reporting requirements.
- E.45 Were they to apply to SMEs, the increased reporting requirements could be a disincentive to wider SME involvement. Therefore, a threshold based on contract value should be applied, below which some reporting requirements will not apply.
- E.46 Exemption thresholds would mean that the SSRO would focus upon higher value contracts, and allow an appropriate volume of contracts to be monitored.
- E.47 The threshold for exemption from most of the requirements of the SSPR should be set at a contract value of £50m. This value is based upon analysis of past single source contracts, and is set to achieve assurance by the SSRO on approximately two-thirds of single source contracts by value, with the steady state number of contracts required to comply with the full reporting requirements estimated to be roughly 100.

- E.48 Specific SSPR requirements exempted below this threshold should be:
  - a. QCR (paragraph E5);
  - b. Annual Board Sign-Off (paragraph E11).
- E.49 The Overhead Report (paragraph E14) would only be required from contractors with single source contracts worth over £100m in aggregate.
- E.50 A different threshold would be applied to CCR, initially at £5m, below which the CCR reports will not be required.
- E.51 The SSRO should review these threshold levels at periodic intervals to ensure the trade-off between expenditure covered and contract volume is maintained at an appropriate balance.

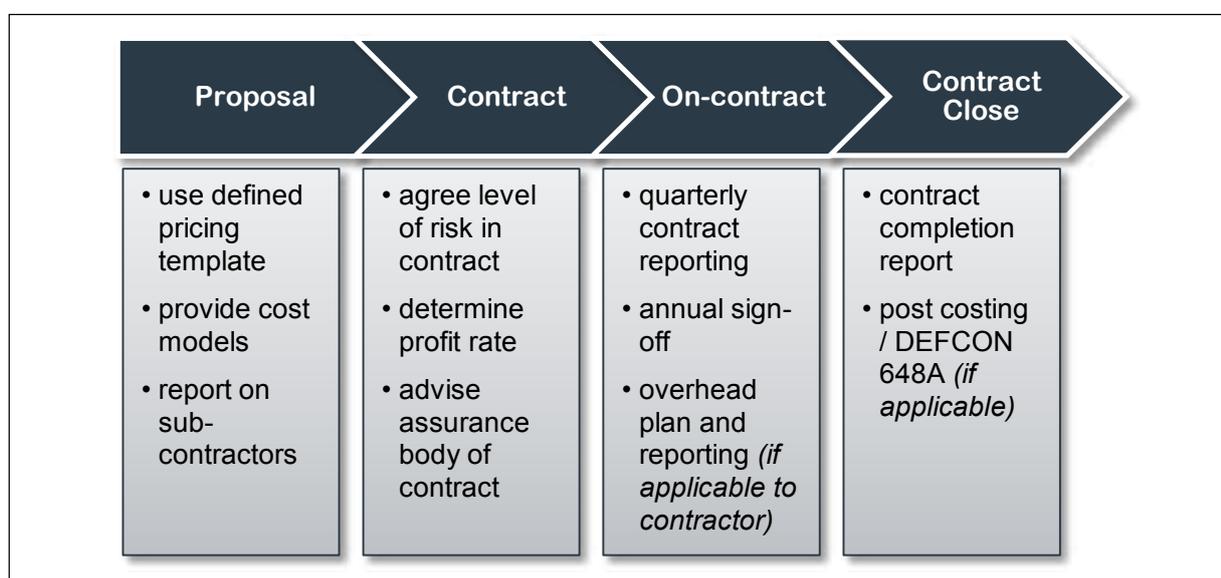


Figure 14 - Summary of Contractor Regulations over Contract Life-cycle

### Two-Tier Profit Rate / Remedy (on materiality)

- E.52 In line with the reporting thresholds, there should also be a two-tier approach to profit setting with a simplified methodology for contracts of lower value. This threshold should be at £5m contract value. Reducing complexity in the application of profit rates removes one potential barrier to the greater involvement of SMEs.
- E.53 In addition, and in line with the reporting exemption based upon contract value, there will be a corresponding exemption to the associated remedy. The threshold level will be the same as that for reporting, and the remedy of appointing reporting accountants will be exempted below this threshold.
- E.54 Other SSPR remedies, information rights, and access to dispute resolution will not be affected by this exemption.

## Summary of Materiality Thresholds

E.55 Not all elements of the SSPRs apply to all single source contracts. Suggested materiality thresholds are summarised in Table 3.

**Table 3 - Suggested Thresholds**

Area	Detail	Suggested Materiality threshold
Contractor returns	Quarterly contract returns (contract level)	Contract value $\geq$ <b>£50m</b>
	Annual overhead returns	Aggregate single source work $\geq$ <b>£100m</b>
	Contract close returns	Contract value $\geq$ <b>£5m</b>
	List of single source contracts	Contract value $\geq$ <b>£5m</b>
	Copies of single source contracts to SSRO	Contract value $\geq$ <b>£50m</b>
	Copies of contractor/joint cost models to MOD	Contract value $\geq$ <b>£50m</b>
MOD returns to SSRO	Budget data	Contract value $\geq$ <b>£50m</b>
	SSPR application data	Contract value $\geq$ <b>£5m</b>
	Independent costing reports (e.g. ICEs, Historic Trend Analyses)	Project value $\geq$ <b>£20m</b> (Category A, B & C)
Simplified profit rate	Offered to SMEs: Standard GPF rate	Contractor single source work $\leq$ <b>£5m</b>

E.56 These are recommended materiality thresholds, they will be finalised after consultation.

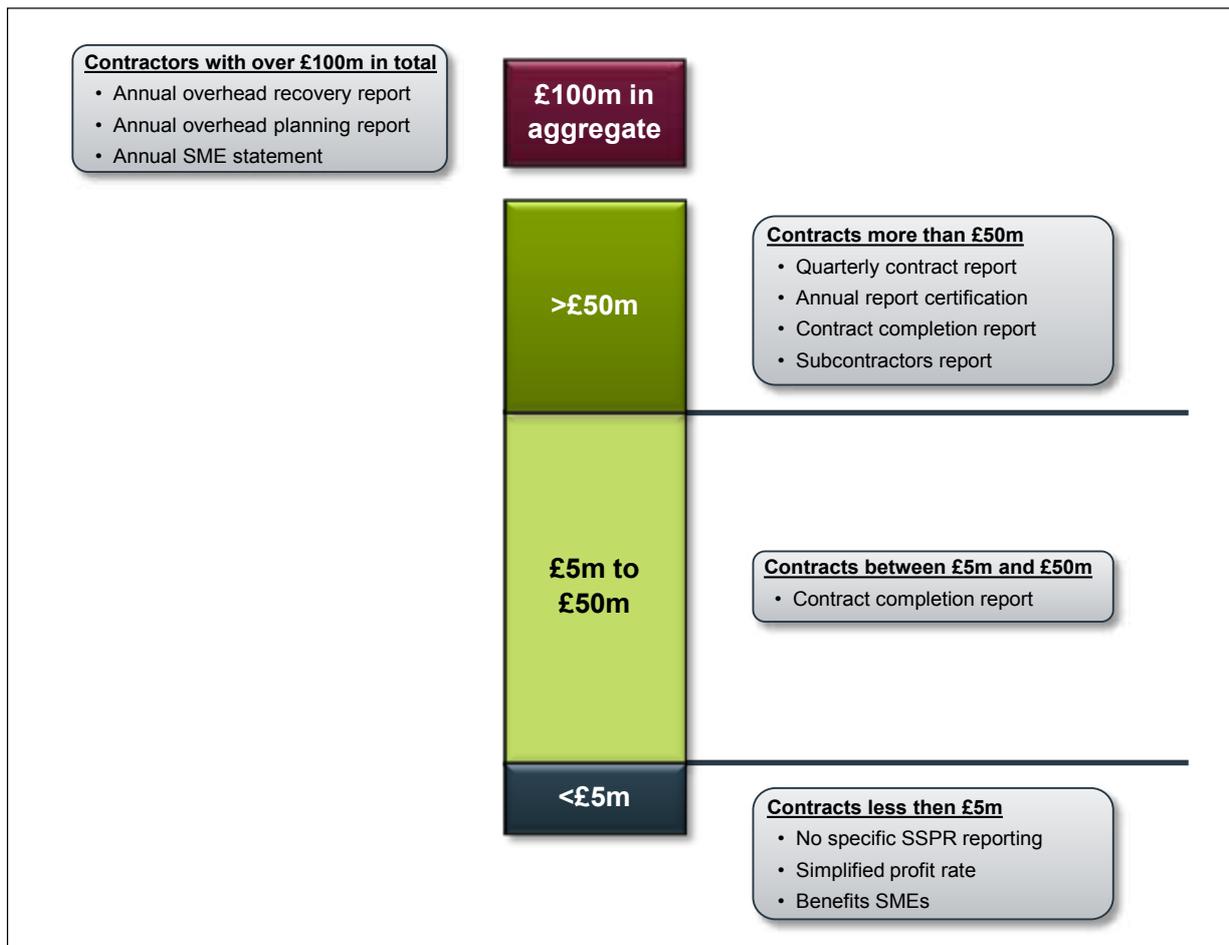


Figure 15 - Summary of Suggested Thresholds

## Information Validation

### MOD Verification and Validation of Contractor Reports

- E.57 Reports provided under contractor assurance (paragraph E1) would each contain a range of estimates, forecasts and analyses. These reports would form the basis of subsequent SSRO analysis to provide pricing information and support MOD pricing processes.
- E.58 These reports must provide consistent and reliable information, across contracts and contractors. Therefore, the MOD should undertake selective (directed and sample based) Verification and Validation (V&V) reviews of these reports.
- E.59 Validation checks that methodologies used in estimating and analyses are appropriate and fit for purpose. Verification checks the accuracy and application of the methodologies. Contractors will already be familiar with V&V approaches<sup>90</sup> through their existing management practices.

90. MOD Acquisition Operating Framework - [http://www.aof.mod.uk/aofcontent/tactical/logistics/content/inv\\_plan/ip\\_vandvtools.htm](http://www.aof.mod.uk/aofcontent/tactical/logistics/content/inv_plan/ip_vandvtools.htm)

- E.60 For example, the QCR should include an Estimate at Completion (EAC) - the MOD V&V exercise could examine the assumptions and approach used to generate this EAC (for example at contractor level), and the application of these to a specific contract.
- E.61 MOD V&V reports should be shared with the relevant contractor, and also provided to the SSRO.
- E.62 The MOD V&V of contractor reporting would provide the SSRO with a level of assurance for the primary information that should be used to support subsequent analysis (paragraph E106) in support of the pricing process. This analysis would be a key mechanism for supporting efficiency incentives within the pricing process and therefore a small volume of MOD V&V reports should be further reviewed by the SSRO.

## **MOD Assurance**

### **CAAS Rate Reports**

- E.63 The CAAS Rates Report should set out, for the lead MOD commercial officer, the direct labour and overhead rate recommendations following the investigation into the contractor's submission of cost recovery rates.
- E.64 The investigation should be conducted at the relevant business unit level and comply with the Accounting Regulations (ARs) (paragraph E122). The main output should be a table of estimated or actual recovery rates agreed with the contractor for use in contract pricing and review.
- E.65 In addition, the CAAS Rates Report should feature the following; the background and general circumstances pertaining to the contractor's business; an analysis of the contractor's costs, particularly any significant changes; discussion of the bases of cost recovery (direct hours etc); and the effect of workload volumes.
- E.66 Annual rate agreements would be informed by the Overheads Report submitted by the contractor (paragraph E14), the associated Overhead Recovery Approval (paragraph E128), and the report on MOD Independent Costing (paragraph E88), if these documents are applicable to the contractor under review.
- E.67 The CAAS Rates Report is required to enable lead MOD commercial officers to agree recovery rates with contractors for use in single source pricing. A significant value of single source pricing is on the basis of estimated rates. Actual recovery rates will be required for single source ascertained cost pricing and cost certification purposes, including post-costing.
- E.68 CAAS have been reporting on recovery rate investigations for many years, and this situation will continue under the new arrangements.

### **MOD SSPR Adherence Report (terms usage)**

- E.69 The application of SSPR policy and guidance, and its implementation through contracts with industry, rests with the MOD. The SSRO requires information to understand the extent to which terms are actually being applied to single source contracts.
- E.70 The MOD should provide periodic reports to the SSRO, noting which terms have been applied. This would allow the SSRO to assess the extent to which rights and obligations are incorporated into contract terms.

- E.71 It would be used by the SSRO (in support of its wider report on SSPR process adherence - paragraph E103) to understand whether the SSPRs are being effectively applied through contracts.

## **MOD Budget Report by Project**

### **Purpose**

- E.72 Maintaining the realism of the MOD budget is a key driver in improving efficiency and value for money (see Part 2 and Annex C). The SSRO would analyse whether forecast industry costs on large single source contracts are consistent with the budget allocated to those projects and the cost risk to which the MOD is exposed.
- E.73 Single source projects have historically been the ones most likely to experience cost growth and delays. The last NAO Major Projects Report (MPR) includes a cost and timescale performance evaluation for the largest 15 MOD projects, and all 7 of the projects that experienced both cost and time delays are being procured single source. Better control of single source budgeting will address the most significant driver of budgetary instability. In the last SDSR, analysis provided to the team showed that 90% of the contracts affected were procured single source<sup>91</sup>.
- E.74 Evaluating the realism of the MOD budget (single source) requires three elements:
- a. the budget allocated to single source contracts;
  - b. forecast contractor costs related to single source contracts;
  - c. forecast MOD costs related to single source contracts (e.g. MOD risk provision, and Government Furnished Equipment or services).
- E.75 This product, the MOD budget report, should include the budgetary data at a level that allows comparison with forecast single source project costs.

### **Level of detail**

- E.76 The MOD budget, like that in any large department or corporation, does not always map neatly onto contracts. There are some budget lines that map one to one onto single source contractor contracts, some which represent only a part of the contractor contract, and others that cover numerous contracts and some internal costs besides.
- E.77 To support the SSPR Budget Report there needs to be the ability to match the contract view with the budget view. This requires the MOD budget lines to be allocated by contract. Although this is not data currently collected centrally by the MOD, it is held within MOD Project Teams so should be available.
- E.78 Any MOD exposure to cost risks related to single source projects must also be provided for if appropriate. For example if a pain/gain share contract has been agreed (e.g. a TCIF contract), the SSRO would need to know what provision has been made for the MOD's share of possible cost overruns, whether against individual projects or through a higher level provision.

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91. MOD Renegotiation Strategy Team, May 2011.

## **Period**

- E.79 To reduce the practice of applying budget cuts, budget realism needs to be looked at over a sufficiently long period. The picture will inevitably become murky as we look further ahead, so a reasonable balance must be struck in determining the period that is assessed. In suggesting a reasonable period, we have considered MOD budgeting periods, SDSR periods, and typical single source contract lengths.
- E.80 The total MOD budget (more specifically the Departmental Expenditure Limits (DEL)) are set by HM Treasury through Spending Reviews (SRs) and Comprehensive Spending Reviews (CSRs). An SR or CSR occurs at least every 2 years, and the DELs are typically provided for 3 years (the last CSR was an exception, setting DELs for 4 years). Thus the MOD will have reasonable certainty around its total budget for a period of 3 or 4 years.
- E.81 Current policy is to run a SDSR at the start of each Parliament. This suggests an SDSR will occur every 4 or 5 years.
- E.82 Typical large single source contracts have an average duration of 7 ½ years<sup>92</sup>.
- E.83 On this basis, we recommend a 5 year view, although this would be a matter for the SSRO and the MOD to agree on. Thus the MOD budget figures would need to be provided to the SSRO looking forward 4 years in addition to the current year.

## **Materiality**

- E.84 The SSRO should agree with the MOD the list of single source contracts the budget data is required for. The level of assurance is commensurate with materiality, so only a small fraction (by volume) of all single source contracts and amendments would be reviewed.
- E.85 We recommend that contractors provide detailed cost data to the SSRO for all contracts over £50m. The SSRO should use this materiality threshold to determine the list of contracts it needs budgetary data for.

## **When will the report be required?**

- E.86 Material changes to MOD budgets happen annually through the Planning Round (PR). The MOD budget report would therefore be required annually.
- E.87 It is appreciated that budget lines frequently change, for example due to the annual MOD PR process. The report should be based on MOD budget data at a particular point, for example the end of stage 1 of the PR. This is a matter to be decided in implementation planning.

## **MOD Independent Costing Report**

### **Purpose**

- E.88 To help ensure the accuracy of the MOD budget and investment appraisal decisions, current MOD policy is to perform independent costing exercises preferably by using a different approach to the original methodology for estimation. Independent Cost Estimates (ICEs) and Historic Trend Analyses (HTAs) are required to support estimated budget requirements for new programmes, and Should Cost models support Initial Gate and Main Gate investment appraisals and negotiations with contractors prior to contract signing.

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92. SSPR Review Team analysis.

- E.89 In practice ICEs are sometimes not done or only partially done, a risk highlighted to the approving authorities. However, capability considerations often override concerns about the lack of an ICE. Although efforts are being made to tighten adherence to independent costing, their success is as yet unproven.
- E.90 To help assess budgetary risk, one of the recommended roles of the SSRO is to monitor the MOD's adherence to independent costing.

#### **Specification**

- E.91 The MOD should provide the SSRO with a list of material single source contracts they have signed in the last year. Against these contracts, the MOD should specify whether any independent costing exercise (whether a Should Cost model, ICE, or HTA) was part of the initial budget setting process or was done to support Genesis/Initial/Main gate and/or contractor negotiations.
- E.92 To help determine if the budget is realistic, the SSRO should also know what the results of the independent costing exercises were. This would include the date it was done, the total cost, risk (if available), and the material changes to the project since the independent exercise was done.

#### **SSRO Budget Report**

##### **Purpose**

- E.93 The purpose of the recommended SSRO budget report is to support the MOD in its desire to have a realistic budget for single source contracts.
- E.94 Focussing on the realism of just one aspect of the MOD budget may seem to address only a small proportion of the issue; if only one part of the budget is realistic then problems outside this scope will have a knock-on impact undermining the benefits. This is less of an issue than one might think. Compared with manpower costs, complex procurement projects and maintenance contracts are usually much harder to forecast accurately. Under the SDSR, the most draconian adjustment to the MOD budget for a decade, 90% of equipment project changes related to single source contracts<sup>93</sup>. Nearly all of the programme cost increases identified in the 2010 NAO MPR related to single source procured projects.
- E.95 The aim of the report is to help the MOD in maintaining a realistic budget. To do this it must identify budget lines at risk of being significantly over or under-provisioned. The report is not addressed at changing MOD policy or diagnosing shortcomings - it is to provide MOD senior management with an independent view of which budget lines might be unrealistic.
- E.96 The SSRO budget report should be provided annually to the MOD Permanent Secretary (MOD Accounting Officer).

##### **Level of detail**

- E.97 The report should be sufficiently detailed to highlight particular low level budget lines, for example MOD Basic Level Budget lines or so called 'P9' lines. This will allow the MOD to focus further investigations precisely where required. The link back to contracts should

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93. MOD Renegotiation Strategy Team, May 2011.

also be made, for example budget line X may be under or overstated by as much as £Ym due to likely over-runs on contract Z.

- E.98 Where relevant, the picture should also be aggregated by project, e.g. Astute or Tornado. These projects typically cover more than one contract and contractor.

### **Risk**

- E.99 A key element of the assessment of possible over or under provision will be any allowance the MOD has made for cost risk. For example approximately 40% of single source contracts include a pain/gain share mechanism<sup>94</sup> known as TCIF. Under TCIF the MOD must pay a share of any cost over-runs. This share can be very substantial, with a recent large contract putting 90% of the share with the MOD. Where this is the case, the MOD must include a provision commensurate with this risk within the budget.
- E.100 It is understood that the risk provision will not always be at the contract-level or even the project-level. The MOD has a diversified portfolio of risks and as such it would make some financial sense to hold a risk contingency at a central level, however in practice this is very difficult to maintain with an overheated budget. The SSRO budget report should attempt to evaluate MOD cost risk and compare this with risk provisions whatever their level.

### **Supporting information**

- E.101 The report should include supporting information, such as the basis for risk assessments and forecast costs. A full audit trail would not be included, however the MOD would have access rights to all supporting information should they wish it.

### **Materiality**

- E.102 Not all budget lines related to single source contracts will be evaluated - only those budget lines related to single source contracts above the materiality level for contractor cost reports will be considered (recommended at £50m). It is estimated that this will cover circa 70% of the single source budget (see Annex D).

### **SSPR Process Adherence Report**

- E.103 Further to the application of the SSPRs through contracts, covered by the MOD provided SSPR Adherence Report (paragraph E69), the SSRO should also receive other reports related to the application of the pricing process for single source contracts. These include the report on ICE and Should Costing (paragraph E88).
- E.104 In addition, the SSRO should receive feedback on how individual aspects of the pricing process are used, for example, whether the risk-reward process was used to determine profit rate, whether benchmark analysis was used to support Should Cost challenges, etc.
- E.105 This information would allow the SSRO to report on how the SSPRs are being applied, and to consider whether changes are required as part of the process of refining the SSPRs in the light of practical experience.

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94. UK Defence Statistics 2010, Table 1.15, MOD.

## **Pricing Information**

- E.106 As part of the SSPRs it is recommended that, for contracts over the proposed £50m materiality threshold, contractors should be required to provide cost and pricing information to the MOD.
- E.107 The SSRO would provide benchmarking and other analysis to the MOD, based principally upon the data provided by those contractors. This analysis, described in more detail in this section, will be provided to inform and support future pricing activity between MOD and its single source contractors.

## **Overhead Analysis**

- E.108 Overhead Analysis should aim to understand the nature and cost of overheads being charged to the MOD by various single source contractors.
- E.109 The primary input for this analysis should be the Overhead Report (paragraph E14) provided by each contractor that has aggregate single source contracts over the recommended £100m threshold.
- E.110 The outcome of this analysis should be a report on each contractor reviewing trends in overhead spend and a summary report reviewing overall trends within the single source defence sector.
- E.111 A summary report on the single source defence sector should also be published by the SSRO on an annual basis and delivered to the MOD.
- E.112 In addition to the individual contractor reports and the summary report, the SSRO would also be well placed to conduct comparative analysis between single source contractors. Whilst recognising that contractors have different operating models, value could be obtained in comparing costs at appropriate levels between contractors. Within the confines of absolute contractor confidentiality, there may be information that the SSRO would be able to provide to aid contract pricing, for example comparison to sector averages.

## **Risk Analysis**

- E.113 The SSRO should have access, from the contract, QCR and CCR, to the levels of contingency funding that have been included in a contract and the value that contractors have spent against specific risks occurring during the contract.
- E.114 Risk analysis by the SSRO should look at the reasons for contingency spend and identify whether the appropriate values and probabilities have been used by contractors when initially estimating risks. If certain risks are repeatedly occurring with a certain contractor the SSRO may suggest that these costs are included in the price or the probability of occurrence is increased. If certain risks are always priced and then identified as never actually occurring the SSRO may suggest that these risks should no longer be included when calculating the contingency funding submitted as part of the price.
- E.115 The level of risk being managed by contractors and the MOD may also be a key driver in setting the level of profit for a contract. The SSRO should be in a position to comment on the total level of risk being managed by specific contractors and the MOD and provide advice if it identifies risks that are misplaced.

## **Estimating Accuracy / Variance Analysis**

- E.116 The SSRO should conduct analysis, including benchmarking, reviewing the accuracy of both contractors' and MOD cost estimates. The SSRO should also review variance analysis provided to it to comment on common issues.
- E.117 The data and information for this analysis will include using the MOD ICE and Should Cost Reports, and contractors' CCRs.
- E.118 The SSRO should report on the various trends in the accuracy of estimates made by individual contractors and the MOD. It will also report on the trend of estimating accuracy within the overall single source defence sector. As with the Overhead Reports, contractor level analysis will be treated as commercially sensitive. Appropriate controls, analysis, and recipients will be considered in the consultation phase.
- E.119 Reviewing the estimating accuracy of contractors and the MOD will lead to the identification of recommendations that could improve estimating accuracy in the future.

## **Pricing Process**

- E.120 As part of the SSPR it is recommended that all contractors with single source contracts should be required to conform to defined pricing processes to price the contract. The use of defined pricing processes should allow the MOD and the SSRO to track and monitor single source pricing activities more easily.

## **Government Accounting Conventions**

- E.121 Under the current regime GACs give guidance to what costs are allowable in the overhead element of single source pricing. The conventions are based on arrangements that have been reached by industry and the MOD, with the oversight of the existing Review Board. The conventions are published periodically in the General Review reports issued by the Review Board for Government Contracts.
- E.122 The GACs were not initially designed as a comprehensive statement of costs allowable in government contracts but have come to be used in this way, and have developed over the years in response to particular issues. Hence the conventions lack clarity and coherence, which can lead to confusion and delays in rates agreements and pricing. We recommend that the GACs be updated into Accounting Regulations (ARs) which are designed to be a comprehensive statement of costs allowable in both direct contract pricing and in overhead recovery (e.g. through rates).
- E.123 Under the new SSPRs the SSRO should become responsible for developing and issuing the appropriate ARs. The SSRO should consult with both the MOD and industry in developing the ARs but should have sole responsibility for the final content of the regulations. As with use of the GPF profit rate, adherence to the ARs will be a matter for the MOD and contractors. We anticipate that MOD policy would be to follow the ARs in pricing and rate setting except in exceptional cases.
- E.124 The ARs must be comprehensive, fair to both parties, and provide coherence, clarity and consistency of approach to single source pricing.
- E.125 The ARs should be designed to aid current and future pricing and must state exactly the limits of their application. Particular attention should be given to significant issues such as marketing, research and development, and rationalisation with a clear statement

of what costs are not to be included in contract pricing. There may be costs which are considered to be outside of pricing, which will need to be subject to separate negotiation between the MOD and the contractor.

E.126 If the parties disagree on the interpretation and/or application of the ARs the SSRO should appoint an appropriate arbiter to resolve the disagreement (paragraph 298).

E.127 The ARs will be reviewed and updated by the SSRO as and when required.

### **Overhead Recovery Approval**

E.128 Those contractors who are required to complete an Overhead Report (paragraph E14) should be required to discuss and obtain acceptance by the MOD of any areas of significant overhead spend. It is not for the MOD to determine what costs the company can incur, but rather to determine what costs it will allow into the overheads that it will reimburse.

E.129 The information provided by contractors in their Overhead Reports and the information from the independent cost estimates (paragraph E88) will be used as the basis for negotiating recoverable spend. The intention is that any significant or contentious items are discussed and agreed before the contractor commits to costs, giving the contractor certainty of the acceptability of those costs before they are incurred.

E.130 Overhead recovery approval should only be given by MOD 2\* commercial directors or a delegated officer. The approval should inform the CAAS rates investigation (paragraph E63) and the determination of the rates to be used in pricing. The Overhead Report should be received annually to facilitate high level discussions between the MOD and the contractor on the outturn overhead rates.

### **Set Annual Profit Rate**

E.131 The base profit rate to be used when pricing single source contracts (prior to contract specific amendments, for example risk adjustment) will be set annually by the SSRO, in accordance with the basis for setting the profit rate that is initially to be agreed in the consultation phase (paragraph 319).

### **Profit Rate Basis**

E.132 Under existing arrangements government and industry have agreed to use the GPF for pricing single source work. The GPF is constructed on the 'comparability principle': contractors should get a return comparable to the average return earned by the rest of British industry. The baseline profit rate can be varied for other factors, such as the financial risk inherent in the work; in addition, contractors get fixed and working capital servicing allowances.

E.133 The GPF is currently maintained by the Review Board, which makes recommendations to update the profit rate and capital servicing allowance, to maintain comparability and reflect current economic factors. Their recommendations are only implemented if agreed jointly by both government and the defence industry (since the MOD and its contractors are the only known users of the GPF).

E.134 Under the SSPRs the Review Board would be replaced by the SSRO. The SSRO would be responsible for determining the basis of setting profit for pricing single source contracts. The SSRO should consult with both the MOD and industry on the basis of

setting profit but should have the final responsibility for deciding the methodology. Our recommendation is that the SSRO continues to use the comparability principle as currently employed, but that this should be periodically reviewed.

- E.135 Methodologies which the SSRO may wish to consider include; establish a number of key principles for the negotiation of a fair and reasonable profit allowance but will not direct a specific rate, or rates; retain the existing approach of calculating a baseline profit rate upon the basis of comparability, which can then be varied to take account of factors specific to each contractor pricing unit (e.g. capital requirements), and contract factors; determine a 'risk free' profit rate (perhaps derived from gilts) which may then be adjusted in negotiation between the MOD and its contractor for each specific contract, commensurate with the risk being taken by the contractor (paragraph 139).
- E.136 While the profit rate is only one element of the price, it often attracts significant attention and needs to be on a basis that is demonstrably fair to both the contractor and the MOD. The profit level is one of the most significant means of rewarding the contractor for undertaking challenging tasks in an efficient manner.
- E.137 The SSRO should consider a two-tier approach to profit setting with a simplified methodology for contracts below the recommended threshold of £5m<sup>95</sup>. This may further encourage the involvement of SMEs.

### **Risk-Reward Basis**

- E.138 The principle that the profit allowance in a contract should be commensurate with the risk being taken is widely accepted.
- E.139 The existing GPF is recognised as performing poorly in this respect. Some efforts to address this have been undertaken since 2004 but have not been progressed into any development of the formula.
- E.140 The GPF effectively provides only 2 rates to apply to single source contracts: a non-risk rate and a risk rate. The non-risk rate is arbitrarily set at 75% of the risk rate and is applied only in a small number of cost-plus contracts using DEFCON 653<sup>96</sup>. The current risk rate is set on the basis of comparability (paragraph B27) and is applied to firm and fixed price contracts whose price is agreed on the basis of estimated recovery rates.
- E.141 The GPF risk rate can be adjusted to take account of certain factors, including the degree of risk, but the mechanisms are weak and do not achieve a good alignment of risk and reward. There is therefore an inadequate differentiation in the rate of profit used in the price of a firm price contract which is truly high risk to a contractor, and one which carries very little risk.
- E.142 There are a number of possible options for aligning the level of profit to the risk taken, and some joint work by the MOD and industry on possible candidate mechanisms has been undertaken in recent years. The SSRO should determine how risk/reward should be addressed when they consider options for the profit rate basis (paragraph E132).

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95. For example using the Reference Group CP:CE ratio as a basis for determining the capital servicing allowance, and hence have a single profit rate available for all small contractors and avoid the need to calculate CP:CE ratios.

96. MOD Acquisition Operating Framework, DEFCON 653 - Pricing Ascertain Costs - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr\\_ascos/full\\_prascos.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr_ascos/full_prascos.pdf)

## **Defined Pricing Template**

- E.143 It is recommended that a defined pricing template is used for all single source contracts. A defined pricing template should enable prices from different single source contracts to be compared, and provide the basis for consistent reporting throughout a contract's duration. It will also enable consistent analysis to be performed.
- E.144 Whilst individual contract prices will not be comparable, as different contracts will be procuring vastly different products and services, the ability to compare easily the value of common cost items (for example HR overheads) will give the MOD a valuable understanding of single source contracts.
- E.145 Contractor cost estimates presented on a defined template should help the MOD to make a more informed assessment of what is an acceptable cost for pricing purposes.
- E.146 Industry may also benefit from using a defined pricing template as it will give contractors the opportunity to standardise further their internal bid processes.

## **Agree Contract Profit Rates**

- E.147 Under the existing approach CAAS accountants apply the GPF methodology to examine an individual contractor business unit's claimed profit rates and capital servicing allowances. Once agreed, these rates and allowances are then used by MOD commercial officers when pricing contracts with those units.
- E.148 Under the SSPRs the CAAS accountants and their industry counterparts should continue to undertake this task, applying the profit methodology determined by the SSPRs (paragraph E132) and using the latest rates set by the SSRO (paragraph E131)

## **Guidance on Pricing Policy**

- E.149 The SSRO will be responsible for some key elements of single source pricing, for example the ARs and the annual profit rate.
- E.150 There is clearly significant interaction between the SSPRs and commercial policy, for example the use of different contracting mechanisms used for single source contracts, such as firm/fixed priced contracts<sup>97</sup>, TCIF contracts, approach to risk assessment etc. We have commented and made some ancillary recommendations upon some of these areas in Part 2 of this report.
- E.151 The SSRO should, as required, issue comment and provide guidance on aspects of policy that have a particular impact upon SSPRs, for example the level of residual pricing risk held by the MOD, or the use of pricing information generated by the SSRO for use in pricing by the MOD.

## **Rights - Information**

### **Open Book Accounting**

- E.152 Open book, sometimes called open book accounting or open book costing, is an approach that has been used for many years in the automotive, utility, civil engineering

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97. MOD Acquisition Operating Framework, Pricing Non-Competitive An Overview - [http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr\\_nonc/full\\_prnonc.pdf](http://www.aof.mod.uk/aofcontent/tactical/toolkit/downloadsindexed/pr_nonc/full_prnonc.pdf)

and construction sectors. It is an approach that allows access to contractors' existing management, financial and operational data that would not normally be available under conventional contractual relationships.

- E.153 A degree of open book has always existed in single source pricing under the access rights and information given to the investigatory arms of the MOD. Open book accounting is normally a feature of MOD Private Finance Initiative (PFI) contracts.
- E.154 The SSPRs should define what is meant by open book. Open book is fundamental to the SSPRs and would be expected to cover the process used:
- a. to generate the reports recommended in our solution;
  - b. to build up the contract price;
  - c. in undertaking performance audits and Truth In Negotiation;
  - d. rate setting.
- E.155 Relevant information should be made available by the contractor to the MOD to enable the MOD to make an informed assessment on initial pricing or on the continuing performance of a contract.
- E.156 The aim of open book is to build trust and constructive engagement between the parties, to reduce risk and encourage efficiency by the sharing of information. The provision of information should not be significantly onerous and requests for information need to be reasonable and relevant to the application of the SSPRs. The extent of the open book approach should be subject to consideration in the consultation phase, but we consider that the MOD should have access to any information held by a contractor that is relevant to costs and estimating processes used in pricing a single source contract.

## **Rights - Remedy**

### **Appointment of Reporting Accountants**

- E.157 Potentially the most disruptive compliance lapses are the submission of inaccurate contract or company financial returns, and the failure to submit returns. We think the remedy process in both cases should be similar.
- E.158 The SSRO should appoint a firm of accountants (other than the firm's auditors) to oversee the preparation of the required returns and provide an accountant's report thereon.
- E.159 Should the lapse be considered sufficiently serious by the SSRO, then the SSRO should determine the period of time both retrospectively (how far back in time they look) and prospectively (how long they should be engaged) that the appointed firm shall perform the task of overseeing the preparation of the required forms.
- E.160 This remedy is intended to place contract reporting, or contractor overhead reporting, back into a position of compliance with the code of conduct. The firm of accountants would not be expected to generate the relevant reports, rather to work with the contractor to ensure they are in a position to provide the retrospective reports, and have the processes and information necessary to produce future reports to ensure repeated failures of compliance do not occur.

## **Performance Audits**

- E.161 The MOD will have the right to conduct a performance audit of single source contractors. The purpose of these audits is to provide a proxy for the pressures that exist in a competitive contracting environment, namely the ongoing pressure to become more efficient.
- E.162 Unlike the requirement for contractors to provide cost reports, this right applies regardless of the materiality of the contract.
- E.163 The MOD would have to give contractors appropriate notice before commencing a performance audit.
- E.164 The right to conduct a performance audit includes a possible review of any policy, business function, activity, or system that impacts upon cost, efficiency, or value for money, access to which is not legally precluded. These rights are expected to be clarified during the next phase of the review.
- E.165 It is anticipated a performance audit would require specialists in a variety of disciplines such as: engineering, pricing, audit, procurement and management. This is likely to require the MOD to employ external support.
- E.166 It is understood that a performance audit will entail overhead for contractors. In theory this could become onerous, however in practice the significant pressure on government staff and resources makes it highly unlikely that the MOD would overuse this right. In the event that a contractor feels the MOD is being excessive in its application of this right, they would have the right to refer to the SSRO.

## **Rights - Dispute Resolution**

### **Truth In Negotiations/Equality of Information**

- E.167 Currently, contractors and the MOD are required to complete and sign Equality of Information Pricing Statements at the time of pricing. This EIPS represents key evidence in any later dispute around whether or not there was equality of information.
- E.168 Truth in Negotiations (TIN) should be a fundamental requirement on both parties when pricing single source contracts.
- E.169 TIN is a term used by the US government and is embodied in the Truth In Negotiation Act which requires contractors to submit cost or pricing data and to certify that such data is current, accurate and complete on the date of final agreement on price. Adherence to it is assessed through contract post award audits. In the UK similar, though lesser, assurances are obtained through the embodiment of the Equality of Information principle within contracts.
- E.170 TIN and Equality of Information both require the contractor to disclose at the time of pricing all material facts that are relevant to the pricing of the contract.
- E.171 In the MOD, adherence to Equality of Information at the time of pricing is reviewed as a part of the post-costing regime, which only occurs at contract completion and on a selective basis. With many contracts being of long duration the reasons for variances between price and outturn are often very difficult to determine, and any lessons identified are too late to be effective.

- E.172 Under the SSPR the Equality of Information requirements at the time of pricing, including the completion and signature by the MOD and contractor of an EIPS should remain. In addition, the SSPR should adopt the US practice of conducting post-award audits within 2 years of the contract start date. This would allow the MOD to investigate the contract pricing to ensure that Equality of Information existed at the time of pricing and to learn lessons for future pricing in a timely manner.
- E.173 Lack of Equality of Information can result in unfair pricing which does not give value for money for the taxpayer. Should it be discovered that Equality of Information did not exist at the time of pricing, re-pricing and financial remedy may be appropriate which in some cases may require arbitration between the two parties as per the agreed dispute resolution procedures outlined within the contract or a professional arbitration body.

### **Amended DEFCON 648A**

- E.174 DEFCON 648A is an MOD contract condition that requires the contractor to give the MOD information and access rights to enable the MOD to post-cost contracts, at or near contract completion.
- E.175 In certain defined circumstances, where the outturn costs are significantly at variance with the costs agreed at the time of pricing, costs above a given threshold are defined as 'excess profits or losses', and are shared between the parties on the basis 75:25 MOD:contractor.
- E.176 The current parameters in DEFCON 648A are viewed as a disincentive to contractor efficiency, because they are invoked at too low a level - at an additional profit of 5% of contract price.
- E.177 In Key Recommendation 3 we propose potential options to change DEFCON 648A, and we welcome views on these options in the consultation phase. The DEFCON should retain the existing safeguard provision allowing either party to challenge the automatic sharing provisions if they believe their application is unjustified. Appeal against the sharing will be firstly through negotiation between the parties; secondly by reference to the dispute resolution procedures outlined within the contract or a professional arbitration body.

## **Nature of Independent Assurance**

### **Introduction**

- E.178 Our review finds that the existing single source regime does not enable the provision of sufficient data to the MOD for the department to gain good assurance that it has achieved fair and reasonable prices for the taxpayer, nor to incentivise contractor efficiency improvements. Nor does it provide sufficient incentives to encourage the right behaviours in the MOD. Accordingly, we propose new regulations for both contractors and the MOD to create a more appropriate framework for single source procurement.
- E.179 A key recommendation of our review is the creation of a more powerful independent SSRO, in place of the existing Review Board. The new SSRO will promote the adherence of both contractors and the MOD to the new framework, including the enforcement of rights when appropriate.
- E.180 The following section summarises the key roles of the SSRO. It examines what it should be tasked with overseeing, potential reporting lines, and the type of public body it might be.

## **Assurance of industry**

E.181 The SSRO role in the assurance of industry will be to undertake expert analysis of the information provided to them by contractors and to use that to provide relevant parties with reports (sometimes generic, sometimes contractor specific). The provision of information should provide an element of proxy for competitive pricing pressure: it is aimed at aiding the achievement of contract prices that are fair and reasonable to both parties.

E.182 The role should include:

- a. receiving, analysing and reporting on contractor reports (Quarterly Contract Reports, Annual Overhead Reports, Subcontractor Reports and Contract Close Reports);
- b. monitoring and reporting on whether the reports provided by contractors are appropriately certified;
- c. assessing cost reports for possible inaccuracy and, if required, recommending that the MOD audit the reports;
- d. monitoring and reporting on contractors failing to provide the required information;
- e. applying sanctions related to non-provision of information, misleading information, or non-certification of information;
- f. consulting with the MOD, industry and other relevant parties over proposed changes to the SSPR, whether those changes are proposed by the MOD, industry, the SSRO or other relevant parties (e.g. HM Treasury).

## **Assurance of the MOD**

E.183 The role in the assurance of the MOD is to provide an independent, expert view of the department's budgetary provisions allocated to single source contracts/projects, and to aid the MOD in its ability to assess contractor and MOD cost risks and to achieve fair and reasonable prices on single source contracts.

E.184 The role should include:

- a. analysing the MOD budget, split by contract, and comparing with contractor cost estimates;
- b. analysing MOD financial risk due to contract risks where the MOD has taken on risk (e.g. TCIF, risk contingencies);
- c. reporting to the MOD on variance between MOD's current budgetary provisions, by contract, and the estimates above;
- d. reporting to the MOD on their adherence and use of the SSPRs (e.g. use of SSPR profit rates, utilisation of open book rights, inclusion of appropriate SSPR DEFCONs etc);
- e. providing information, as appropriate and subject to commercial confidentiality, to enable the NAO to perform its duties in relation to MOD procurement activities.

## **Summary of SSRO tasks**

E.185 The purpose of the SSRO would be to define and maintain a framework that encourages efficiency and value for money in MOD single source procurement, compensating for the absence of competitive market pressures. The roles we propose are outlined in Part 3 (paragraph 256). Table 4 shows how the outputs and activities discussed above related to these roles.

**Table 4 - Summary of SSRO Tasks and Activities**

Roles	Outputs and Activities
<p>Ensuring consistent and high quality cost information flows from contractors to the MOD through appropriate access rights and regular reporting</p>	<p><b>Equality of Information and open book rights (at the point of pricing)</b></p> <p>Defining Equality of Information and open book rights to ensure both parties have access to the right information relevant to pricing, including the pricing of overheads.</p>
	<p><b>Audit and open book rights (once on contract)</b></p> <p>Defining audit and open book rights the MOD should have to help ensure contractors are spending judiciously, and to audit contractor returns if there are concerns about their accuracy.</p>
	<p><b>Quarterly contract report template</b></p> <p>Setting the content of the quarterly contract reports to ensure they fulfil three roles:</p> <ul style="list-style-type: none"> <li>(1) provide the MI that the MOD needs to assess cost/risk growth;</li> <li>(2) provide cost information that helps generate benchmarks useful for pricing;</li> <li>(3) provide other high level project information relevant to efficiency and value for money.</li> </ul> <p>The SSRO will use the data collected to prepare the pricing and benchmark report.</p>
	<p><b>Annual overhead reports</b></p> <p>Setting the content of the annual overhead reports to ensure they:</p> <ul style="list-style-type: none"> <li>(1) provide forward plans to enable the MOD and contractor future capacity and capability planning;</li> <li>(2) highlight material overhead activities occurring next year so the MOD can engage appropriately to both agree to and make provision for the cost.</li> </ul> <p>The SSRO will use the data collected to prepare the pricing and benchmark report.</p>
	<p><b>Assessment of the use of competition within supply chains</b></p> <p>The quarterly contract reports will include a fourth requirement:</p> <ul style="list-style-type: none"> <li>(4) provide information on any material subcontractor contracts that have been awarded to the subcontractor on a single source basis and why competition was not used.</li> </ul> <p>This will also allow the SSRO to monitor whether SSPRs have been flowed down the supply chain. If there are concerns, these will be raised with the MOD as necessary.</p>

Roles	Outputs and Activities
	<p><b>Assessing the risk of inaccurate reports from contractors</b></p> <p>The SSRO will analyse the data provided by contractors for consistency with previous reports and make comparisons across relevant benchmarks. This analysis will highlight areas where there is a risk that the report data may not be accurate (for whatever reason). The SSRO will then carry out preliminary investigations with the contractors and, if not satisfied, will recommend the MOD does a full performance audit to investigate the process used to generate the report.</p>
<p>Analysing collected information to help the MOD agree prices that incorporate strong but realistic efficiency targets</p>	<p><b>Annual pricing and benchmark report</b></p> <p>Analysing the contractor data provided to the SSRO from:</p> <ul style="list-style-type: none"> <li>● Quarterly Contract Reports</li> <li>● Overhead Reports</li> <li>● Contract Close Reports</li> </ul> <p>Extracting pricing benchmarks and providing these to the MOD in an annual report so that the MOD can use these to support its negotiations.</p> <p><b>Assessment of over or under recovery of overhead</b></p> <p>The annual overhead reports will include a third requirement:</p> <p>(3) Show the total overhead costs incurred vs. recovered on MOD single source projects, and the proportion of the total business unit overhead that is being recovered on single source contracts</p> <p>This will allow the SSRO to comment on any inappropriate commercial behaviour - for example any significant and systematic over or under recovery - and notify relevant parties as necessary.</p>
<p>Reporting to the MOD Accounting Officer on the realism of MOD budgets allocated to major single source projects</p>	<p><b>Annual MOD budget reports</b></p> <p>Analysing forecast costs (based on contractor cost forecasts, an assessment of MOD cost risk, and any other adjustments) with MOD budget lines, to form an opinion of whether the budget is realistic, providing an annual report summarising the results to the MOD.</p>

Roles	Outputs and Activities
<p>Providing assurance of the MOD's adherence to procurement practices that help ensure value for money and supplier efficiency</p>	<p><b>Assessment of MOD use of procurement processes</b></p> <p>Analysing MOD provided data to determine the extent to which MOD processes, designed to ensure more realistic budgeting, have been followed. In particular looking at the use of Genesis gate, independent cost estimates, historic trend analysis, and should costing. Any concerns will be communicated as necessary to the MOD.</p>
	<p><b>Assessment of the commercial constructs used in single source procurement</b></p> <p>At the start of a contract the MOD and contractor sign an Equality of Information Pricing Statement (EIPS), which includes details of the commercial construct. By receiving copies of the EIPS, the SSRO will be able to assess the use and appropriateness of the commercial constructs being used and discuss with the MOD as necessary.</p>
	<p><b>Assessment of the cost impact of requirement change</b></p> <p>The quarterly contract reports will include a fifth requirement:</p> <p style="padding-left: 40px;">(5) provide information of significant specification changes since the last report, and their impact on forecast contract costs.</p> <p>This will allow the SSRO to comment, as necessary and to the MOD, on projects where requirement change appears to be driving significant cost growth.</p>
<p>Monitoring and ensuring compliance with the single source pricing regulations, and managing their change over time</p>	<p><b>Monitoring the application of the single source pricing regulations</b></p> <p>The SSRO should receive notifications from contractors for any contract that falls under the SSPRs. The SSRO will also require information from the MOD on all contracts that have been procured on a single source basis. This would allow the SSRO to understand which single source contracts have been entered into without the protections of the SSPRs and to investigate why this is the case. Where the SSRO has concerns about this, these will be notified to the MOD as necessary.</p>
	<p><b>Monitoring the receipt of reports from contractors</b></p> <p>The SSRO should monitor the receipt of all the quarterly contract reports, annual overhead reports, and SME reports for all the contracts under SSPRs. The SSRO would also monitor whether appropriate Board certification has been provided. Any failures to provide the reports or certification would be recorded, and appropriate remedies would be applied.</p>
	<p><b>Monitoring the receipt of MOD data</b></p> <p>The SSRO would require timely data from the MOD. This would be underpinned by arrangement, such as a service level agreement. Non-provision of this data would be highlighted as necessary.</p>

Roles	Outputs and Activities
	<p><b>Managing the SSPR change process</b></p> <p>This would involve running a clear review and update process that allows both the MOD and industry to raise issues and present evidence to make their case for changes to the framework. Each year the SSRO will recalculate the baseline profit rate and update the framework, including the legal terms to be incorporated into contracts and contractor level agreements, as appropriate.</p>
<p>Oversee and set the profit rate mechanism and the GACs (or ARs), taking over these functions from the Review Board. This will include making provision for an appropriate relationship between profit and risk</p>	<p><b>Profit rate</b></p> <p>Setting the risk-free profit rate to apply to single source contracts on an annual basis.</p>
	<p><b>Profit and risk mechanism</b></p> <p>Setting out a mechanism for relating profit and risk.</p>
	<p><b>Profit and loss sharing mechanism</b></p> <p>Setting out a profit sharing mechanism that suitably balances efficiency incentives (allowing contractors to benefit from efficiency through higher profits or lose out if efficiencies are not achieved) and value for money (protecting against super-profits and super-losses). This will modify the current DEFCON 648A.</p>
	<p><b>Cost reporting and pricing regulations</b></p> <p>Defining the allowable, non-allowable, and partially allowable cost categories (as currently contained within the GACs) to ensure clarity and consistency. It will also define the basis for cost reporting and pricing (for example “all costs must be presented, in both reports and price build-ups, at original cost to group”)</p>
<p>Monitor and encourage the use of SMEs within single source procurement</p>	<p><b>Annual SME report template</b></p> <p>Setting the content of the SME reports to ensure prime contractors will provide a summary of how they manage their SME subcontractors, and how they provide support and assistance to this sector.</p>

**Basis of the SSRO’s authority**

E.186 As described in Annex B, the current single source regime is founded upon a 1968 Memorandum of Agreement between HM Treasury and CBI. The Agreement is not a legally binding document but key principles have been incorporated into contract conditions and pre-award processes. Despite this, crucial elements of single source pricing are barely touched upon by the 1968 Agreement e.g. the critical process by which the MOD agrees labour and overhead recovery rates with its contractors. These processes have been built on ‘custom and practice’ and there is a lack of definition and hence consistency in the information requirements placed upon contractors. As a consequence the MOD is not receiving from contractors across the board the data it needs to improve single source pricing.

- E.187 There are a number of ways in which the SSRO could be provided with the necessary powers to obtain the required information.
- E.188 **Legislation** - Similar to the way the USA, France and some other nations manage the pricing of single source defence equipment (Annex F) the SSRO would be given the powers required to carry out its defined functions through an Act of Parliament. There are a number of practical difficulties in achieving a legislative solution, such as:
- a. fitting into the current busy legislative programme;
  - b. defining which contracts the legislation applies to;
  - c. applying to only one government department.
- E.189 However, there are real benefits in giving the SSRO powers through legislation:
- a. long-term adherence to consistent single source information requirements across the contractor base;
  - b. no requirement for the MOD and industry to enter into prolonged - and possibly fruitless - negotiations about the adoption of new SSPRs (joint negotiations under current Yellow Book arrangements have resulted in few changes in single source arrangements from one Review Board 'Yellow Book' to the next, given both sides have effective powers of veto);
  - c. it should provide the SSRO will real independent substance and authority.
- E.190 **Contractor Level Agreements with the MOD** - terms and conditions would be agreed with each single source contractor at a contractor level that would then take precedence over individual contracts. This option would be easier for the MOD to implement than seeking legislation and could ensure the consistent application of SSPRs across all single source contracts. However, the drawbacks of this approach are that it may lead to an inconsistency in application if different terms are negotiated with individual contractors. It may not be possible to negotiate any agreements that offer significant improvements on the levels of information provided under the current system. There may also be issues regarding legal precedence, with contractor level agreements needing to take precedence over individual contract terms.
- E.191 **Individual contract terms** - terms and conditions could be agreed with a contractor for each single source contract. This would give the MOD and contractors the freedom to negotiate bespoke SSPRs for each contract. However this would lead to sporadic implementation of SSPR terms and the negotiation away of important terms that at a project level might hold little value but are essential for the MOD at a strategic level. Individual contract terms for SSPRs would completely undermine the aim of achieving consistency in the information provided to the MOD, the SSRO and other relevant parties.
- E.192 **Code of Conduct** - This is a code of conduct, published by the SSRO after consultation with the MOD and industry. The code could be incorporated into single source contracts through the inclusion of a special condition, mandated through MOD commercial policy.
- E.193 The decision on the creation of a new SSRO and how it will be vested with authority will be taken in the next phase of this review. Our recommendation is that a code of conduct, given effect through the incorporation of a new special condition into single source contracts, presents the most practical way forward. In the event that contractors do not sign up to this code of conduct, we would recommend formalising such powers in legislation.

## Reporting Lines

- E.194 To fit within the constitutional architecture the SSRO must report to a branch of government whose purpose is aligned to the purpose of the SSRO. Four options have been identified:
- E.195 **HM Treasury** - the department responsible for public spending, including efficiency and value for money in public service.
- E.196 **MOD** - The MOD Accounting Officer (Permanent Secretary) acts within the authority of the Minister but has a separate personal responsibility to Parliament for the management and organisation of the MOD, including the use of public money and the stewardship of its assets. This includes propriety and regularity; prudent and economical administration; avoidance of waste and extravagance; efficient and effective use of available resources; and the organisation, staffing and management of the department. The Accounting Officer has to appear before the Public Accounts Committee (PAC) to give evidence of their and the MOD's performance.
- E.197 **The National Audit Office** - The NAO scrutinises public spending on behalf of Parliament, to which it reports. We favour an option that reports to an appropriate part of government. This is because the key objectives of creating new SSPRs (including a new SSRO) is to ensure provision of sufficient data so that the MOD can give better assurance that it has achieved fair and reasonable prices, to incentivise contractor efficiency improvements and to encourage the right behaviours in the MOD.
- E.198 **The Public Accounts Committee** - the PAC is appointed by the House of Commons to examine "the accounts showing the appropriation of the sums granted to Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the Committee may think fit" (Standing Order No 148<sup>98</sup>). The Committee does not consider the formulation or merits of policy (which fall within the scope of departmental select committees); rather it focuses on value for money criteria which are based on economy, effectiveness and efficiency.
- E.199 Our view is that the SSRO should report to the MOD Accounting Officer as this is likely to provide the most effective positive influence on the MOD's procurement activity and will allow the SSRO to influence decisions in a timely manner.

## Organisational Options

- E.200 There are a number of organisational options for bringing the SSRO into existence:
- E.201 **Modify the existing Review Board** - The current Review Board could be given additional powers and resources. Pragmatically, given the scale of the change in its duties, we believe it will be preferable to start afresh than try and adapt the existing Review Board to fit a new SSPR model.
- E.202 **Out-source** - The nature of the functions undertaken by the SSRO are not suitable for outsourcing. The activities of the SSRO will not be profit making and will require access to a wide range of commercially sensitive information which needs to be held in such a manner as will provide contractors with adequate confidence. This makes outsourcing not an appropriate model.

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98. Standing Orders of the House of Commons - <http://www.publications.parliament.uk/pa/cm200506/cmstords/416/41605.htm#a164>

E.203 **Voluntary Organisation** - The importance and technical complexity of the functions undertaken by the SSRO means that it could not be dependent upon volunteer resource.

E.204 **Give role to another, existing Public Body** - Currently no other Public Body has been identified with the necessary powers, skills or resources to deliver the functions required from the SSRO.

E.205 **Create a new Public Body** - Our review considers that the creation of a new public body with sufficient technical expertise is the most desirable way forward. This will clearly signal a new beginning for the assurance and management of single source defence contracts, which are such a significant proportion of the projects within the defence budget. A number of options are available when forming a new Public Body and these are described in paragraph E207.

E.206 We note the current Government restrictions on creating new public bodies. We are recommending a new public body on the basis that following transition this follows the one-in, one-out principle as the SSRO would replace the existing Review Board.

### **Public Body Options**

E.207 Our review has considered the following options for creating a new public body:

- a. Executive Agency;
- b. Non-Departmental Public Body;
- c. Non-Ministerial Department;
- d. Public/Statutory Corporation.

E.208 A decision on the creation of a new SSRO and the best organisational fit will be an issue for consultation in the next phase of this review. Our view is that a Non-Departmental Public Body is likely to be the most suitable arrangement.

# Annex F - Comparative Practices within NATO and Australia

## Introduction

- F.1 This annex describes the findings of a study conducted by the review team to understand the procurement procedures used by a group of similar allied countries. Information was gathered relating to their industrial background, legal authority, organisational structures, pricing methodologies, efficiency initiatives, and treatment of SMEs. Information sources included defence administration booklets and websites; legislation and regulations; media reports; correspondence, interviews with France and the US; and a single source procurement survey conducted by NATO in 2006.
- F.2 Four NATO nations and one other country were selected for the study:
- a. Australia;
  - b. Canada;
  - c. France;
  - d. The Netherlands;
  - e. USA.
- F.3 These countries were selected due to the similarity to the UK in their general approach to single source procurement and the availability of data required for the study.

## Level of Spend

- F.4 World military expenditure is estimated to have been US\$1,630bn during 2010<sup>99</sup>. As shown in Figure 19 the level of expenditure in the USA was by far the biggest throughout NATO and the rest of the world. Data from 2010 shows that US military expenditure amounted to US\$698bn (an estimated 43% of the global aggregate). As a percentage of its GDP US military expenditure has been steadily increasing for the last 4 years. In 2010 France spent equivalent to US\$59.3bn, representing 2.3% of their GDP, making them NATO's 3rd largest spender (narrowly behind the UK) and the world's 4th largest investor in defence (figures from China and Russia, the world's second and fifth largest respectively, are estimated). In contrast, defence expenditure in 2010 for, Australia, Canada and the Netherlands was far lower at US\$24.0bn, US\$22.8bn and US\$11.2bn respectively.
- F.5 Although the lack of sufficiently detailed data makes it difficult to apply a common definition of military expenditure on a worldwide basis, Stockholm International Peace Research Institute (SIPRI) has adopted a definition as a guideline. Where possible, SIPRI military expenditure data includes all current and capital expenditure on:
- a. the armed forces, including peacekeeping forces;
  - b. defence ministries and other government agencies engaged in defence projects;
  - c. paramilitary forces, when judged to be trained and equipped for military operations;
  - d. military space activities.

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99. SIPRI Military Expenditure Database 2011 - <http://www.sipri.org/research/armaments/milex>

F.6 Such expenditures should include:

- a. military and civil personnel, including retirement pensions of military personnel and social services for personnel;
- b. operations and maintenance;
- c. procurement;
- d. military research and development;
- e. military aid (in the military expenditure of the donor country).

F.7 Civil defence and current expenditures on previous military activities, such as veterans' benefits, demobilization, conversion and weapon destruction are excluded.

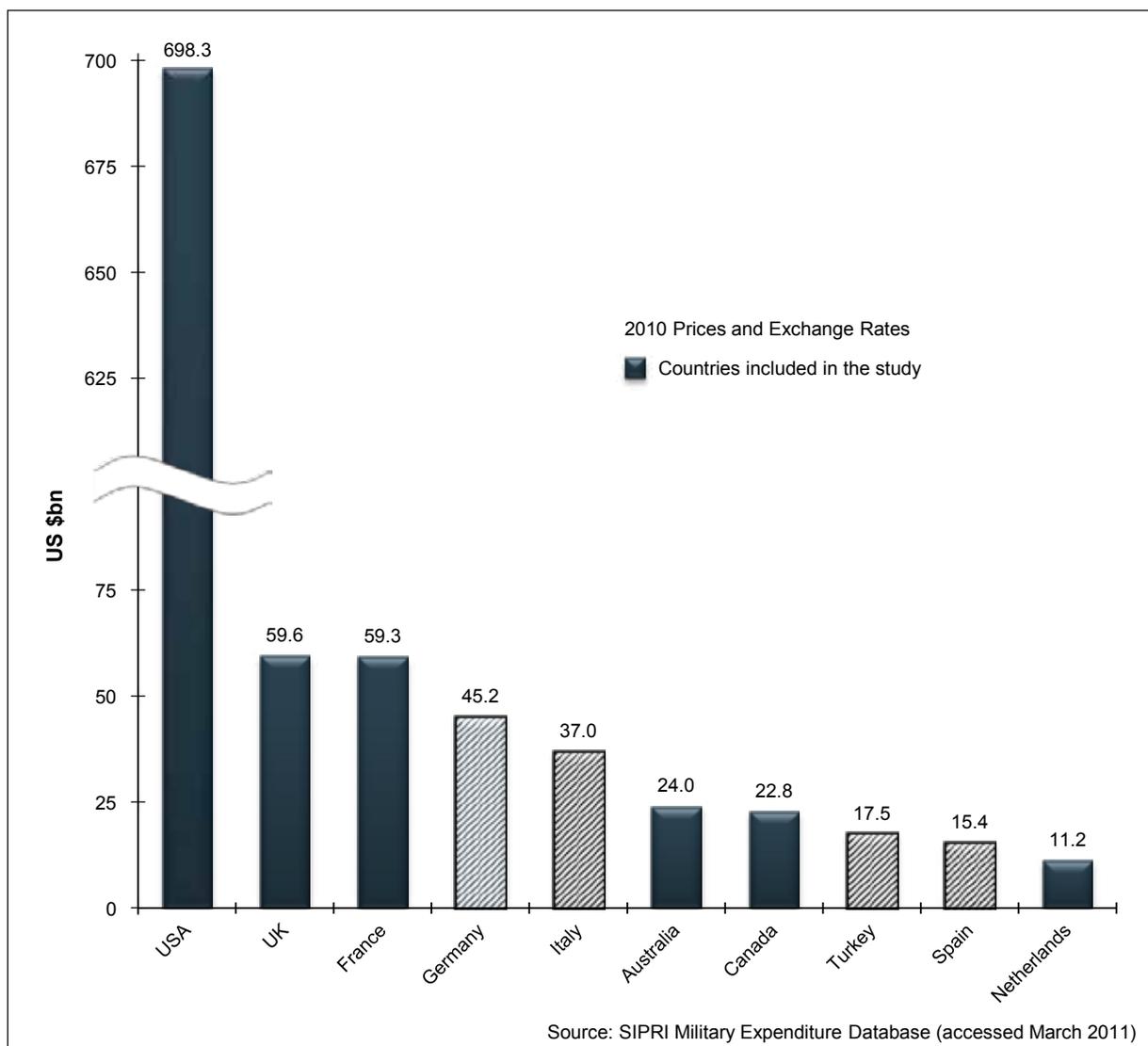


Figure 16 - Top Ten Defence Expenditure in 2010 (NATO Countries and Australia)

## Industry

F.8 The US has the largest defence industrial footprint in the world. The largest defence contractors such as Boeing, Lockheed Martin, General Dynamics, Raytheon, TRW and Northrop Grumman are all based in the US to supply the bulk of US defence requirements. France also has a significant defence industry, the most notable companies being Dassault, Thales, EADS and DCNS. The remaining nations have far smaller defence industries. Australia has a domestic capability in the manufacture of surface ships and submarines, but air and land requirements are generally competitively tendered and supplied by non-domestic contractors. Canada's defence sector consists largely of electronics companies and aerospace firms producing sub-systems or sub-assemblies for inclusion in final products. Some sectors, such as ammunition and light armoured vehicles, have a large percentage of goods produced by sole-source contract holders or by companies that possess a large share of the market.

## Single Source Procurement

F.9 Although most countries declare an ambition to procure all items through competition, all 5 have recourse to single source procurement to satisfy certain defence requirements. Unfortunately data concerning the extent of this practice is difficult to access. In the US fiscal year 2008-09, 35% by value of defence contracts were awarded on a single source basis<sup>100</sup>. In Canada 26% of contracts by value are procured on a single source basis<sup>101</sup>. The extent of single source procurement in the other countries under review is not available.

## Authority

- F.10 Of the 5 nations under review, 4 have embedded the government's authority to audit single source price proposals within a legal framework. Only the Netherlands does not provide any laws enforcing pricing audits, choosing instead to rely on Internal Regulations and specific contract clauses.
- F.11 In the US auditing authority is provided by Federal Law (Federal Acquisition Regulation (FAR)), and the Truth In Negotiations Act (TINA). Although not specifically intended for single source procurement, TINA imposes the necessary obligations on contractors for full and frank disclosure of relevant information at the time of contract negotiation. Penalties for detected non-compliance are both civil and criminal, and at the corporate and individual level. Additionally the Cost Accounting Standards Board (CASB), a US federal government body, promotes consistency for cost accounting activities involving government contracts.
- F.12 In France all defence procurement is governed by Article 54 of the 1963 Finance Act, the Public Transactions Act, and a statutory instrument defining the control of costs (20 December 2000 - JO of 29.12.2000)<sup>102</sup>. Parliament also authorises annual expenditure for the next 6 years through the Loi de Programmation Militaire<sup>103</sup>.
- F.13 The Canadian procurement process is covered by the Defence Production Act. This is enforced by a government body called the Controlled Goods Directorate (CGD).
- F.14 The Financial Management and Accountability Act 1997 (FMA Act) governs the procurement of goods and services in Australia, and includes severe penalties for

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100. Overview of UK and French Sole Source Defence Contracting, MOD memorandum, Jun 2011.

101. Correspondence from Public Works and Government Services Canada, 5 April 2011.

102. NATO AC/327 survey on Contract Audit 2006.

103. <http://www.defense.gouv.fr/>

breaches<sup>104</sup>. This is supplemented by the Commonwealth Procurement Guidelines, which set out the core policy framework applicable to all government procurement, not just defence<sup>105</sup>. The principal reference document for defence officials conducting procurement is the Defence Procurement Policy Manual. It provides procurement officers, and others involved in the procurement process, with the policy and operational guidance necessary to comply with Commonwealth policy<sup>106</sup>.

- F.15 As previously stated, the Netherlands has no laws relating to single source procurement. Instead applicable regulations are held in the form of Internal Regulations, which require a contract audit clause in the Request for Proposal and in the contract.

## Public Bodies

- F.16 This study found that each of the 5 nations maintain organisations tasked with reviewing single source price proposals. These organisations generally sit within the structure of defence administration, the notable exception being Canada where the audit division is a part of the central procurement body for all Canadian government requirements. The audit agencies of the US and the Netherlands, whilst located within defence administration, are independent of the procurement agencies. Australia is the only country directly aligned with the UK, with the audit agency sitting within the defence procurement body. France partly follows this pattern, but depends heavily for price scrutiny on Cost Engineers working directly with project teams. Canadian project teams also contain specialist Cost Engineers.
- F.17 The US Department of Defense (DoD) has several procurement agencies for each of its four armed services (Army, Navy, Air Force and Marines). Procurement for the US Navy, for example, is conducted by NAVAIR, NAVSEA and several others. These are known as Buying Commands. Responsibility for monitoring contract pricing, including single source contracts, is split between two independent agencies, which work alongside the Buying Commands.
- F.18 The Defense Contract Management Agency (DCMA) is responsible for monitoring contracts on behalf of buying agencies and ensuring compliance with contract terms. It is also involved with pre-award teams to assist with the tendering process. DCMA is staffed by contract management personnel, including cost engineers and cost/price analysts and reports to the Under Secretary of Acquisition, Technology<sup>107</sup>.
- F.19 The Defense Contract Audit Agency (DCAA) is staffed by accountants employed to audit contractor rates and costs. Contracts are audited a few months after inception for compliance with TINA and the findings are reported to the Under Secretary of Defense (Comptroller)<sup>108</sup>.
- F.20 In France the structure of the Ministère de la Defense is relatively simple. The Minister has 3 direct reports: Joint Chief of Staff - Le Chef d'État-Major des Armées (CEMA) - responsible for capability decisions in requirements and deployment; Secrétariat Général pour l'Administration (SGA) - responsible for budgets, legal and support functions; and Direction Générale de l'Armement (DGA)<sup>109</sup>. The DGA is the arm of the Ministry responsible for procurement. It co-ordinates programmes with industry, acts for export

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104. Financial Management and Accountability Act 1997 - <http://www.comlaw.gov.au/Details/C2011C00328>

105. Commonwealth Procurement Guidelines - <http://www.finance.gov.au/procurement/procurement-policy-and-guidance/CPG/docs/CPGs-2008.pdf>

106. Defence Procurement Policy Manual - [http://www.defence.gov.au/dmo/gc/dppm/DPPM\\_1Apr11.pdf](http://www.defence.gov.au/dmo/gc/dppm/DPPM_1Apr11.pdf)

107. <http://www.dcma.mil/about.cfm>

108. <http://www.dcma.mil>

109. <http://www.defense.gouv.fr/english/portail-defense/ministry/organisation/organisation>

customers and undertakes testing and assessment of all new equipment and technology. Within the DGA the Cost Expertise Branch is comprised of accountants and economists. Cost Engineers are deployed to work directly with project teams. This activity is given a very high level of priority in the DGA with resources including over 5,500 technical experts.

- F.21 Any audits of defence contracts in Canada are conducted by the Contract Cost Analysis and Audit (CCAA) division of the Public Works and Government Services Canada (PWGSC). This is the central procurement authority and audit body of all branches of the Canadian government. It is therefore independent of the Department of National Defence. Cost Engineers are based within Project Teams, and are therefore outside the CCAA.
- F.22 The CEO of the Australian Defence Materiel Organisation (DMO) is directly accountable to the Minister of Defence (under the Financial Management and Accountability Act) for DMO's performance and finances, while also remaining accountable to the Parliamentary Secretary for Defence<sup>110</sup>. The Financial Investigation Service (FIS), within the DMO, provides analysis and investigation on financial aspects of all types of procurement, using commercial cost accountants. There is a specific documented handbook on engagement of FIS, who must be engaged on all contracts over A\$100,000<sup>111</sup>.
- F.23 In the Netherlands the Defensie Materieel Organisatie (DMO) is responsible for all military equipment through life. It was established in 2006 as a separate part of Ministerie van Defensie<sup>112</sup>. An independent financial advisory service to procurement activities is provided by the Audit Dienst Defensie (Contract Auditing). This is a branch of the Ministerie van Defensie, thus outside the DMO, reporting directly to the Minister via the Secretaris-Generaal.

## Pricing Basis

- F.24 In general terms, the most common method used to establish prices for single source contracts is to apply an agreed profit rate to the estimated contract cost. This method is most stringent in the US, where allowable costs are tightly defined within the FARs, and profit rates are based on weighted guidelines which consider over thirty different factors. The other countries reviewed operate a code of allowable costs, though none as detailed as the US FARs. Profit setting methodologies vary from defined formulae, as used by the French, to less prescriptive assessments based on considerations such as risk, as made by the Australians and the Dutch.
- F.25 Prices in the US are agreed on the basis of estimated allowable cost-plus negotiated profit. Estimated costs are audited prior to contract award by both the DCMA and DCAA. Profit is negotiated by the Contracting Officer on a case-by-case basis for each contract, using 'weighted guidelines'<sup>113</sup>.
- F.26 The French base profit on 3 established Margins:
- a. **Margin A**, to reward against the level of Working Capital - negotiated by the project team for each contract in a range of 2% to 6%.
  - b. **Margin B**, to reflect the level of risk in a contract - negotiated by the project team for each contract in a range of 0% to 5%.

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110. "Inside the Defence Materiel Organisation" - [http://www.defence.gov.au/dmo/id/publications/Inside\\_the\\_DMO\\_10.pdf](http://www.defence.gov.au/dmo/id/publications/Inside_the_DMO_10.pdf)

111. Defence Materiel Handbook (Procurement) - Engagement of Financial Investigation Service.

112. <http://www.defensie.nl/english/dmo>

113. NATO AC/327 survey on Contract Audit 2006.

- c. **Margin C**, to reward Cost Reduction Efforts made by the contractor. This margin is based on company results, service quality and diversification of customers - negotiated centrally for each contractor by the DGA (up to 2%).
- F.27 The French do not have an exhaustive list of allowable or disallowable costs, and the issue of costing is addressed in a handful of broad concepts. Furthermore, there is no provision in the law which authorises government agencies to audit contractor cost estimates prior to contract award, and prices appear to be set later in the contractual process.
- F.28 The Canadian government has a 'Profit Policy' which is dependent on the value of a contract. The policy contains specific calculations relating to the capital employed and risk in a contract. The profit allowance is limited based on the size of the contract and in no event can exceed 20% of total contract costs. Canada lists 17 specific costs that cannot be charged, 2 of which are Unreasonable Remuneration and Re-organisation Fees.
- F.29 In Australia, Commonwealth Procurement Guidelines and the Defence Procurement Policy Manual contains the laws, regulations and policy that govern single source procurement. They also use Cost Principles and Procedures for pricing single source contracts. There is no set profit formula, profit being based on an assessment of risk. High value contracts with major defence contractors have a set profit rate.
- F.30 The Dutch generally use firm or fixed (i.e. firm with some indexation) pricing with TCIF type arrangements rarely used. However, failure to complete projects within performance, cost and time targets routinely results in applications of penalties on contractors. They do not use a profit formula, but the auditors might provide an opinion on profit levels, taking into account the perceived level of risk of a contract. Frequently external consultants are used to assess prices submitted by contractors.

### **Incentives for Efficiency**

- F.31 This study discovered relatively few methods designed to provide incentives for efficiency. Both France and the US allow an element of flexing within their profit formulae to reward past performance and cost reduction (and order-book diversity in the case of France). In our discussions with officials from France and US, both expressed scepticism about how effective this method was at incentivising supplier efficiency.
- F.32 France has a more rigid approach to commercial constructs, namely that only fixed price contracts are permitted and there is tighter commercial control over requirement change. The use of a fixed price together with tight control over change provides strong incentives for its contractors to reduce their costs as all the financial benefit is passed to the bottom line and it is clear that the contractor is liable for cost overruns. Using this approach, the French achieve value for money by ensuring that the benefits of any efficiency improvements are embedded in follow-on prices. This is done through a more comprehensive use of post-costing than is used by the MOD, which also provides them with substantial cost information which they draw upon in agreeing future prices.
- F.33 We have considered whether this approach would be successful in the UK. Our conclusion that it would not be successful is based on two concerns. Firstly there are strong cultural differences: in particular France has a more legally formalised contracting process which gives the contract greater primacy than is typical in single source UK defence procurement. Secondly the rigidity of the French system with regard to requirement change would require a substantial shift in behaviours within the MOD. The current UK approach could be characterised as being more of a partnership between the

customer and the contractor, whereas the French approach is more legal and inflexible, and thus, as we were advised, can become adversarial. There are pros and cons to both approaches; however any change that requires a significant shift in culture will be both difficult and slow to achieve.

- F.34 US procurement regulations provide a limit to cost overruns via the Nunn-McCurdy Provision of the Defense Authorisation Act. This requires that Congress be notified if a weapons programme exceeds cost estimates by 15% and that programmes are to be cancelled if a 25% overrun occurs. However, whilst this level of overrun is common in the US, cancellations are rare and the Secretary of Defense is also empowered to override cancellations by submitting a report detailing why the programme is essential<sup>114</sup>.
- F.35 The core principle of defence procurement in Australia is achieving VFM. This means that extensive comparative analysis is conducted during the procurement process to assess all of the relevant costs and benefits of any proposal<sup>115</sup>. Whilst this activity may identify where efficiencies could be made it does not explicitly incentivise efficiency to be achieved. Other considerations during the procurement process are:<sup>116</sup>
- a. fitness for purpose;
  - b. performance history of each prospective contractor;
  - c. the relative risk of each proposal;
  - d. the flexibility to adapt to possible change over the product life-cycle.

## SMEs

- F.36 The cultivation of opportunities for SMEs is a widespread policy within the countries studied. Initiatives include:
- a. dedicated offices to promote the interests of SMEs (in Canada and the US);
  - b. targeted levels of procurement from SMEs (in the US and Australia);
  - c. ensuring that SMEs are able to engage in fair competition (in Australia and France);
  - d. accessible publication of contract opportunities (in Australia).
- F.37 The US DoD conducts SME focused activities within a dedicated Office of Small Business Programs. In addition, the DoD participates in the Federal Governments Small Business Innovation Research Programme. Federal government is required to set aside a 'fair' proportion of all its contracts for small businesses<sup>117</sup>.
- F.38 The French require evidence from prime contractors that they have carried out appropriate competitions for subcontracting opportunities, and can fully justify the basis on which subcontractors have been solicited.
- F.39 The government of Canada is committed to giving SMEs access to compete for government business. The Office of Small and Medium Enterprises (OSME) supports SMEs by working to reduce barriers and by simplifying requirements for SMEs that want to do business with the government of Canada.

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114. The Nunn-McCurdy Act - Congressional Research Service paper, 21 June 2010.

115. Commonwealth Procurement Guidelines, paragraph 4.1.

116. Commonwealth Procurement Guidelines paragraph 4.4.

117. Office of Small Business Programs - <http://www.acq.osd.mil/osbp/>

F.40 SMEs account for approximately 50% of employment in Australia’s defence industry. The government is committed to sourcing at least 10% of purchase value from SMEs. To ensure that SMEs are able to engage in fair competition for government business, officials undertaking procurement must ensure that procurement methods do not unfairly discriminate against SMEs. Agencies should seek to ensure that procurement processes are readily communicated and accessible to SMEs and should not take action to deliberately exclude SMEs from participating<sup>118</sup>. Agencies must publish on AusTender, by 1 July each year, an Annual Procurement Plan to draw contractors’ early attention to potential procurement opportunities.

## **Key Observations**

- F.41 This study has looked at the industrial background, legal authority, organisational structures, pricing methodologies, efficiency initiatives, and treatment of SMEs. Table 5 summarises the findings.
- F.42 The majority of countries have specific laws and pricing mechanisms in place to control defence spending. Laws are not limited to single source contracts but ensure that all costs are accounted for correctly. The US has the most stringent set of laws and regulations and has 2 separate public bodies responsible for auditing contracts and costs to ensure adherence. All countries studied have public bodies responsible for auditing and reviewing levels of defence spend. Only Canada places this organisation outside the defence department. Other countries are split in placing this organisation as either directly part of the defence department or specifically within the defence procurement branch.
- F.43 Most countries also run a variety of initiatives to support actively the involvement of SMEs. The only area in which there was not a clear common approach was in the incentivisation of efficiency. Both the US and France flex their profit margin to incentivise contractors to improve, by awarding a higher profit rate to contractors with a good track record. However during interviews with the DGA in France and the US DoD it was clear that this flexing was rarely applied and was not regarded as an effective method of incentivising efficiency.

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118. Commonwealth Procurement Guidelines, paragraphs 5.6, 5.3 and 5.4.

**Table 5 - Summary of NATO and Australia Findings**

Country	2010 Spend US\$bn	Industrial Background	Authority	Public Bodies	Pricing	Efficiency	SMEs
US	698	Largest defence contractors	Federal Acquisition Regulations, Truth in Negotiation Act and CASB promoting consistent accounting activities	DCMA, DCAA, CASB and Buying Commands	Weighted guidelines on profit considering over 30 factors	Element of flexing profit formulae to reward past performance	Dedicated office to promote SMEs, targeted procurement levels
France	59	A number of leading contractors	Article 54 of the Finance Act 1963, Public Transactions Act and statutory instrument defining the control of costs	DGA, Cost Expertise Branch	Three margins for profit; level of working capital, level of risk in contract and reward for cost reduction efforts	Element of flexing profit formulae to reward past performance	Initiative to ensure SMEs can compete
Canada	23	Large electronics and aerospace companies providing components as part of the supply chain	Defence Production Act	PWGSC, CCAA	Profit Policy including an allowance not to exceed 20%	-	Dedicated office to promote SMEs
Australia	24	Internal capability for ships and submarines but external supply of aircraft and land equipment	Financial Management and Accountability Act 1997, Defence Procurement Policy Manual	DMO, FIS	Profit based on risk. High value contracts have no set profit rate	Core principle to achieve VFM through extensive comparative analysis	Targeted procurement levels, initiatives to ensure SMEs can compete
Netherlands	12	Limited national capability and capacity	Internal Regulations with no specific laws	DMO, ADD(CA)	No profit formula	Nothing specific known to this review	Nothing specific known to this review

# Annex G - The Pharmaceutical Price Regulation Scheme

## Introduction

G.1 The review team found no significant single-source procurement in Other Government Departments (OGDs)<sup>119</sup>, with the exception of the Department of Health (DH). This annex summarises why the DH undertakes single source procurement, describes the main features of the Pharmaceutical Price Regulation Scheme<sup>120</sup> (PPRS) used by the DH and the pharmaceutical industry to control single source procurement and lists the conclusions the review team have drawn from reviewing the PPRS.

## Single source pharmaceutical procurement

G.2 The nature of the pharmaceutical industry means that the DH must often rely on branded medicines to achieve the best levels of health care. Branded medicines are proprietary products protected by many patents which means the National Health Service (NHS) is limited to a single source of supply. The NHS spends broadly the same amount as the MOD through single source procurement, about £9bn a year. This accounts for approximately 80% of the NHS drugs bill and consumes around 12% of the total NHS expenditure in England<sup>121</sup>.

## The Pharmaceutical Price Regulation Scheme

G.3 Regulation. The PPRS is a voluntary 5 year agreement<sup>122</sup> between the DH and the branded pharmaceutical industry that regulates single-source procurement. The agreement aims to encourage and reward innovation. Although the majority of companies choose to join the voluntary scheme the DH has a fall back statutory scheme, enforced under sections 263 and 272 of the National Health Service Act 2006, for those companies who choose not to be part of the scheme. Statutory measures do not apply to companies who are members of the voluntary scheme.

G.4 Allowances. The PPRS makes allowance for certain categories of spend. Contractors may include certain marketing, Research & Development (R&D), and information costs in product prices.

- a. The **marketing allowance** may be spent on the costs of market research, developing marketing strategies, advertising, selling and promotional activities. Contractors may include expenses related to the provision and dissemination of factual information on the medicines supplied to the NHS.
- b. The **R&D allowance** is intended to encourage R&D of new medicines. R&D allowances are only accepted when a scheme member can demonstrate that the amount claimed relates to actual expenditure incurred. The amount allowed reflects both a contribution to the worldwide cost of R&D undertaken by

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119. Letter from the Home Office Ref: T18663/10 and email from the OGC dated: 14 Oct 2010.

120. Available at [http://www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH\\_091825](http://www.dh.gov.uk/en/Publicationsandstatistics/Publications/PublicationsPolicyAndGuidance/DH_091825) (accessed June 2011).

121. DH data from <http://www.dh.gov.uk/en/Healthcare/Medicinespharmacyandindustry/Pharmaceuticalpriceregulationscheme/index.htm> (accessed June 2011).

122. The 2009 Pharmaceutical Price Regulation Scheme became effective on 1 January 2009.

companies developing human medicines and a desire to reward and provide an incentive for success in R&D.

The R&D allowance is comprised of a flat rate and 2 variable rates, one for innovation and another for paediatrics. As incentive for contractors to join the PPRS, during their first 3 years, the variable rate for innovation is increased, although this is still subject to a maximum allowance of 10%.

- c. The **information allowance** provides for expenses incurred relating to the provision and dissemination of factual information including the cost of samples for identification purposes, summaries of product characteristics and material for medical symposia.
- G.5 The following forms of expenditure are not allowed as a charge in NHS prices and are excluded from reporting requirements:
- a. samples (other than samples for identification purposes);
  - b. gifts;
  - c. hospitality (other than that provided for eligible medical symposia).
- G.6 **Information Requirements.** The DH satisfies public accountability by scrutinising Annual Financial Returns (AFR) submitted by each scheme member and approving price increase applications under specific terms of the scheme. The scheme recognises that there is a balance to be struck between recognising the costs to scheme members of providing information and the level of detail necessary to enable the DH to reach conclusions on scheme member's PPRS position.
- G.7 All scheme members with sales of NHS medicines in excess of £35m in a financial year are required to submit an AFR to the DH between 6 and 12 months after year end.
- G.8 A full AFR includes information taken from statutory (published) and management accounts, including an independent accountant's review. The information from statutory accounts includes capital employed, sales, costs and profit made, return on sales and a list of all products supplied to the NHS. A detailed forecast of future sales is provided from management accounts.
- G.9 **SMEs.** Any scheme member with total home sales of NHS medicines not exceeding £5m per financial year is exempt from supplying financial information. However, the DH reserves the right to call for a full AFR if circumstances appear to warrant it. In particular, in the case of an application for a price increase, the DH may demand additional financial information.
- G.10 Any scheme member with total home sales of NHS medicines of more than £5m and less than £35m per financial year is required to provide a copy of its audited accounts and a certificate signed by its managing director or chief executive, giving a breakdown of turnover for the year between home sales of NHS medicines, export sales of NHS medicines and sales of other products. If a company in this category wishes to modulate the price of its products, it has the same obligations as larger companies. This information should be submitted annually to DH within 9 months of the end of its financial year.
- G.11 Any scheme member relieved of the commitment to supply full financial information remains subject to the need to contain costs and the price restraint provisions. The DH reserves the right to call for a full AFR or forecasts or both at any time if circumstances warrant it.

- G.12 **Profit Setting.** The PPRS seeks to achieve a balance between reasonable prices for the government and a fair return for pharmaceutical industry. The scheme provides a framework for determining reasonable limits to the profits to be made from the supply of branded medicines to the NHS.
- G.13 The pricing regime differs for new and existing products but are both underpinned by 3 key drivers:
- a. The Return on Capital Employed (ROCE). The target level for ROCE that can be earned by each scheme member is currently 21% a year based on the historical value of average capital employed.
  - b. The Return on Sales (ROS). For scheme members whose sales exceed their average assessed capital employed by a factor of 3.5 or more, sales figures rather than the capital value is used to determine the profit target. The target rate of profit is calculated by dividing the ROC target rate by a factor of 3.5 and applying this rate to the sales figures. The target for ROS is currently 6%.
  - c. The Margin of Tolerance (MOT). The allowable return is associated with a MOT. Scheme members are allowed to retain all profits up to 140% of the ROC target but are not allowed to request price increases on unprofitable products unless they forecast profits less than 40% of the ROC target. The MOT is not available to a scheme member for any year in which they have implemented a price increase agreed by the DH. Where a scheme member exceeds its target profit for a year in which it has received a price increase, all profits above the target are repayable to the DH. Where a price increase is agreed by the DH in the second half of a year, the MOT is not available to a scheme member for the year following the increase.
- G.14 **Dispute Resolution.** The DH and scheme members agree to resolve any issues through discussion. Discussions may be escalated to a more senior level in the organisations involved. Significant issues may arise that cannot be resolved by discussion. These issues may be referred to a dispute resolution procedure panel.
- G.15 The dispute resolution panel consists of 3 members, one appointed by the Secretary of State for Health, one by The Association of the British Pharmaceutical Industry (ABPI) and a Chairman who is appointed by the Secretary of State but who the ABPI have the right to veto. The panel gives each party to the dispute the opportunity to put forward its case on the issue that is in dispute. Each party to the dispute is allowed a reasonable period within which to make oral representations.
- G.16 The panel may then request supplementary written information from any party to the dispute where it considers this necessary to understand the issue(s) properly. All information provided to the panel members and the panel members' reasoned decision is made available to all parties. The panel is expected to make a decision and communicate it with all parties within 30 days of the oral hearing or within 45 days if additional written information has been necessary.
- G.17 The costs of the panel are shared equally by the parties and each party is responsible for paying their own costs.
- G.18 **Management.** The DH have a team of 16 dealing with the PPRS<sup>123</sup> whose responsibilities include negotiations, price modulation, policy issues, Parliamentary reports, statute issues.

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123. <http://www.dh.gov.uk/en/Healthcare/Medicinespharmacyandindustry/Pharmaceuticalpriceregulationscheme/PPRSstaff/index.htm>

- G.19 **Reporting.** The DH publishes a report to Parliament on the performance of the PPRS. It includes aggregated figures for data submitted and adjustments made, and publication of comparative data on uptake of new medicines alongside international price comparisons.

## Conclusions

- G.20 Single source pharmaceutical procurement and single source defence procurement are very similar with each representing significant amounts of UK government spend requiring regulations to ensure prices represent value for money.
- G.21 The DH runs a voluntary scheme of regulations that the majority of the pharmaceutical companies have signed up to. Those that have not signed up to the scheme have their single source prices controlled by statute. Our recommendations would also put in place a voluntary code of regulations to control single source defence procurement but would initially not be mirrored by statute. If the voluntary code proved unsuccessful we would then recommend making the regulations legally binding through statute as described in Part 3.
- G.22 The provision of allowances within the PPRS, although different in detail to reflect the different ways of working within each industry, is very similar to the Government Accounting Conventions (GACs) that our recommendations suggest retaining.
- G.23 One of the most effective ways to achieve confidence that prices are fair within single source procurement is to obtain transparency of pricing data. This allows each party to make separate judgements on the fairness of prices based on the same source data. This is achieved by the submission of the Annual Financial Returns, which are reviewed by reporting accountants prior to submission. This approach provides the DH with an increased understanding of the financial situation of suppliers.
- G.24 As large government departments both the MOD and DH have developed specific strategies to manage SMEs. Both the PPRS and our recommendations relieve SMEs from the burden of reporting on small value contracts by defining thresholds for information requirements.
- G.25 Both the PPRS and our recommended solution include setting profit rates to avoid excess profits or losses by companies engaged through single source contracts.
- G.26 The PPRS includes a detailed dispute resolution process to allow disagreements to be settled by an independent panel. This element of our solution will be considered in more detail during the implementation phase of this review due in the spring 2012.
- G.27 The team managing the PPRS on behalf of DH is an internal team of 16. Our recommendation for a team to manage the regulations as an independent body is described in detail in paragraph E179.
- G.28 Whilst the PPRS team from the DH submit a report to Parliament, the SSRO, as an independent body, will submit findings and reports to the MOD.

# Annex H - Small and Medium Enterprises

## Introduction

H.1 The coalition Government stated that it would promote procurement from small business, in particular by introducing an aspiration that 25% (by value) of government contracts should be awarded to small and medium-sized enterprises (SMEs)<sup>124</sup>. This review has investigated how changes to single source pricing regulations may maximise SME involvement in MOD single source contracting either directly or as a subcontractor. The following summarises the findings of our investigation.

## Current arrangements

- H.2 The MOD places over 40% (by volume) of its direct contracts each year with SMEs and many SMEs also contribute significantly to the supply chains of larger prime contractors.
- H.3 The MOD currently has a range of online publications and guidance readily available to potential contractors, some of which are targeted directly at SMEs. Guidance already available on the subscription based Defence Contracts Bulletin<sup>125</sup> (DCB) website includes:
- Selling to the MOD (edition 18)<sup>126</sup>
  - SMEs: How to grow your business with the MOD<sup>127</sup>

## Current Government and MOD activity

- H.4 Public procurement has been made more accessible due to Government wide initiatives, including the Transparency Agenda<sup>128</sup>. In relation to SMEs this includes:
- the new, free-to-access, Contracts Finder<sup>129</sup> website that advertises tendering opportunities, and contract documents, across government (including the MOD) over £10,000<sup>130</sup>;
  - the appointment of a Crown Commercial Representative for SMEs;
  - co-ordination of departmental action plans to help achieve the Government's aspiration for 25% (by value) of public procurement contracts with SMEs;
  - amendments to the requirement for a Pre-Qualification Questionnaire (PQQ) with the aim of eliminating PQQs for contracts under £100,000 in value.

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124. SMEs as defined by the European Commission - [http://ec.europa.eu/enterprise/policies/sme/files/sme\\_definition/sme\\_user\\_guide\\_en.pdf](http://ec.europa.eu/enterprise/policies/sme/files/sme_definition/sme_user_guide_en.pdf)

125. Defence Contracts Bulletin - <http://www.contracts.mod.uk/introduction/index.shtml?gclid=CPG3qPWroakCFVJX4QodHgpptg>

126. Selling to the MOD - <http://www.bipsolutions.com/pdf/S2MOD.pdf>

127. SMEs: How to grow your business with the MOD (interactive eBook) - <http://edition.pagesuite-professional.co.uk/launch.aspx?referral=other&refresh=kW1840sM0eK3&PBID=fbf5890b-37f9-423d-8a4c-c31b130aafe4&skip=>

128. Press Briefing 7 July 2010 - <http://www.number10.gov.uk/tag/transparency-agenda>

129. Contracts Finder - <http://www.contractsfinder.businesslink.gov.uk/>

130. This currently excludes 'war-like' requirements and those where publication is precluded by national security considerations.

H.5 The MOD has already:

- a. commenced advertising tenders over £10,000 on Contracts Finder;
- b. adopted the new common core PQQ (and is working towards the Government aim of minimising the use of PQQs for low level requirements);
- c. revised internal MOD guidance to ensure that SMEs are not rejected at the pre-qualification stage on the basis of turnover to contract value ratios without proper assessment of capacity and potential;
- d. created a new Defence Contractors Forum with a dedicated SME group chaired by an MOD minister to give a better voice for SMEs;
- e. written to key contractors to ask them to consider specific actions they (the key contractor) could take to increase SME participation in the supply chain on MOD contracts.

## **Conclusion**

H.6 Our recommended changes to single source pricing and contract management aim to encourage use of SMEs. Improvements to the framework that are likely to positively impact SMEs include:

- a. reduced requirements to provide financial and management information for contracts below £50m in value (Annex E);
- b. a defined level of profit for single source contracts with SMEs below a value of £5m (Annex E);
- c. requiring contractors with single source contract totalling above £100m in value to produce an annual subcontractor report detailing how they have selected their subcontractors and how they manage their relationships with SMEs.

# Annex I - Definition of Single Source Contracts

- I.1 The term 'single source' refers to the award of a contract to a contractor after negotiation, but in the absence of a competitive bidding process (hence single source is also referred to as 'non-competitive contracting'). In most cases it will be obvious that a contract is single source as opposed to competitively let. However, there are a few scenarios which might give rise to ambiguity:
- a. **amendments to competitive contracts** - In general, contract amendments are considered as single source, however it will not always make sense to apply SSPRs to a sub-set of a competitive contract. On the other hand there will be cases where the SSPRs should apply to contract amendments, for example where the competitive contract is a thin framework, and the amendment is a £bn call-off from this framework. This requires clarification;
  - b. **ineffective/failed competitions** - some competitions result in a single bid, or single compliant bid. The criteria that determine whether this should be considered single source procurement need to be defined;
  - c. **single source subcontracts** - we need to clarify whether the SSPRs apply where a single source contract has been awarded to a Prime Contractor, and they in turn use single source to subcontract. The mechanism for this second tier application also needs definition;
  - d. **international collaborations** - some large MOD projects are multi-national collaborations, such as Typhoon, A400M and F-35 Joint Combat Aircraft. How the SSPR applies in this situation needs clarification.
- I.2 The SSRO should work with the MOD to help provide guidance on the types of contracts to which the SSPRs should apply.
- I.3 The decision of whether SSPRs can or should apply to a given contract will rest with the MOD as the contracting authority. SSPRs provide additional and independent controls to incentivise efficiency and achieve value for money in areas where structural market factors undermine this incentive. This is the overarching principle that determines judicious application.
- I.4 One of the roles of the SSRO (see paragraph E182) would be to monitor the application of the SSPRs. This includes forming an opinion on whether contracts have been appropriately included/ excluded from SSPRs. To support this task, contractors should provide the SSRO with a list of contracts they consider to be under SSPRs, which would be contrasted with MOD data covering all new single source contracts and amendments.

# Annex J - Overlap with Defence Reform

## Defence Reform

- J.1 Lord Levene delivered recommendations for a new MOD management structure in June 2011, which have been accepted by the department. A key driver of his review was the MOD's over-heated programme, with many proposals designed to help the MOD avoid getting into such a poor financial position in the future.
- J.2 We have placed budgetary realism at the top of our concerns during this review and have made recommendations to improve financial and commercial controls within the context of single source procurement. Given the potential overlap, we consulted with Lord Levene to ensure our recommendations are coherent with his.
- J.3 Lord Levene made several proposals in his recommendations and supporting text. A number of these overlap with our recommendations and these intersections are considered in this Annex. We believe that our recommendations are coherent with Lord Levene's proposals, and provide enablers to their successful implementation within the context of single source procurement.
- J.4 Defence Reform sets out changes to strengthen top-level decision making. It is proposed that the new Defence Board (and the Director of Resource roles) regularly discuss financial controls, risk, and periodic performance monitoring. A number of our recommendations, if implemented, would readily support this activity. The quarterly contract reports provided by contractors would give a good basis for performance monitoring large single source projects. The annual compliance report on adherence to single source pricing regulations and independent costing would support Defence Board reporting on financial controls. The SSRO budget report would provide an independent evaluation of MOD cost risk on large single source projects, supporting better risk management.
- J.5 Defence Reform proposes that the current equipment and infrastructure budgets are transferred from the delivery organisations (DE&S / the Defence Infrastructure Organisation) to the commands (Army, Navy, Air Force, and Joint). The commands currently have little of the financial analysis skills they would need to conduct the trade-off decisions which they would be responsible for. Levene acknowledges that the MOD's financial skills should be strengthened, and by moving budgetary responsibility to the commands, the dependency on these already stretched skills may increase. The SSRO budget report would provide an independent evaluation of areas of budgetary risk based on the best contractor forecasts and high quality analytics. This would help mitigate the MOD's risk associated with this proposal.
- J.6 In more general terms, Levene proposes that financial and performance management should be strengthened throughout the MOD in terms of skills, systems, and culture, and that more use is made of evidence based decision making, with improved analysis and management information. Our recommendations would provide the MOD with a wealth of contract and project cost data and management information. The SSRO pricing report and contractor cost report will together provide the MOD with a plethora of evidence and

management information, and it would support the MOD up-skilling agenda by providing high quality analysis of pertinent information.

J.7 In addition to the above, we have made a number of ancillary recommendations that are also consistent with Defence Reform which are illustrated in Figure 20.

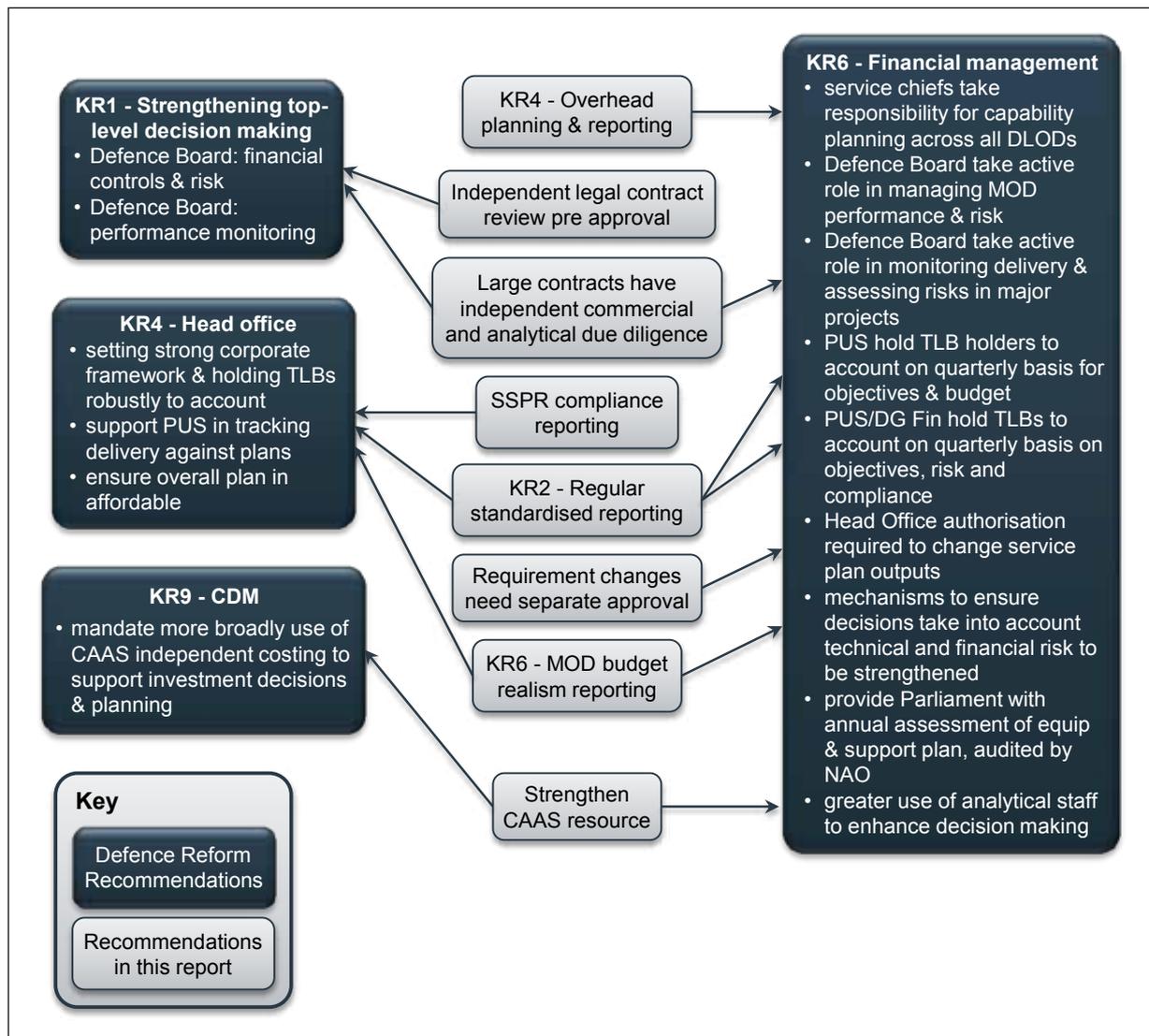


Figure 17 - Overlap between Defence Reform and our Recommendations

# Annex K - Glossary of Acronyms and Abbreviations

**Table 6 - Glossary of Terms**

Acronym/Abbreviation	Meaning
AR	Accounting Regulations
AFR	Annual Financial Returns
AOF	Acquisition Operating Framework
BPR	Baseline Profit Rate
CAAS	Cost Assurance and Analysis Service
CADMID/T	Concept, Assessment, Demonstration, Manufacture (Migration), In-service, Disposal/Termination
CASB	The US Cost Accounting Standards Board
CBI	Confederation of British Industry
CCR	Contract Completion Report
CDM	Chief of Defence Materiel
CE	Capital Employed
CGD	The Canadian Controlled Goods Directorate
CEMA	The French Le Chef d'État-Major des Armées
CP:CE	Cost of Production: Capital Employed
CSR	Comprehensive Spending Review
CVF	Carrier, Vehicular, Future (Queen Elizabeth Class (QEC) Aircraft Carriers)
DASA	Defence Analytical Services and Advice
DARP	Defence Acquisition Reform Programme
DCAA	The US Defense Contract Audit Agency

<b>Acronym/ Abbreviation</b>	<b>Meaning</b>
DCMA	The US Defense Contract Management Agency
DE&S	Defence Equipment and Support
DEFCON	MOD Defence Conditions
DEL	Departmental Expenditure Limit
DFARs	The US Defense Federal Acquisition Regulations
DG Fin	Director General Finance
DGA	The French Direction Générale de l'Armement
DH	Department of Health
DoD	The US Department of Defense
DSPD	The EU Defence and Security Procurement Directive
DSTL	Defence Science and Technology Laboratory
DWG	DEFCON Working Group
EAC	Estimate at Completion
EC	European Commission
EIPS	Equality of Information Pricing Statements
EU	European Union
FAR	The US Federal Acquisition Regulation
FMSSC	Financial Management Shared Service Centre
FSTA	Future Strategic Tanker Aircraft
FY	Financial Year
GACs	Government Accounting Conventions
GPF	Government Profit Formula
GPFAA	Government Profit Formula and its Associated Arrangements
GR	General Review (of the Yellow Book)
HMG	Her Majesty's Government

<b>Acronym/ Abbreviation</b>	<b>Meaning</b>
HM Treasury	Her Majesty's Treasury
HTA	Historic Trend Analyses
IAC	Investment Appraisals Committee
ICE	Independent Cost Estimate
IGIU	Intra-Group Inter-Unit trading
ISD	In-Service Date
IRSSPR	Independent Review of Single Source Pricing Regulations
JRBAC	Joint Review Board Advisory Committee
MI	Management Information
MOD	Ministry of Defence
MPR	Major Projects Report
NAPNOC	No Acceptable Price, No Contract
NAO	National Audit Office
NATO	North Atlantic Treaty Organisation
NDPB	Non-Departmental Public Body
OGDs	Other Government Departments
OSME	The Canadian Office of Small and Medium Enterprises
PAC	Public Accounts Committee
PCT	Performance, Cost, Time
PFI	Private Finance Initiative
PPRS	Pharmaceutical Price Regulation Scheme
PQQ	Pre-Qualification Questionnaire
PR	Planning Round
PT	Project Team (MOD team charged with the delivery of a single or several projects)
PUS	Permanent Secretary at the MOD

<b>Acronym/ Abbreviation</b>	<b>Meaning</b>
QCR	Quarterly Contract Report
QEC	Queen Elizabeth Class (Future Aircraft Carriers)
QMAC	Questionnaire on the Method of Allocation of Cost
R&D	Research and Development
Regulations	The Public Contract Regulations 2006
Review Board	Review Board for Government Contracts
SDSR	Strategic Defence and Security Review
SIPRI	Stockholm International Peace Research Institute
SME	Small and Medium Enterprises
SR	Spending Review
SSPR	Single Source Pricing Regulations
SSRO	Single Source Regulations Office
TCIF	Target Cost Incentive Fee
TIN	Truth in Negotiations
TINA	The US Truth in Negotiations Act
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom
UOR	Urgent Operational Requirements
US/USA	United States (The United States of America)
V&V	Verification and Validation
VFM	Value for Money

