

# SSRO

Single Source  
Regulations Office

*Assuring value, building confidence*



**Perspectives on non-competitive defence  
spending - September 2016**

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# Foreword



Clive Tucker, Interim Chair

Single Source Regulations Office

The Single Source Regulations Office was established to be the independent expert on single source defence procurement and the custodian of the regulatory framework. The organisation has made great strides in both these areas since its inception. In order to further develop our expertise in single source defence procurement we want to hear the views of others and learn from what they say.

The SSRO has no statutory role in determining whether the Ministry of Defence (MOD) should contract on a single source basis. However, as part of keeping the single source regulatory framework under review, the SSRO is concerned that price control and transparency requirements are applied effectively to cases where contracts are not the result of a competitive process. The SSRO seeks to understand whether the right contracts are being controlled and, in this context, queries contracts that appear to meet the criteria for qualifying contracts but are not reported.

We have developed this discussion paper with input from others to spark an informed debate on the appropriateness of procuring from a single supplier without competition. We have sought a range of different perspectives including military, commercial, academic and business. I would like to thank all our contributors for their input which has been invaluable in starting this discussion. We encourage this debate in advance of the SSRO's review of the Defence Reform Act (the Act) and Single Source Contract Regulations (the Regulations) 2014 and as part of our collaborative approach to regulation and stakeholder engagement. The SSRO will run a public consultation in early 2017 on the changes to the Act and the Regulations which we are considering recommending to the Secretary of State by June 2017.

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Competition is the default starting point for the UK Government when it decides to procure, however single source procurement remains a prominent feature in the UK defence acquisition landscape. Choosing the right procurement option is critical to achieving value for money, building public trust and managing risk. Competition can deliver good outcomes through lower cost and greater innovation. As this discussion paper demonstrates these outcomes can also be achieved from single source procurement if it is managed in an appropriate way and with consideration for how taxpayers' money is being used. In a climate where public sector spending continues to be constrained it is critical that single source procurement can pass the value for money test.

Our contributors from King's College London in previous research have shown that the UK's defence industry is a cutting-edge, high-technology sector that provides key military benefits to the nation's security by ensuring a secure, assured and agile supply chain which is developed and maintained over the long term. Without a thriving domestic defence industrial base with the capacity and capabilities to provide this, the UK jeopardises its freedom to act in an unstable, fast-changing world<sup>1</sup>.

The long term impact of Brexit on the UK economy and the defence sector is not yet known but the landscape will undoubtedly change. Exchange rate fluctuations could make defence contracts more or less expensive. Investment in UK defence companies will be highly dependent on future trade arrangements. UK defence single source procurement is currently regulated by EU and UK legislation and there may be demand to amend existing frameworks.

The Act and the Regulations have created greater oversight of single source procurement in the UK. Controls over single source procurement compare favourably to those in place in other major defence spending nations. Our international contributors give us an insight into how defence procurement is managed in Germany and Canada.

If competition is being encouraged, we would expect single source procurement to only be used in exceptional cases but this is not supported by the value of single source contracts awarded. There can be legitimate reasons for using a single source supplier and avoiding competition. It is also possible in cases where single source is necessary to ensure there is competitive pressure and transparency in the supply chain especially as many prime contracts can have large numbers of sub-contracts, some of which will be delivered by other prime contractors. It is therefore important that these reasons are clear and, where there has been no competition, it is possible to demonstrate value for money and understand why a competitive process could not be used.

The public should understand when single source procurement is being used and what the justification for it is. It is clear that business cases are being used by the Ministry of Defence to set out this justification and that there is a robust approvals process in place. However, this is not always visible to the public. The whole decision making process could benefit from being more structured and clear about the reasons why single source procurement is used, when it is appropriate and how it will deliver better outcomes. This would increase transparency to go along with the form of open book accounting and reporting that the regulatory regime brings.

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1 Appendix 1 – Reference 1

The SSRO values external views and perspectives, so if you would like to send us your thoughts on this paper or the topic more widely we would be very glad to hear from you.

A handwritten signature in black ink, appearing to read 'Clive', with a stylized flourish at the end.

Clive Tucker  
Interim Chair

# 1. Summary

There is limited research on the topic of single source procurement. This may be partly because of the commercial sensitivity of information on these procurements and the lack of published data. Research which the SSRO has been able to identify or which our contributors have used is included at Appendix 1.

The contributions provided to us add to this body of knowledge and provide views to be discussed more widely. There are issues for Parliament, the Government, the Ministry of Defence, industry, the SSRO and the public to consider in the future. There are a number of themes which have been identified across all the contributions.

## Theme 1 – Value for money

Every individual, government or organisation whether not for profit or private sector needs to consider how they will achieve value for money when they are using public funds. Accounting Officers in the public sector are responsible for ensuring the value for money case has been made. There have been many value for money lessons from defence over the years since the National Audit Office and others began to look at the sector. It is not clear that these lessons are always being applied to future acquisition as significant cost overruns and delays still occur in some defence programmes.

As many of our contributors recognise, the SSRO has to balance ensuring value for money from qualifying single source defence contracts for the taxpayer and a fair and reasonable return for contractors. This is a different dynamic from that which other economic regulators try to manage. The SSRO also focuses on value for money issues in defence through its studies programme including our first report on wage inflation produced for the Secretary of State.

The process of determining value for money in defence is still the subject of much debate. Value for money is currently considered at a number of different points in the defence landscape and by different parties. Parliament will have a view on an appropriate budget for defence. The Ministry of Defence and the SSRO will be involved in considering value for money during the acquisition process whether as a result of competition or single sourcing. The National Audit Office and others will undertake hindsight reviews looking back at what was or was not achieved for the investment made.

Some of our contributors have recognised the difficulty of assessing value for money in defence contracts particularly those over a period of time which can be greater than five years. This is largely because there are other factors which need to be considered. For example, the wider economic benefits of defence acquisition decisions need to be properly factored into an assessment of value for money. Often a value for money judgement is made when a contract is awarded, but can only be fully assessed when the contract has been completed and the life time value and cost are known.

Where competitive forces do not exist it is essential to assess value for money effectively. These assessments in single source procurement also need to factor in the potential costs which have been avoided by not running a competitive process. Bid costs can be significant in procurements where there are a number of competitors. Contributors recognise the need to focus on the cost base as this often represents around 90 per cent of the price. The market can drive competitive prices, while Allowable Costs claimed under qualifying defence contracts are not necessarily efficient. However, while competitive prices represent value for money in terms of efficient resource use they might not always be considered to be fair and reasonable for the contractor selected. The single source regime allows the supplier's as well as the customer's interests to be evaluated.

Finally, it should be recognised that the SSRO has a role to clearly communicate how the taxpayer is getting value for money from single source contracts. This includes raising awareness as Transparency International has done that the risk of corruption, which impacts on value for money, is low in the United Kingdom.

## Theme 2 – Innovation

It is often considered that monopolies are likely to be less efficient, less productive and less likely to innovate. Innovation is key to developing defence solutions which allow nations to maintain operational superiority over others, particularly where new technologies are involved. It also helps to generate radical ideas that can result in significant cost reductions. Savings are possible when the status quo is abandoned. The MOD recognises this and the Centre for Defence Enterprise (CDE), part of the Defence Science and Technology Laboratory (Dstl), funds new, high-risk, high-potential-benefit research to develop cost-effective capabilities for the armed forces and the UK's national security.

There are two distinct view-points on whether single source procurement stifles or supports innovation. Single source procurement can perhaps shut out opportunities for different ideas to be generated because of the lack of competition to come up with the best idea. In competitive scenarios innovation can also be stifled where it is not a significant feature of the choice of method or evaluation criteria for the procurement.

Innovation is key to the UK being able to be a leader in the global defence business, especially as the nature of conflict can change. A fair and reasonable return for industry also encourages investors to invest in defence companies. The need to align incentives between the customer and the supplier has been identified by a number of contributors and these incentives can be used to encourage innovation where they will increase benefit, reduce cost or both.

## Theme 3 – Culture and behaviour

Establishing a sound business relationship between the customer and the supplier is key to securing value and the best deal in any procurement. This may result in there being a difficult relationship at times but this is seen as required in order to deliver both a fair and reasonable return for industry and value for money for the taxpayer. The MOD needs to act as an intelligent customer, negotiating well, using its bargaining power and ensuring the outcomes it seeks will be delivered. The MOD's bargaining power may be diminished where there is a lack of co-ordination or threats by contractors to leave the market.

With the right mindset it is possible to secure value for money from single source procurement. Largely this is one where taxpayers' money is considered to be important and not wasted particularly when resources are constrained. Contractors should only be rewarded when they have delivered the outcomes specified in the contract. Some of our contributors recognise the problems that can arise with cost plus contracts and consider that they should only be used in exceptional circumstances. There are other pricing methods which can be used to better price single source contracts. Gain share arrangements and use of key performance indicators could prove effective for the MOD within the contracts they let.



An appetite for risk, not always prominent in the public sector, may also be necessary to achieve value for money. Senior people will often set this appetite but should remain engaged throughout contract delivery and held accountable for achieving the required outcomes. Sometimes they will need to know that they have political backing for some of the tough decisions they will have to make. Proper planning and tight contract management can help to make delivery much less risky and can avoid costs which are built in to contracts to manage risks that might not ever materialise.

One of our contributors talks about the importance of avoiding complacency on both the customer and supplier side. In a single source environment where threats from competitors do not exist, complacency is a risk. The MOD can guard against complacency by asking whether it is possible to compete a contract which has perhaps always sat with the same monopoly supplier. To manage the same risk the supplier can be rigorous in the review of their costs, knowing that introducing competition in some case is an option for the MOD. The MOD might also look at the assets it holds (for example, dockyards or facilities) in a more commercial way to ensure that they are fully optimised.

#### Theme 4 – Skills development

The defence reform programme within the MOD has been aimed at equipping the department with the skills it needs to secure the best deals. The skill set required throughout the acquisition process to successfully meet the needs of the front line commands ranges from negotiation, financial management, commercial and contract management. Some contributors talk about an unequal relationship in terms of skills and experience where those of the contractor can outweigh those of the MOD, particularly where staff are regularly moved to new teams to manage corruption and other risks.

Often an essential skill which can be missing is the ability to take a strategic view and not get lost in the detail of each individual acquisition. Focusing on the key issues that matter and identifying whether outcomes are being achieved rather than becoming overly concerned about process and large numbers of performance indicators is critical.

Understanding the market is also key to be able to determine whether there is the potential for a competition. Even if single source looks inevitable some form of market assessment should always be undertaken. Linked to this is the ability to benchmark costs and determine if a fair and reasonable return is being offered to industry. It is recognised that the MOD has progressed in respect of its ability to benchmark and compare costs. Being able to design contracts in such a way that avoids needing to re-contract again with the same supplier if requirements change would also benefit the MOD.

Our contributors who have been involved in acquisition suggest that even if a programme needs to be mostly single source there may be opportunities to compete certain elements of it. This requires an understanding of the market and where there are potential competitors. While contracts with prime contractors in the UK are likely to be single source there will be scope to introduce competition into the supply chain and promote the Government's policy to encourage more small and medium sized enterprises into the defence sector.

## Theme 5 – Strategic and economic benefits

The defence industry can deliver wider strategic and economic benefits for the United Kingdom. The prosperity agenda set out in the Strategic Defence and Security Review 2015 recognised this. Loss of contracts to foreign competitors could potentially have significant impacts for UK defence companies and for the prosperity of UK regions. One of our contributors stated that perhaps the wider economic benefits are not always fully measured or understood and that MOD reporting on economic growth implications could be improved.

There will be occasions when there are legitimate strategic, economic and political reasons for using a single supplier based in the United Kingdom. In some cases sovereign capability is used as the reason for single sourcing. Politicians may decide to award a contract to one company even after a competition has taken place or may decide that the UK should not procure from a foreign company. There are also scenarios where single source contracts go outside the UK. Foreign military sales (for example, Poseidon P-8A and Apache helicopters) are decisions to award single source contracts which do not fall under the Regulations and therefore do not benefit from the transparency brought by the regime. It is vital that there is transparency in all these cases and the reasons are fully justified.

## Theme 6 – The role of the SSRO and the single source regime

Most of our contributors recognise the importance of introducing the single source procurement regime and the creation of the SSRO. They consider it is helping to shine a light on an area of public expenditure which was perhaps previously not well understood. They concede that it is still early days for the SSRO, with some notable successes and some areas where there is more to learn.

The key to any regulatory regime working well is that all those involved want it to succeed and recognise why it is beneficial. The SSRO needs to be fully aware of the impact of its decisions on defence companies, particularly their attractiveness to investors.

Some contributors identify that the Defence Reform Act and Single Source Contract Regulations did perhaps not go as far as it could have. Others indicate that the legislation may not be achieving what it was intended to. Moving forward the MOD, industry and the SSRO need to work together to make the regime operate more effectively. The analytical messages from open book accounting and contract reporting should help the MOD to negotiate better deals in the future and re-invest savings into improving defence capability. While not possible under the current Defence Reform Act, alternative approaches to pricing and profitability may need to be considered in the long term.



## 2. The strategic view



Lord Currie<sup>2</sup>

Chair of the Competition and Markets Authority  
and Author of the Review of Single Source Pricing  
Regulations

### Why the SSRO is needed

As Chairman of the UK's competition authority, it is unsurprising that I start with the statement that government procurement is best undertaken in competitive markets through an open and transparent procurement process. And much government procurement is conducted in this way, ensuring the best deal for taxpayers provided collusive bidding behaviour is rooted out.<sup>3</sup> However, in the defence area this has not proved possible, and a sizeable chunk of defence procurement has always been single source.

The reasons for this are several. First, in a number of areas, for example nuclear submarines, there may well be only one possible domestic supplier, and Government may legitimately decide on strategic grounds not to shop internationally. Second, even when there is a choice of supplier and Government is able to arrange a competitive tender, with long lived and complex kit, once the contract is awarded it may well become very difficult subsequently to switch. This would not necessarily matter if the original specification was complete and unchanging, so that the initial contract stands for the life of the kit. But with complex equipment and rapidly changing technology, there is likely to be the need to re-specify. And then Government finds itself negotiating a re-contract with a single source supplier.

Things can be done to mitigate this dependence on a single-source supplier. Thus it is desirable if possible to negotiate initial contracts so that manufacture and maintenance need not be with the same supplier (though this may require careful attention to issues of intellectual property). And there should be a tight discipline (absent in the past) to limit the frequency of re-specifications. But even with these mitigations, a significant part of MOD procurement is likely to remain single source. So that raises the question of the relationship between the MOD as procurer and the major defence suppliers, often multinational.

Until recently, single source procurement was governed by the so-called Yellow Book, which determined what the supplier could charge the MOD. Prices were set essentially on a cost mark-up basis, with an appropriately defined profit margin. That would have been legitimate were allowable costs subject to appropriate discipline for efficiency, which one might well have thought the MOD as a single, large-scale procurer could provide. But unfortunately that was a forlorn hope.

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2 David Currie is Chairman of the Competition and Markets Authority and author of the report *Single Source Defence Procurement* (September 2001) that informed the legislation that created the SSRO. He writes in a personal capacity, not on behalf of the CMA.

3 The CMA, together with other competition authorities around the world, has developed a set of tools and protocols to help government procurement agencies detect and stamp out collusive behaviour.

Procurement decisions were made in a decentralised way by the individual project team, with little effective coordination.<sup>4</sup> The scope for coordination was undermined by the diverse and confusing ways in which project costs were accounted for, differing across project, supplier and time. This both undermined overall budgetary control and efficiency comparisons across projects and suppliers. The consequence was that the MOD could not begin to flex the bargaining power that its many billion pound single source procurement budget should have given it.

It was to address these weaknesses that my report recommended the replacement of the Yellow Book regime and the associated Review Panel by the Single Source Regulations Office. This was charged not with negotiating on behalf of the MOD but rather to put in place a consistent and transparent accounting regime for all single source procurement. Over time, the accumulation of data collected on a consistent basis would allow for the smart analytics to compare costs and efficiencies across projects and suppliers.<sup>5</sup> And that in turn should allow the MOD to negotiate more effectively with the major suppliers, while still allowing a reasonable profit to be made. Over time (and the benefits would take time to accrue as the comparable and consistent data accumulates), this should yield very considerable cash benefits to the MOD.

That was the proposal, which led to legislation and to the creation of the SSRO. Unfortunately the new regime got off to a slow start, with the MOD referring only a handful of single source procurements to the SSRO, and treating a large part of its single source procurement as extensions of pre-existing contracts. Matters have improved more recently, with an acceleration of the number of referrals, but it is still the case that a significant number of contracts have not been referred. This has two problems. First, since the legislation swept away the Yellow Book and oversight by the Review Panel, those contracts not referred are essentially unregulated, which was not the intention of my report and the legislation. Second, it means that the accumulation of accounting data on a comparable and consistent basis is happening more slowly than it should, considerably delaying and reducing cash benefits to the MOD<sup>6</sup>. Rectifying this by ensuring that the vast bulk of contracts are referred to the SSRO should be high up in Stephen Lovegrove's in-tray.

*“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.”*

**Lord Currie's Review of Single Source Pricing Regulations 2011<sup>7</sup>**

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4 This is described in Bernard Gray's report 'Review of Acquisition for the Secretary of State for Defence' and in my own.

5 Such comparisons across very different types of weaponry are not simple, but possible.

6 The cash benefits are very likely to rise disproportionately with the volume of contracts referred, so the benefits of increasing the flow of referrals are correspondingly greater.

7 Appendix 1 – Reference 12



Lord Levene

Former Permanent Secretary,  
Chief of Defence Procurement

I believe that levels of single source procurement are still too high and, in my view, may not be delivering best value for money. The introduction of the pricing formula for single source contracts in the Defence Reform Act is helpful but there is more that can be done to secure the best deal for the taxpayer.

There is no reason why the customer/supplier relationship which exists in all other spheres should not be present in defence procurement. The term “confrontational” is nothing more than a true reflection of commercial negotiations. When there is a buyer and supplier present, each will negotiate to obtain the best deal and the same should undoubtedly apply to MOD procurement. This is perfectly normal business behaviour. Instances where the MOD and the supplier appear to be sitting on the same side of the fence do not normally lead to a good solution.

In order for the MOD to obtain the best deal, competitive contracts undoubtedly lead to a good solution. In competitive procurements, it is not necessary to spend a lot of time determining what makes up the costs of the suppliers. However, where there is only a single source of supply, then understanding the breakdown of the costs of the supplier is important. Where competition exists, as is the case in most areas of the economy, the buyer has far less interest in the costs of the suppliers than the final price. If a consumer is buying a car, he does not enquire how the costs of the manufacturer are made up but simply compares prices across a number of potential suppliers. When, however, there is only one supplier, then their cost base has to be fully understood. The introduction of the Defence Contracts Bulletin many years ago helped to ensure that opportunities for new business were widely known.

Where, however, it is not possible to have a competition, for example in the procurement of nuclear submarines, then competition needs to be demanded in the subcontract procurement of the main contractor. In large contracts, the MOD should implant its own contract staff to sit with the manufacturer in policing the subcontracts and applying the same rigorous examination as the MOD does for its own prime contracts.

When I first became involved in MOD procurement, I regarded the levels of single source contracting as far too high and we were able to reduce these with a rigorous examination of such contracting. The percentage of single source procurement has risen again considerably and definitely needs to be reduced in order to ensure that front-line commands are getting good value for money and that requirements are delivered on time and in line with the estimated cost.

Unlike other countries, the level of political involvement in defence acquisition in the UK is relatively low. In other countries, political involvement may take place early on and cause the procurement process to be long and drawn out, sometimes even over a period of years. Consolidation within the defence sector has become a problem as this increases the market share of individual large suppliers. Nevertheless, the MOD needs to ensure that decisions which are made have political support. This is the responsibility of politicians to ensure that the Armed Forces are able to secure the best possible equipment on the best terms from any supplier, whether they be in the UK or elsewhere.

Defence procurement involves considerable expenditure of public money. For this reason, it is important that those overseeing that procurement have experience of large budgets of similar size to those in the defence sector. I believe that outsiders coming into defence with such experience bring a significant advantage. The devolution of responsibility for equipment procurement decisions to the front-line commands is an important step forward and it is to be hoped that savings made are then able to be reinvested into the budgets of those commands.

Where cooperation is possible with other countries, this can help to obtain good value for money in both of those countries. Reciprocal procurement has often proved to be a good route to obtain value for money, provided that it does not degenerate into an obsession with “juste retour”<sup>8</sup>. Where large contracts have milestones imbedded in them, it is very important that the MOD should insist that those milestones are met and that expenditure is not approved where contractors are not meeting the dates set as milestones in the contracts and that the suppliers are only paid when they have performed in accordance with that contract. There have been too many examples of contracts with payments made on dates regardless of whether the milestones have been met.

Procurement is not an easy or self-evident skill. The customer base needs to be well founded with experienced operators. For this reason, length of time in post can play an important role. It is encouraging to see that tour lengths in the MOD are now longer than they were as this enables staff to build up their own experience and thus strengthen their negotiating position. The MOD should follow the example of industry, expending time on understanding contractors’ businesses in the same way that the contractors spend time and money in understanding the MOD’s business. Changes in requirements should be kept to an absolute minimum since these can lead to renegotiation of the contract which is rarely to the advantage of the buyer.

*“The recent budget settlement, providing stability for the Defence Budget for the next 5 years, reflects the political importance attached to a stable Defence programme and the increased confidence in the changes that Defence has made in financial management. The opportunity for the Department is to use the financial security created to address the systemic issues which remain, which are both cultural and political, and deliver the sort of sustained reform which has eluded Defence for a generation.”*

**Lord Levene’s Defence Reform – Fourth Annual Report 2015<sup>9</sup>**

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8 a fair return

9 Appendix 1 - Reference 2





Cate Pye

Executive Director,  
Security Sector Lead,  
Ernst & Young LLP



Graham Beal

Partner, Infrastructure, Transport  
& Government Lead,  
Ernst & Young LLP

### Single source procurement – When it should be considered and how it should be measured

Single source procurement has long been a subject of debate and divided opinion. From clear cut cases where there is only one provider to the maintenance of sovereign capability, the success of single source procurement depends on leadership and a coherent strategy within which single source plays a key part.

#### Why single source?

The default position for UK government in recent years has been that competition provides best value for money. This is only true where the requirement is well understood, there are multiple suppliers in the market with viable solutions, and whole-life costs are considered, rather than just procurement costs. Hence, there are likely to only be a few situations in which single source procurement is a better solution and which naturally link to the benefits expected from single source such as lower whole-life costs and UK industrial capability and job protection:

- there is only one provider and competition would therefore be costly and pointless (we will now consider this reason 'parked' and focus on the more contentious points).
- maintenance of UK sovereign capability.
- long-term partnerships with industry that drive value for money.
- retention of capability for the 'health' of UK industry.
- speed – this is also sometimes cited but the answer is to speed up the competitive process not avoid it.

Sovereign capability, long-term partnerships and the health of industry are all worth further discussion.

## Sovereign capability

This hangs on the need for the UK to maintain independence of action through sovereign capability, which means keeping industrial capacity and building our supply base through investment. On a purist level, though, the argument that we need military capability that is genuinely independent is undermined by our move away from full spectrum capability to dependence on operating in a coalition in any major campaign; where we have allies it is unlikely we would have an operational argument for sovereign capability.

## Value for money partnerships

As government and industry become more interdependent (and the gap between aspiration and affordability increases), long-term partnering agreements that provide incentives for joint working, common goals, efficiencies and innovation provide a route to develop the intelligent customer whilst giving industry the confidence to invest in long-term improvements. The key to this is assessing appropriate reward; both profit and risk transfer. Profit needs to cover the “hurdle rate” for company sign off and costs have to be transparent. Direct costs are easy to attribute, but overheads are much more opaque. Jointly understanding the costs at the outset and providing granularity and transparency of overheads must be a key requirement. Where a company derives a significant proportion of its income from single source procurements it will need to demonstrate a “lean” approach to overhead costs, how they are charged and demonstration of efficiency. This also opens the door to innovative funding models and joint venture type arrangements that enable government to generate, as well as spend, money on behalf of the taxpayer. If a private company had the assets of the MOD for example, they would be ‘sweating’ them far more...not just selling them off.

## ‘Health’ of UK industry

The role of defence procurement in retaining capability in industry is often controversial, at least for those inside the system who believe that supporting industry should be a government expense rather than a departmental expense. The ‘utility’ cost of decisions, that is, which is the most beneficial decision for the UK economy once the wider factors of unemployment, skills base, exports and future potential for industry should be considered. The policy and incentives associated with ‘whole of government’ expenditure can be used to drive the UK skills base, provide investment from industry, and indirectly create jobs for UK citizens. Would we rather jobs be created in the UK and reduce the welfare bill, or jobs be created overseas and pay slightly less for the product? Measurement of this strategic investment should be through increased UK industrial capability and pull-through of science, technology, engineering and maths (STEM) skills; not number of ships produced.

## Conditions for success

There are, of course, risks in the single source route and conditions for success. A few to consider include: the ability of government to be a genuinely intelligent customer, keeping ahead of technology and working in more collaborative teams with industry will need new ways of thinking and different management skills. Single source should not equate to siloed operation; innovation needs to draw on new ideas from across the public and private sectors. The forward plan often doesn’t exist, so needs to be developed jointly between industry and government that trust and respect each other, and have the right ways of working.

## Conclusions

In summary, single source can offer good value for money but we need to be clear on the benefit desired. The measurement of success should include both the delivery of solutions and a view of impact on the economy. Currently it might be argued that the focus is too great on value for money, costs and process, and that the wider benefits to “UK PLC” should be considered through wider economic impact analysis measuring the contribution to the health of the UK economy, now and longer term. This implies a new Defence Industrial Policy against which to measure success, and which builds on a clear understanding of the UK’s position in the world, the capabilities we need to maintain and the threats we are seeking to manage.

*“The strength of any defence industrial base is underpinned by the skills and competencies of both the employees within the companies that provide support to governments, and the officials that place the equipment capability requirements with industry. However, the nurturing and maintenance of critical skills depend on numerous factors, including the defence sector’s pipeline of work, skills transfer to the next generation of defence employees, and the number of new employees entering the workforce.”*

**Key Skills and Competencies for Defence, RAND Research Report for the European Defence Agency, July 2015<sup>10</sup>**

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10 Appendix 1 – Reference 19

# 3. The military view



Major General Tim Tyler

former Director General, Land Equipment

The majority of my procurement experience as a customer has been in the Urgent Operational Requirements (UOR) process for land equipment where single source suppliers were frequently used, largely because of time constraints. Even for UORs, the starting point should be a market survey to confirm whether or not there is likely to be the possibility of and benefit in holding a competition. Working in industry as a supplier in non-UOR procurement, I have found that the simple application of competition as a standard model does not necessarily result in best value for money. The MOD needs to procure complex equipment and services – there is no simple solution which fits every requirement. Achieving operationally effective solutions at demonstrable value for money places heavy demands on procurement staff and requires the MOD to be a genuine ‘intelligent customer’. I have set out below some of the issues which play into this complex arena.

The difficulty for a procurement team, where the case for a competition is finely balanced, is making the case for a single source procurement against the weight of a competition ‘policy’ and additional approval demands of a single source route – the temptation to follow the competition route as the default approach is strong, even if this results in delay and additional procurement costs.

Single source procurement has worked well in some areas, for example the development of complex weapons. This is largely because of the need for specialist technology and to ensure protection of national security and sensitive information. However, technology advances may mean that competition is needed to ensure that innovative approaches are not missed. In the infrastructure domain where technology is not generally complex, there are often commercial challenges which excessively complicate a straight competitive procurement at the head contract level – where financing is involved this may well be the case. Where full competition is not possible consideration should be given to breaking the programme down into single source and competitive elements to increase the opportunity to achieve value for money. Framework contracts can also be a good alternative solution when used well.

Customers shape their supply chain, and this is heavily influenced by the procurement policies. The cost to industry of involvement in competitions must eventually be recovered through customer revenue streams. If these are not strong, or are tied up in long contracts, competition will not succeed in the long-term. The MOD has endeavoured to develop strategies to deal with this difficulty. Recognition of the importance of the MOD’s supply chain to overall defence capability, and more effective supply chain management would be welcomed.

The Pre-Qualification Questionnaire (PQQ) process has an important part to play in achieving effective competition and supply chain management – it is essential to consider these factors at the very earliest stage of the formal procurement process. A PQQ needs to be carefully constructed in a way which ensures a range of suppliers to provide a genuine and constructive competition. I sense that this phase of the competitive process is not given sufficient thought and can lead to ‘driving forwards continuously looking in the rear-view mirror’. This is particularly important where follow-on service contracts and ‘replacement’ equipment requirements are brought to the market – there is little enthusiasm in industry to support a procurement just to drive down the price of an incumbent.

The importance of assessing value for money in through life costs is particularly difficult in many cases. The uncomfortable truth is that we only know for sure whether value for money has been achieved once the equipment procured goes out of service or the service contract has ended - but this is not an excuse for under-weighting through life costs in the procurement stage. Assessing through life VFM will necessarily rely on a series of assumptions which could prove some way away from real life experience. There is a history of contracts which, having started as nominally fixed price competitive contracts, have progressed gradually to ‘cost plus’ with the loss of competitive benefits. It is in these situations, where risk and uncertainty are high, genuinely collaborative behaviours and the ambitions of BS11000<sup>11</sup> are particularly relevant. Unfortunately it seems that the effort, by both the MOD and industry, put into developing genuinely collaborative models as a way of mitigating some of these risks during procurement are not being followed through into contract delivery.

Competition should be a driver of innovation. For this to be effective, the competitive procurement evaluation model must factor in and encourage innovation sufficiently to allow it to be a genuine influence. This can be difficult to achieve as the evaluation criteria are set at the beginning of procurement – before the bidders have had the chance to develop delivery solutions. Ideally we should be encouraging potential suppliers to ask: ‘Wouldn’t it be helpful if we could do this?’ rather than saying: ‘We could achieve the lowest price by doing this’ - the former is easier in a single source procurement, the latter likely in a competition! In this context, industry finds it difficult to generate unsolicited proposals – where there is no formal procurement in train it is difficult to generate engagement and where there is a formal procurement such offers are not welcomed as they complicate the procurement route.

In my experience, the MOD invests heavily in achieving VFM in procurement and then assumes that this will be delivered as planned through the contract. Experience indicates that this assumption is a poor one. There is a case for a shift in emphasis away from attempting to achieve very high levels of confidence in the initial contract towards achieving desired outcomes through effective contract management. This goes beyond just having a large number of key performance indicators which focus on process and may actually constrain the relationship between the customer and the supplier. The MOD incorporates the tools (for example, benchmarking, transparency and effective collaboration) for contract management as standard, but does not always follow them through effectively. Gain share also has a part to play, particularly where the customer and supplier jointly come up with ideas about how they can operate best together and where incentives are aligned.

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11 BS 11000 provides a framework for collaborative business relationships, to help companies develop and manage their interactions with other organizations for maximum benefit to all.

I recognise that in the United Kingdom while we manage corruption risks well it is important that these are not forgotten about particularly in relation to defence contracts. There is often good circulation of MOD staff between different teams to reduce the risk of corruption occurring but this movement of staff can also be problematic in terms of loss of knowledge and expertise.

*“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.”*

**Lord Currie’s Review of Single Source Pricing Regulations 2011<sup>12</sup>**

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12 Appendix 1 – Reference 12

# 4. The Defence Board member view





Sir Gerry Grimstone

Lead Non-Executive Ministry of Defence

Defending the United Kingdom and promoting our interests and values around the world is a hugely important task, the outcomes of which affect everyone throughout the United Kingdom. In the 2015 Spending Review, the Government committed to a real-terms increase in the defence budget over the next five years. At the same time, the MOD committed to delivering some £7 billion of efficiencies. All of these efficiencies will be 'recyclable', so every pound saved will be reinvested in delivering military capability. If we are more efficient, we will have more to spend on people, their training, their kit and our capabilities and infrastructure. All that is good news, but it means we are living in an era where every penny counts.

Around half of MOD's £15 billion per year procurement spend is through contracts that are not competed. We cannot make savings of the required magnitude - and therefore acquire all of the military equipment we need - without addressing such a significant part of our spend. One key contribution for making the savings is implementation of the reforms set up by the Defence Reform Act 2014.

These reforms mark a radical change from the 'Yellow Book' regime that had been in place since 1968. The key change from my perspective is shifting from a system where the MOD had to pay costs unless they could demonstrate that they were "unnecessary, wasteful or extravagant" to one which puts the onus squarely on suppliers to demonstrate that costs are appropriate, attributable and reasonable. Who could argue with that? Well some might, so the Act sets up an independent body, the Single Source Regulations Office empowered to rule, amongst other things, on cases where industry and MOD disagree on what costs are allowable.

Implementing this change presents a substantial long-term challenge to both the MOD and industry. One of the key features of the new regime is that it is backed by statute which provides a powerful means of ensuring that they rise to these challenges. But my experience is that where costs are lower, the benefits are greater and perverse outcomes are less likely to arise if all parties work closely together. Regulatory systems work best if people want them to succeed. Regulators need the respect of those they regulate, and in the context of the SSRO, this means both the Department and Industry must want the new regime to work. There will be times, no doubt, when the SSRO will annoy people on either side of this divide or maybe both simultaneously. That is not necessarily a bad thing but it does mean that the SSRO needs to be authoritative, balanced, and transparent in the way it goes about its work.

The variety and complexity of contracts covered by the regulations means that it could well be that the detail of the regime would not have been got right first time. This was recognised in the legislation, which required the Defence Secretary to review the regime after three years. The SSRO's recent Call for Input is the first stage in that process.

The SSRO has got off to a great start and, most importantly, is already saving money for the taxpayer to be spent on defence. Its job is not easy. UK prosperity and innovation greatly benefit from a vibrant defence sector that has legitimacy in the eyes of the public. Unnecessary negativity or inappropriate publicity detracts from that. Equally, the SSRO mustn't be seen to let large powerful businesses off the hook. I'm sure it will continue to focus on listening carefully to what both industry and the MOD require and to produce fair, balanced outcomes. Everyone will benefit if that is the case.

*“A key part of the reform lies in the creation of the SSRO as an independent, arms-length mediator between MOD and industry on single source contracts. The SSRO was set up in late 2014 and has been active in producing a range of statutory guidance for industry and MOD on how the reforms will work in practice. The SSRO is able to give opinions and make legally binding judgements on issues referred to it by either the MOD or industry. The MOD is committed to making full use of the SSRO's expertise and has already referred the Astute Boat 5 contract to the SSRO for an opinion on pricing.”*

**The Defence Equipment Plan 2015, 22 October 2015<sup>13</sup>**

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13 Appendix 1 – Reference 20



# 5. The industry view



Paul Everitt

Chief Executive, ADS Group

Established under the terms of the Defence Reform Act 2014, the Single Source Regulations Office (SSRO) must aim to ensure that good value for money is obtained for the UK taxpayer in qualifying defence contracts (QDCs), and ensure that contractors are paid a fair and reasonable price for undertaking such contracts. Industry worked closely with Government and Parliament during the development of this legislation. During this process industry stressed the importance of the SSRO maintaining its independence and building the trust and confidence of the sector.

Some of the UK's most important capabilities, including Astute and Successor submarines, Type 45 destroyers, the Queen Elizabeth Class carriers, and Typhoon fast jets are bought using single source procurement. Indeed, single source procurement represented around 53 per cent of new Ministry of Defence (MOD) contracts in 2014/15 and the MOD spent approximately £8.3 billion on single source contracts in that year.

Since its launch, the process of determining 'value for money' has been subject of much debate, but it appears it is increasingly understood as delivering cost reductions. The SSRO has made much of its ability to find cost savings and its recent launch of a series of 'value for money' studies to identify further opportunities for reductions reinforces the focus on cost down, rather than value for money.

During 2015 the Government made a number of important defence commitments: meeting the 2 per cent NATO target, increasing MOD expenditure by 1 per cent per annum in real terms and allowing any efficiency gains to be re-invested into the equipment and support programme. These were supported by the 2015 Strategic Defence and Security Review (SDSR), which highlighted the importance of UK industry to the Government's prosperity, innovation and exports agenda.

It is important that our future prosperity and the determination of what a fair and reasonable price constitutes receive more attention. To view all commercial relationships through a narrow transactional lens runs the risk of ignoring some of the broader issues and measures that are important to shareholders and investors.

In accepting the SSRO's recommendation, in March 2016, the Secretary of State for Defence announced that the baseline profit rate for QDCs in 2016/17 would be set at 8.95 per cent. This represented a 15 per cent reduction in the rate applied to single source contracts signed during 2015 and, without changes to the SSRO's methodology, it signals industry can expect further reductions in future years. The reducing baseline profit rate, together with the SSRO's disallowance of sales and marketing costs and its increasingly conservative treatment of risk in contract pricing, risks creating significant disincentives for those investing in the UK defence market.

While industry does not dispute the need for the SSRO to aim to ensure value for money for the taxpayer, it should also aim to ensure fair and reasonable prices for defence companies. Following the EU referendum result, it is more crucial than ever that businesses are investing in the UK.

Only by doing so can the UK defence industry deliver the agility, capability and support our armed forces need. If the UK is to remain at the forefront of research and development, retain its place as a world-leader in innovation and continue to be competitive in the global market companies need a fair return for the work they do. In the current environment, it is critical that the Government continues to signal that it remains committed to investing in economic security and prosperity as set out in SDSR 2015. This means the SSRO and MOD must create market conditions that give managers, shareholders and investors in domestic and international defence companies confidence in the value of the UK defence market.

The SSRO remains a relatively new organisation implementing regulation in a complex and strategically important sector. Traditional regulatory models, for example for network utilities such as water or energy, focus on entire companies, rather than specific contracts as is the case in defence. Typically, regulators are there to protect consumers, by regulating prices. In the case of defence, the regulator is ‘protecting’ value for money for taxpayers instead.

Under this new regulatory regime for defence, the return is determined partly as a mark-up on costs and partly as a return on capital. While this is likely to be a more suitable approach given the low levels of capital investment under the contracts (compared to maintenance of national networks), it is sensible for the SSRO to review and adapt the assumptions, adjustments and approaches underpinning its methodology to ensure that it is delivering a fair return for industry.

Some initial questions worth exploring include whether eliminating companies with a loss in a given year generates volatility in the baseline rate, and whether it is sensible to have a minimum turnover threshold of £5 million for companies in the comparator group when the minimum threshold for a QDC is £5 million (which suggests the minimum turnover threshold should be closer to £50 million).

Industry must continue to work closely with both the SSRO and the MOD to ensure the regime succeeds in achieving its objectives. The defence industry plays a vital role in delivering our national security and is an important contributor to our country’s prosperity. Making sure the SSRO gets the balance right is in our national interest and should be a high priority for us all.

*“The defence industry is of strategic importance to the UK, generating £22bn in turnover during 2014 and making a direct and vital contribution to national security. Productivity within the defence industry continues to outpace national levels, growing by 17 per cent over the past four years compared with just six per cent in the rest of the economy. The percentage of companies with a UK-based supply chain has also increased, up by ten per cent since 2014.”*

**Paul Everitt, ADS UK Defence Outlook Report 2015<sup>14</sup>**

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14 Appendix 1 – Reference 21



# 6. The commercial view





Les Mosco

Former DE&S and MOD Commercial Director

At first glance the high level of single sourcing by the UK MOD is surprising. However, one quickly comes to understand that single sourcing is needed in the defence sector as the MOD is the monopoly purchaser of many of the things it procures and therefore the normal rules of competition do not exist. Indeed in some cases entire factories and even industrial sectors - e.g. UK submarine building - are there solely for the MOD requirement. This being the case, and in the absence of normal market forces and competition, some sort of regulation is needed for single source pricing. This is not a UK phenomenon – every country in the world necessarily deals with single source defence procurement.

Single source procurement is unusual and uncomfortable by nature, particularly when one comes at it from a commercial background where competition is the norm. The absence of market forces and competition cause difficulties but monopoly supply is the only option in certain circumstances, and is the fact of life for a large proportion of the MOD's value of spend.

Examples where monopolies exist, almost regardless of efforts to create competition, include:

- When maintaining a competitive supply chain means carrying duplicate and spare capacity that is never likely to be used efficiently, because the demand will only fill one supply chain, not two or more.
- When the volume of requirement isn't even enough to fill the capacity of the irreducible minimum production capacity of just one supply chain, but the resource needs to be maintained for future strategic security.
- The natural legitimacy of a monopoly supplier given intellectual property rights (IPR).
- Where maintenance and through-life support is tied to one supplier, e.g. competitive procedures have resulted in only one supplier being awarded a multi-year long-term support contract.

So having accepted the necessity of monopoly supply in some cases, and that it is reasonably common in defence, the best way of handling this situation is some version of what is happening at the moment. One needs to measure and assess the reasonableness of costs, benchmark and evaluate a reasonable profit margin, and hence construct a representation of what a 'normal' or 'reasonable' competitive market price should be.

Previously this was done via the 'Government Profit Formula'. This set of rules, developed in the 1960s and periodically updated, was written down and codified in a soft back publication, with a yellow binder, and so was known by all as the "Yellow Book". That has now been replaced by the SSRO which acts as the regulator and independent arbiter of reasonable and fair costs, benchmarks profits and calculates a 'fair' market price.

The SSRO has a difficult role. It sits between the MOD and the major defence contractors. This is between a rock and a hard place. The MOD has a need to demonstrate Value for Money and good use of taxpayers' money. The defence contractors need to be fairly rewarded for their business, including achieving a reasonable profit. The SSRO is similar to regulators in other sectors, such as OFGEM and OFWAT, in trying to set fair arrangements in the absence of normal market forces. It will benefit all if it builds a reputation for integrity, accuracy, professionalism and a firm but fair approach.

In short, it needs to build respect from both the MOD and industry that its recommendations, methods and views are fair and reasonable to all. If it can do that, then it can help streamline and take some of the friction out of the current single source pricing arrangements.

The previous Yellow Book arrangements suffered from both buyer and supplier complacency. On the MOD side as buyer, it was perhaps not complacency, but inadequate resources - both time and access to enough skilled people - to challenge much of the costing and accounts which came from industry. The pressure was always to place the next new and important contract, rather than devote very scarce people resources to forensic examination of historic contracts.

Regarding supplier complacency, both the Yellow Book and current SSRO mechanisms are variants of cost plus arrangements. Cost plus - where the supplier is allowed to charge its base costs, and then get an agreed profit margin on top - are deeply uncomfortable arrangements for the buyer. The supplier is incentivised to include anything it can get away with in the base costs. It will then both get these reimbursed, and get a profit margin on top. So the more costs it can attribute to the arrangement the more the supplier will earn. And there are real examples which have been identified in the past where unnecessary and profligate items of expenditure have been included in the base costs. To illustrate with a trivial but real example, if a company car is a legitimate base cost - and I'd agree in many cases it is - then cost plus incentivises that the company car should be as expensive as can be explained away! Whilst the MOD Cost Assurance and Analysis Service (CAAS) has often highlighted costs that should not be borne by the MOD, there is a real problem of asymmetry of skills and resources between the MOD and contractors. Indeed, to emphasise my point, contractors' cost engineers who are employed to maximise the base cost line, are themselves chargeable to the very overhead that is paid by the MOD, so of course a contractor can - and in some cases did - employ and charge to MOD for significant numbers at salaries well above anything MOD could itself offer!

So there is also a lack of incentive for contractors to take painful management decisions to make their operations leaner and more efficient in single source contracts.

There is also a more understandable lack of incentive for contractors to take risks, e.g. on innovation on new working methods in single source contracts. Will the MOD agree to underwrite the up-front costs and risks of trying the innovation, and if it succeeds, say by reducing manufacturing costs, will the contractor get any reward, or simply be expected to pass on to the MOD the cost reduction, and also less profit on a lower base cost?

Put simply: single source pricing arrangements increase the incentives for companies to continue with the status quo, rather than push innovation.

There is absolutely, without any doubt, the need to consider base costs and overheads. All costs incurred need a very vigorous scrub. The SSRO should focus its attention on the underlying costs of the contracts as well as the profit margin. If, say, the agreed profit margin is 10 per cent, 90 per cent of the price is incurred in the base costs, so this is where the focus and attention should be. Sure, let's debate whether profit should be 10 per cent, or 8 per cent or 5 per cent, or 12 per cent or 15 per cent, but the bigger gearing on price is by ensuring the 90 per cent underlying costs are as lean as possible. And within the 90 per cent is the allocation of overheads, both local and head office. These need a thorough scrub, to ensure that the MOD is only paying for overheads which are both relevant to its requirements, and are lean and mean and demonstrated value for money. This is an uncomfortable challenge for contractors, often pitting head office against local business units.

Cost plus arrangements are a poor form of contracting, but are sometimes inevitable. If the UK is going to have these arrangements, it absolutely has to have a regulatory framework to oversee it. A body such as the SSRO can discharge that role. If so the force of the regulator must be felt. Almost inevitably, the SSRO will be unpopular with both the MOD and industry, but its role should be to be firm and fair, and to earn the respect of those it is regulating.

*“Innovation – generating ideas and putting them into practice to overcome challenges and exploit opportunities – drives the UK’s economic strength, productivity and competitiveness. Innovation and our exploitation of science and technology are also vital to our national security. They underpin the equipment, capabilities and skills that give us an advantage over adversaries, and enable us to deal with threats and hazards now and in the future.”*

**National Security Strategy and Strategic Defence and Security Review 2015<sup>15</sup>**

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15 Appendix 1 – Reference 3

# 7. The academic view



Professor Matthew Uttley  
Chair of Defence Studies,  
King's College London



Professor Andrew Dorman  
Professor of International  
Security, King's College  
London



Dr. Benedict Wilkinson  
Senior Research Fellow,  
King's College London

The government announced its intention in the National Security Strategy and Strategic Defence and Security Review 2015 (NSS/SDSR) to 'refresh our defence industrial policy and take further action to help the UK's defence and security industries to grow and compete successfully'<sup>16</sup>. The Ministry of Defence (MOD) currently defines 'value-for-money' (VFM) in defence procurement as 'the optimal combination of time, cost, and effectiveness, within available resources' derived from 'the comparison of potential and actual outcomes of different procurement options'<sup>17</sup>. The MOD's 'default' is to secure VFM by sourcing defence goods and services through open competition in the domestic and global market<sup>18</sup>. However, over 50 per cent of MOD contracts are currently awarded to a single supplier in the absence of competition on the grounds that there is only one contractor able to meet the requirement and/or because of the need to 'preserve industrial and technological capabilities in the UK for strategic reasons'<sup>19</sup>.

Since 2011, British government reforms have sought to minimise the well-documented scope for 'adverse selection' and 'moral hazard' accompanying single source contracting<sup>20</sup>. Evidence suggests that Lord Currie's report on single source pricing regulations, provisions in the Defence Reform Act 2014, the creation of the Single Source Regulations Office and implementation of the new single-source governance framework have improved on previous approaches to 'establishing an appropriate price' for 'Qualifying Defence Contracts' (QDC), transparency, risk sharing and ensuring a 'fair return to industry'<sup>21</sup>.

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16 Appendix 1 – Reference 3 (page 75)

17 Appendix 1 – Reference 4 (page 12)

18 Appendix 1 – Reference 4 (page 13)

19 Appendix 1 – Reference 5 (page 7)

20 Appendix 1 – Reference 6 (pages 1-15)

21 Appendix 1 – Reference 7

Yet, questions remain about the scope of the MOD's broader 'value-for-money' definition within which single-source contracting reforms are located. As we have argued elsewhere, the UK's onshore defence industry is a key sector of the British economy that provides strategic value to national defence and security<sup>22</sup>. The MOD is required to promote UK growth and report on the effects of its procurement expenditure on the British economy in the context of the 'prosperity agenda' announced in the NSS/SDSR<sup>23</sup>. However, MOD reporting on the economic growth implications of its equipment procurement expenditure is patchy and incomplete, particularly regarding impact comparisons as between domestic and imported off-the-shelf equipment alternatives. This is particularly worrying as there is a growing body of evidence that there is economic value to a thriving domestic defence industry, together with the national strategic and security benefits the industry provides. This suggests that the MOD's open procurement philosophy and value-for-money definition are not able to identify where it might generate economic growth through its equipment choices.

Moreover, there are single source contracts that fall outside the QDC regime. In the Defence Reform Act 2014 contracts with foreign governments and contracts made within the framework of a collaborative international defence programme are excluded from the UK single source procurement framework. The MOD's recent decision to purchase P-8 aircraft built by US company Boeing through America's 'Foreign Military Sale (FMS) scheme has led to the accusation that 'SSRO regulation adds immense bureaucracy and cost to UK companies who have to open their books and submit documents a mile thick while US firms get a free pass'<sup>24</sup>.

The government, therefore, needs to take two actions. First, it should clarify how UK taxpayers are getting better value-for-money for single source contracts placed outside the auspices of the SSRO. Second, it should re-instate the requirement for the MOD to gather data on the economic benefits of defence expenditure, placing particular importance on producing estimates for UK employment dependent on MOD expenditure; data that help differentiate between equipment sourced from the UK and equipment sourced via direct imports; and, the contribution to the UK economy generated by the MOD's £166 billion equipment plan for the period 2015-2025<sup>25</sup>.

*"The domestic defence industry supports and creates highly skilled jobs and strengthens the economy. MOD expenditure within the UK defence industrial base and beyond provides significant economic value to the UK in terms of domestic employment levels, high-technology skills and financial contributions."*

**Professor Dorman, Professor Uttley and Dr Wilkinson**

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22 Appendix 1 – Reference 1 (page 25)

23 Appendix 1 – Reference 3 (page 75)

24 See A. Tovey, 'Huge deal to buy US spyplanes risks row over defence profits', The Daily Telegraph, 21 May 2016. <http://www.telegraph.co.uk/business/2016/05/21/huge-deal-to-buy-us-spyplanes-risks-row-over-defence-profits/> [accessed 20 June 2016].

25 A. Dorman, M. Uttley & B. Wilkinson BJ. Written Evidence, House of Commons Defence Committee, Second Report: *Shifting the Goalposts? Defence Expenditure and the 2% Pledge*, Session 2015-16, HC 494. 2016.



Professor John Louth

Senior Research Fellow and Director for Defence, Industries and Society, Royal United Services Institute

### Single source procurement and UK defence – A personal reflection

As a research director in a defence think tank, most of my work is written in the third person, heavily referenced and evidence-derived rather than opinion led. It is a pleasure, therefore, to be asked to submit a personally reflective piece on the development and progress of the SSRO. Since at least 1998, successive governments have been grappling with defence acquisition reform in a variety of guises. This initially took the form of the Smart Procurement Initiative which yielded Smart Acquisition and a succession of derived change programmes centred on Abbey Wood and the role of Head Office in procurement. These programmes over the years have focussed inevitably on structures, values, competencies, behaviours and processes. The ghost at the banquet was what to do with single source procurement, a subject finally addressed by the Defence Reform Act of 2014. This brought the Single Source Contract Regulations and offered the possibility of a refreshed, more agile and fairer single source procurement regime. Is it possible, as yet, to assess whether this promise has been fulfilled?

The first thing to note, of course, is that it is still early days. Whilst there was strong support for the Currie Review of 2011, the benefits of the SSRO regime are still emerging. There has been legitimate concern around the notion of a qualifying defence contract (QDC) and just how many potential contracts would be referred to the SSRO. For example, during the last financial year, the SSRO was notified of 31 QDCs and a small number of sub-contracts to the cumulative value of £11.5 billion. However, in the same year, the MOD and its contractors signed a further 127 single source contracts that were not referred to the SSRO, falling beyond the panopticon of the regulator.

So a first question to ponder is: can a regulatory organisation be credible if it only has access to a limited number of qualifying contracts to review within a much broader population? There is no binary answer at this stage, but it makes more sense, in logic, for all single source defence contracts to be subject to the regime. I do not underestimate the difficulties this might cause in government-to-government and Foreign Military Sales (FMS) arrangements. But the SSRO was established to deal with difficult issues and should be asked to develop a road-map for substantially expanding the reach of the regime. Indeed, as a new prime minister beds-in with a commitment to a more pervasive UK industrial strategy, the defence sector could take the lead in rising to this ambition. The regulator could have an important role to play.

The next point to ponder is the organisation location of the regulator. The SSRO is there to provide guidance to both the MOD and industry on what costs are allowable within single source arrangements, with the intent to offer industry greater certainty and the department better value for money. On the occasion of dispute between the MOD and contractor the SSRO acts as an independent regulator and adjudicator. If the SSRO is the honest broker between two parties within complex commercial arrangements, can it really be, in essence, an office of the MOD subject to Ministerial whimsy? Credibility is key as the SSRO develops and the debate on where it sits within government should continue.

Third, the statutory duty of the SSRO is to recommend a baseline profit rate to the Secretary of State for Defence, to be used within all qualifying defence contracts worth over £5 million. For this financial year the recommendation was 8.95 per cent – down from 10.6 per cent – and this, of course, caused some concern within the defence industrial establishment. The difficulty experienced by all parties is that the baseline profit rate is seldom the actual contract profit rate. Rather the complexity of capabilities sought and the risks in delivering can, and should, drive the commercial arrangements between the MOD and its key partners from the private sector. This message has to be continually relayed so that those who develop complex solutions for defence, taking substantial commercial risks within its execution, can feel confident that the returns they receive merit the effort expended. This is absolutely critical for defence as, on input costs and headcount, the overarching burden on the delivery of UK defence and security now resides in the private sector.

If this is right, the SSRO is not merely a statutory body concerned with the mechanics of a customer-supplier relationship. Rather, the SSRO has to develop as a strategic tool to keep healthy the complex balance of our public-private defence partnerships. It has to learn to see beyond the numbers to the rare competencies uniquely housed within our defence industrial base without which our defence is imperilled. Industry also has to engage to offer assurance to the regulator that the critical mission of ensuring, and assuring, value for money to the tax payer is being delivered. The critical component is the relationship not the regulation.

This is a short “op ed” piece and, unusually for this author, heavy on opinion and light on data. It seems to me that the SSRO has a pivotal role to play in developing a healthy and enduring commercial regime for the delivery of defence. This has never been more important as so many core competencies for defence are now found in the commercial sectors rather than the governmental. Gone are the days of large, standing military forces and government armouries. Today instead we have a complex defence extended enterprise with the majority of the ingredients for defence housed and nurtured beyond government.

In part, this is the space the SSRO seeks to regulate. It is not unreasonable to suggest that it needs to understand better the constituent parts of the complicated ecosystem. Likewise, it is reasonable to point out that some businesses could better help the SSRO in exercising its role, thereby influencing its development and emergence as an active defence player. Lastly, the government should also support the development of this key ingredient of the Defence Reform Act. Undertaking to work towards a regime that embraces all single source defence contracts with sophisticated and nuanced profit arrangements delivering long-term, affordable capabilities would be a start.

*“Concerns about the UK’s dependency on international suppliers and the erosion of sovereignty are also not addressed by the Strategic Defence and Security (SDSR) review. The coalition government’s 2012 White Paper stated clearly that government policy towards capability generation would be conducted, where possible, through off-the-shelf procurement of mature assets and platforms following a global, open competition to meet a stated requirement. The UK government would, however, reserve the right to intervene in defence procurement as necessary in order to protect the country’s sovereign capability and technical advantage – this was seen as a critical component of the UK’s ability to conduct independent defence and security operations.”*

**Professor John Louth, SDSR Doubts about Affordability and Dependency, RUSI Newsbrief 22 January 2016<sup>26</sup>**

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26 Appendix 1 – Reference 23





Professor Keith Hartley

Emeritus Professor, University of York

## Introduction

Single source procurement is challenging and controversial. Economics offers some policy guidelines but these are not easy to apply. Sole source procurement requires the SSRO to be involved in the determination of prices and profits for contracts; but competition can solve these problems.

### Use of competition to determine prices and control profits

Single source procurement arises where the MOD chooses to buy from UK or overseas monopoly suppliers. Whether a firm is a monopoly depends on the definition of the market. Domestic monopolies arise where the market is restricted to the UK defence industrial base where there are sole suppliers for aircraft, helicopters, aero-engines, missiles, warships and submarines e.g. (BAE Systems; Leonardo; Rolls-Royce; MBDA). But if the market is extended to include the world, there are sufficient numbers of alternative suppliers to provide competition for all major weapons systems (e.g. France; Germany; Japan; Italy; USA). On this basis, UK sole source procurement reflects a preference for 'buying British' for military-strategic and wider economic benefits. Such benefits need to be identified, valued and assessed critically.

Military-strategic benefits include independence, security of supply and equipment designed specially for the requirements of national armed forces. Wider economic benefits embrace jobs, technology, spin-offs and exports. But such benefits are not costless: imported equipment might be considerably cheaper. To use a civil example: it would be costly for the UK to 'grow its own bananas.' Also, the so-called wider economic benefits need to be assessed and justified in terms of market failures. For example, the jobs benefits have to be justified by failures in labour markets with national defence equipment procurement shown to be the most cost-effective solution to providing jobs. Often, there are lower-cost alternatives to providing jobs (e.g. construction projects are labour-intensive). Overall, the claimed benefits of domestic procurement need to be subject to a proper value for money assessment: perhaps a task for the SSRO?

Some defence procurements might be genuine single source types and these need to be clearly identified, costed and justified. Nuclear systems are the classic case with national monopoly suppliers for construction of nuclear submarines (BAE Systems, Barrow) and nuclear reactors (Rolls-Royce, Derby). These are costly acquisitions involving small numbers where there are political reasons for national procurement and the monopoly suppliers can be treated as regulated firms. Other areas of UK single source acquisition need to be identified and subjected to critical appraisal. Otherwise,

the appropriate policy option should be to buy competitively from the world market where competition would replace the pricing, profit and regulatory roles of the SSRO.

### Can competitive pressures be replicated in single source procurement?

Replication requires the SSRO to make a set of complex judgements which are made by competitive markets. It has to consider least-cost solutions, risks and the appropriate reward for risks, all of which have to be assembled into a final price which has to be 'fair and reasonable' and provide value for money. Competitive prices provide value for money in terms of efficient resource use but such prices are not guaranteed to be 'fair and reasonable': vague ideas of equity do not enter into competitive prices!

The SSRO has to select a comparator reference group. Here, there is an opportunity to report the sensitivity of its profit recommendations to different definitions of the reference group. A starting point would be to specify the profit rates for a group of low risk activities which would benchmark the recommended profit rate (e.g. government gilt rates; bank deposit rates).

The SSRO's task in replicating competitive market pressures is facilitated by the fact that in UK procurement markets, the government is a major or monopsony buyer. It can use its buying power to determine the size of the UK defence industrial base, ownership, industry structure, conduct and industry performance. For example, government can use its buying power to allow new entrants to the UK defence market or it can prevent both new entry and exit from the industry (e.g. by bailing-out failed firms). Or, it can use its contractual powers to promote mergers to create larger firms. However, the government's bargaining power in achieving lower prices is limited by the threat of firms to exit the UK market. All policy choices involve costs as well as benefits.

### Single source procurement, innovation, efficiency and productivity

Competition is more likely to promote innovation, efficiency and productivity. In contrast, monopolies are more likely to be inefficient, less productive and less likely to innovate, all of which makes it difficult for the SSRO to achieve value for money. Major problems arise in identifying least-cost solutions for sole suppliers. In competitive markets, firms have to be efficient to survive. But for monopoly suppliers, the SSRO surveillance of 'allowable costs' does not guarantee that these are least-cost solutions: an allowable cost is not necessarily efficient and this is a major challenge for the SSRO.

Inevitably, the SSRO will focus on 'successes' in reducing contractor costs without recognising that such successes will either lead to exits or encourage firms to seek alternative ways of recovering costs: firms are experts on their production possibilities.

Economics suggests an alternative approach to pricing and profitability based on establishing a target rate of return determined by the cost of capital. The Capital Asset Pricing model (CAPM) provides an estimate of the rate of return for risky assets. A 1999 study used this model and found that the average cost of capital was lower than the return set by the Review Board<sup>27</sup>.

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27 References in the contribution from Professor Hartley are at Appendix 1 – References 8, 9 and 10.

Conclusion: where next for the SSRO?

Many challenges remain of which three are identified. First, the SSRO needs to focus on estimating efficient costs rather than allowable costs. Second, it needs to recognise strategic interactions in bargaining between a monopsony buyer and a monopoly supplier. Third, if value for money is to be achieved, a more critical analysis is needed of the UK commitment to sole source procurement.<sup>28</sup>

*“The UK submarine industry is a unique industry with a single customer, monopoly suppliers and small production numbers. Gaps in design and construction work present major problems in retaining the specialist design and construction worker skills, especially the skills needed for nuclear work. However, more analysis and evidence is needed on the costs and benefits of production gaps of different magnitudes, including their cost and employment implications.”*

**Defence Industrial Issues: Employment, Skills, Technology and Regional Impacts, BASIC discussion paper produced by Professor Keith Harley, March 2012<sup>29</sup>**

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28 References in the contribution from Professor Hartley are at Appendix 1 – References 8, 9 and 10.

29 Appendix 1 – Reference 22

# 8. The international view

## Germany



Regina Dornieden

Federal Office  
of Bundeswehr  
Equipment,  
Information  
Technology and  
In-Service Support



Hans-Peter Müller

Federal Ministry  
for Economic  
Affairs and Energy



Captain Ludwig Lennartz

Federal Ministry of  
Defence



Martin Ditzer

Federal Ministry  
of Defence

### Pricing for public contracts in the Federal Republic of Germany

#### German pricing law congruent with fundamental economic order

Starting from the premise that competitive markets lead to better results than state coordination, Germany's fundamental economic order was created on market economic conditions.

This fundamental principle also applies to the field of public procurement, where competitive markets are regularly created by "special bidding markets" that result from bidding procedures. Ideally, this desired competition leads to competitive pricing.

There are, however, cases where competitive bidding is impossible. The public customer often needs customised or specialised services as is common in the military sector. Consequently, monopolistic structures may form on the supplier side, which complicate or even prevent market economy pricing of the services to be procured.

The German legislature has therefore established a set of regulatory instruments designed to guarantee maximum possible market economy pricing despite monopolistic supplier structures.

This instrument, "Regulation PR No. 30/53 on Pricing for Public Contracts" (VO PR No. 30/53) defines the priority of market economy pricing as the relevant guiding principle.

It ensures that suppliers of services under public contracts will always receive the price they would have achieved otherwise. The supplier must, in turn, accept the market price for the services offered in the bid. Asking for a higher price in the bidding process is generally prohibited by pricing law.

Cost prices may only be agreed in exceptional cases:

- where market prices cannot be determined; or
- a supply shortage has occurred or competition is limited on the supplier side and the market price is significantly affected as a result.

Three types of cost prices are possible:

- fixed cost prices to be calculated as a price predetermination;
- target cost prices as “interim prices” to be converted to either fixed cost prices or cost reimbursement prices; and
- cost reimbursement prices to be calculated on the basis of a price audit based on actual costs.

Where they are agreed, the verification of their legal permissibility focuses on whether contractor costs are reasonable. In this context, it is essential to thoroughly understand the production cost curve of the contractor, from which to deduce a reasonable price.

Permissible costs are formally determined according to the “Guidelines for Pricing on the Basis of Cost” (LSP) annexed to VO PR No. 30/53 in order to avoid as much as possible the adverse effects of non-competitive pricing due to monopolistic supply structures.

The preference for market prices dictates that partial services (e.g. spare and repair parts, accessories as well as hourly rates) that are subject to market economy pricing be included in cost prices at their relevant market prices.

In addition to the agreed imputed profit, further market economy elements are taken into account such as calls for a proper accounting system and imputed interest on the working capital. Thus, neither contractor nor public customer is worse off with a cost price contract than if a market price had been determined.

VO PR No. 30/53 not only establishes the preference for market prices, but also for fixed-price agreements. Where the circumstances of the contract permit, fixed, i.e. unchanging prices must be agreed. This is meant, among other things, to improve planning security for contractors and customers and to avoid inflationary trends.

Compliance with the provisions of VO PR No. 30/53 is monitored by the price monitoring agencies of the Laender<sup>30</sup> exercising their sovereign rights within Germany’s federal structure. As neutral expert agencies of the Laender, they are vested with adequate powers to audit prices for public contracts.

### The Bundeswehr as a privileged user in public pricing law

Of the total value of centrally awarded contracts by the Bundeswehr, around 40% are concluded at market prices based on competition while the remaining approx. 60% are concluded at cost price. As there are no special arrangements for single source procurement in Germany, including the Bundeswehr, the same regulations apply to all these market or competitive relationships. Owing to its specific military requirements of products and services, the Bundeswehr, however, has a higher than average share of contracts at cost price compared with other public purchasers.

The regulator responsible for VO PR No. 30/53 is the Federal Ministry for Economic Affairs and Energy. This ministry has come to an inter-ministerial agreement with the Federal Ministry of Defence (among other things because of the latter’s procurement volume).

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<sup>30</sup> Germany is split up into 16 federal states or ‘Laender’

This agreement contains provisions concerning the largely autonomous price auditing powers for the Federal Office of Bundeswehr Equipment, Information Technology and In-Service Support when it comes to Bundeswehr contracts and cooperation with the price monitoring agencies. As a user of pricing law, the Bundeswehr is thus in a privileged position, not least so that it can make flexible use of its own price auditing service when conducting urgent cost price audits.

Audits of market prices and cost reimbursement prices are the responsibility of the price monitoring agencies. The Federal Office of Bundeswehr Equipment, Information Technology and In-Service Support performs audits of predetermined prices (fixed cost and target cost prices). It has no sovereign powers over price audits. The respective right must be contractually agreed with the relevant contractor.

### Price auditing by the Bundeswehr

The auditing sections of the Federal Office of Bundeswehr Equipment, Information Technology and In-Service Support are staffed with business and technical auditors in the relevant subject areas. In order to ensure the independence of price auditors, they are organised in a central division as a dedicated group, separate from operative armaments affairs in the project divisions.

The point of price auditing is to determine a price that is in line with pricing regulations. Price auditors are not proactive but rather take action at the request of the price negotiation sections. Such sections are represented in every project division and are responsible for contractual remuneration agreements. This includes establishing the price type.

The basis for a price audit is the cost price calculation of the contractor. Price auditors will usually inspect the contractor's business, view technical and business-related documents (e.g. technical drawings, invoices, delivery orders) and examine production flows. Depending on the extent to which supply firms are involved in the contract, these suppliers are also included in the price audit. Price audits, which may take anywhere between several weeks and a few months, are conducted prior to contract conclusion for fixed cost prices or, for target cost prices, at the time when these target prices are converted into fixed cost prices during production and thus after the contract has been concluded.

The result of a price audit is documented in an audit report which is presented to the project division as an independent expert opinion on the appropriateness of the audited price. The project division will then come to a contractual price agreement with the contractor based on this report.

### Conclusions

Besides regulations concerning marketable services, the pricing law provides all that is necessary to audit prices in markets with limited competition.

The basic principles of "competition" and the "preference for fixed-prices" ensure maximum competition and planning security for customers and contractors.

As a supra-ministerial regulation, pricing law reflects principles in line with the fundamental economic order of the Federal Republic of Germany without referring only to the work of one ministry.

Structurally, German pricing law is a suitable template for an abstract and coordinated European pricing law.

## Canada



Public services and procurement Canada/Government of Canada

Desmond Gray, Director General, Acquisition Branch

Canadian law and regulations promote competition and innovation as a way to obtain best value for Canada and strengthen the Canadian industrial base. While competitive procurement defines the approach for the vast majority of Canadian government procurement, section 6 of the Government Contracts Regulations allows single or sole source procurement in Canada when the proposed procurement meets one of the following four conditions:

- the need is a pressing emergency where delay would be injurious to the public interest;
- the procurement contract is under a certain threshold, generally \$25,000;
- the nature of the work is such that it would not be in the public interest to solicit bids (i.e. national security concerns); or
- only one person or company is capable of performing the work.

Sole source contracting is more frequent in the defence and security sphere, where a smaller base of suppliers, urgency and requirements for interoperability may mean that only one supplier meets the stated needs. For sole-source situations, the Canadian Federal Government has established a cost-based pricing framework using a costing standard consistent with most cost accounting methodologies. The key element in the framework is the attribution of costs to production.

The cost base of the contract is assessed to determine what is allowable and disallowable and then the final costs are negotiated with the contractor. For example, interest charges for loans are disallowed direct costs. The intention is to have a consistent treatment for profit regardless of the financing used by contractors.

A formula is used to determine the profit rate. The formula provides return on capital employed (fixed and working capital) and takes into consideration the contractor's risk. For example, the procurement officer will define an acceptable profit margin for the contract based on knowledge of the specific business or contractual risk associated with what is being procured.



In those cases where the rationale for sole sourcing is the assertion that there is only one person or company capable of performing the work, procurement officers are strongly encouraged to issue an Advance Contract Award Notification (ACAN) to validate this belief by testing it in the marketplace. The ACAN is published publicly (similarly to a Request for Proposal), and advises that the government intends to award a contract for a specific good or service to company X for a specific value, because we believe there are no other suppliers capable of meeting this requirement. Potential bidders can then respond to the ACAN to demonstrate they can also meet the government's needs. Responses to ACANs are evaluated, and if another potential supplier is identified, the sole source process is set aside and a competitive procurement process is launched.

Once it is determined that a sole source procurement is the most suitable means for obtaining the required goods or services, the procurement officers, along with the technical authorities and cost analysts will assess the cost estimates provided by the supplier in order to determine if the proposed costs are fair and reasonable. Often such considerations form the basis of a negotiation process with the contractor in order to clarify the reasonableness of the proposed costing. Once an agreement has been reached on the basis of cost, discussions continue to determine a fair profit calculation.

While single or sole sourcing is used as mentioned in specific situations, the approach has risks. The most obvious risk to the government is the possibility of paying too much for the goods or services being procured. An equally significant concern is the possibility that the selected contractor will not perform according to the terms of the contract. In both cases, the lack of options for selecting another supplier increases the possibility that the price or quality of the goods or services could deviate from the initial contract. This risk is firmly addressed by ensuring the contract is managed rigorously, the terms of the contract are respected and that any changes do not undermine the intent or value of the contract.

A significant change in managing sole source procurements is the movement away from the traditional "cost +% fee" as the basis of payment, to a more incentive based basis of payment. In the former, the contractor may be encouraged to keep costs high even when new technologies or processes might reduce costs, because costing is based on a percentage of total expenses. The higher the continued expenditure, the more revenues earned by the supplier. The introduction of an incentive (performance) based basis of payment model recognizes the value of introducing efficiencies and innovation in the life of the contract, and the basis of payment is such that savings achieved are shared with the supplier. Accordingly, suppliers are motivated to reduce costs and demonstrate performance because there is a clear positive return to them. In the Government of Canada, sound guidance documents are being developed to help ensure performance based contracts become the norm rather than the exception.

As part of an analysis undertaken, the Government of Canada looked at other countries' pricing frameworks. It was noted that in order to manage the risks associated with the uncertainty of the cost model, suppliers are likely to add an additional cost to reflect their increased risk. Also, cost based pricing requires ongoing and regular validation of costs, adding to the level of effort required.

The Government of Canada as part of its approach includes clear audit rights including Defence Production Act rights which reads as follows:

“A person who has entered into a defence contract shall:

(a) keep detailed accounts and records of the cost of carrying out the contract and retain those accounts and records until the expiration of six years after the end of the calendar year in which the contract is terminated or completed; and

(b) on demand, produce to any person thereunto authorized by the Minister every account, record or document of any description with respect to the contract and with respect to his other business that may be required by the person so authorized and permit him to examine, audit and take copies of and extracts from the accounts, records or documents.”

In a sole source environment other measures are needed to manage the customer/supplier relationship beyond simply arriving at the right price. Benchmarking a proposed technical solution both before the contract is awarded and during contract delivery is also important especially for long term contracts. The concern is that in some cases we may be paying today’s costs for yesterday’s solutions. Establishing a solid, clear baseline for identifying costs is important in ensuring not only delivery but the fair and reasonable attribution of costs and profit or incentive payments to suppliers.

Industry recognizes that in a single source arrangement, there can be less financial incentive to innovate. Incentives and partnerships with industry can be used to encourage innovation. However, if the basis of payment is not properly designed, the motivation for industry to be innovative may be replaced by a motivation to only lower their own costs. Incentivizing efficiency and performance as part of the basis of payment is essential to encouraging and rewarding contractor innovation when competitive pressure is not present.

Canada fosters close partnerships with its prime contractors as a means to better understand the processes of primes with regard to sub-contracting. This enables Canada to have a better idea of where costs are incurred and saves time in terms of cost negotiation. In several large contracts, as part of the contract agreement, the contractor may agree as part of the terms of the contract to apply the government principles of fair and transparent procurement in their supply chain. This encourages primes to compete their requirements through public tendering, helping to promote competition and encourage innovation. This can further encourage the contractor to deliver many of their services to remote areas of Canada by using local, and often small and medium sized enterprises, and further related social objectives (such as identifying and employing First Nations’ suppliers).

Recently, Canada has been including clauses within its contracts to value the importance of sound partnerships using alternative approaches such as incentives, performance based contracting, etc., to improve the relationship with contractors. The basic principles that foster this are open book accounting, alternative dispute resolution, key performance indicators, etc.

Every government has to ask how it can better leverage public expenditure to benefit their country. The solution is to find a balance between achieving a range of social benefits (value) and achieving the best price. Money is measurable – this means we can easily assess best price, but defining value is more challenging. We have to look at value from various angles, such as in terms of performance of the product, sector development or economic benefits. To assess it correctly, you need to understand what your client really needs. And of course continuous management of value throughout the life of the contract is essential.

# 9. Conclusions

The SSRO hopes this discussion paper has sparked debate on the topic of single source procurement. It is clear that there are a range of views on the appropriateness of single sourcing. The themes of value for money, innovation, culture and behaviours, skills development and strategic and economic benefits which the SSRO has identified will hopefully help to focus further discussion on this topic. It is important that the effectiveness of the regime and the SSRO are also considered. Single source spending will remain a feature of the UK defence sector for many years and therefore should be of interest to Parliament as public resources continue to be scrutinised and priorities change.

The possibility of competition needs to remain the starting point for any defence procurement. However, where single source procurement is required it can be a viable and appropriate alternative to competition with the right mind-set and if the justification for it is open and transparent. There are examples where single source procurement has worked well. The Strategic Defence and Security Review includes commitments for significant single source spending in the next five years. It is therefore important that single sourcing continues to be kept under review and that contracts come within the single source procurement regime where they should.

Defence is a global business and it is critical that UK defence companies can compete with international suppliers and sell exports to other countries. A vibrant UK defence industry delivers wider benefits strategically and economically. Single source suppliers must be able to retain their competitiveness in the worldwide market place and their investors need to be confident that they will receive a fair and reasonable return from single source contracts.

We will continue to develop our expertise in single source procurement and will work with others to better understand its risks and benefits. The SSRO will play its role in making information about single source procurement more publically available and transparent. We will encourage the Ministry of Defence to make justifications for using single suppliers more explicit.

In January 2017, the SSRO will be holding a public consultation on changes to the Defence Reform Act and Single Source Contract Regulations which we will propose recommending to the Secretary of State to strengthen the single source procurement framework. We have just completed our first round of stakeholder engagement on a number of the Review of Regulation themes (coverage, pricing, SSRO operations, referrals and enforcement) which we wanted to explore before January. The next round of engagement on the theme of transparency, which the issues in this discussion paper are closely related to, will be in September.

If you have any thoughts or comments on single source procurement that you consider can inform the SSRO's Review of Regulations or the other areas of the SSRO's work, we would be pleased to hear from you at [reviewofregulation@ssro.gov.uk](mailto:reviewofregulation@ssro.gov.uk)

# Appendix 1 – Background research

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# Appendix 2 – Contributor biographies

## Lord Currie

Lord David Currie is the Chairman of the Competition and Markets Authority (CMA), which was established on 1 October 2013 and assumed full functions and powers on 1 April 2014. As Chairman of the CMA he is responsible for establishing and managing the organisation and working with the Chief Executive, the Board and Executive Team.

He is also Governor of the Institute for Government, Member of the Board of the Dubai Financial Services Authority on the cross benches in the House of Lords as Lord Currie of Marylebone.

Previous career highlights include the roles of Founding Chairman of Ofcom (2002-2009) and Dean at Cass Business School (2001-2007)

## Lord Levene

Lord Levene started his career in the Defence Industry, and subsequently was appointed as Permanent Secretary in the UK Ministry of Defence responsible for defence procurement. He then served in a number of other government posts including as Adviser to the Prime Minister on Efficiency.

Prior to joining Starr Underwriting Agents Limited, Lord Levene was appointed as Chairman of the Docklands Light Railway and Chairman and CEO of Canary Wharf Ltd. He has served as an Alderman of the City of London as well as Sheriff and Lord Mayor. In the financial services sector he became Vice Chairman of Deutsche Bank in the UK with earlier appointments at Wasserstein Perella and Morgan Stanley. More recently he served as Chairman of the Lloyd's insurance market for nine years and as a director of the China Construction Bank for six years. Currently he serves as Chairman of General Dynamics UK Ltd, and on the boards of Haymarket Group Ltd and Eurotunnel SA.

He holds degrees in Economics and Politics from the University of Manchester as well as honorary degrees from the City University and the University of London. He was knighted for his services to Defence and subsequently received a peerage whereby he sits on the cross benches of the House of Lords. He is a Commander of the Ordre Nationale de la Merite in France, a Knight Commander of the Order of Merit in Germany, and of the Order of Merit in Hungary.



## Cate Pye

Cate is an experienced Advisory Executive Director who has worked extensively at senior levels in the defence and security sectors. She has advised on policy, strategy and delivery for both large programmes and change initiatives, and providing coaching to senior department leaders. Since joining Ernst and Young in 2010 Cate has been based in the London office. Prior to that she provided advice to various organisations in the security sector and enjoyed a first career in the Ministry of Defence and Cabinet Office. Cate is a Chartered Engineer and Member of the Institution of Mechanical Engineers and an Associate Member of the Association of Project Management. She holds a Master's Degree in Engineering and has spoken and published widely on the challenges the sector faces.

## Graham Beal

Graham is a Partner in Ernst & Young's Lead Advisory practice. He has 25 years of experience of working on the interface between public and private businesses and of complex procurement, finance raising and outsourcing. His work includes the responsibility for leading a large number of advisory teams on a range of strategic and financial advisory projects which focus specifically on infrastructure, procurement, corporate finance, transformational and PPP related issues.

He has conducted and supported a range of complex procurements both in the UK and overseas.

## Major General Tim Tyler

Before retiring from the Army in 2008, Tim was Director General Land Equipment as well as on the Army Board. With his expertise in defence procurement, he has since been working in the private sector providing strategic advice and bid support. As a soldier (serving and retired) working in procurement both as a customer and supplier he has found himself at the uncomfortable conjunction between the desire for timely military capability, long term value for money and procurement policy and practice. In his military career he also served as Deputy Commander of the Iraq Survey Group and as Deputy Adjutant General.

## Sir Gerry Grimstone

Sir Gerry Grimstone is Chairman of Standard Life, one of the UK's largest savings and investments businesses. He also chairs Standard Life's business in China and sits on the Board of HDFC Life in India. He is also Deputy Chairman of Barclays and is an Independent Non-Executive Board Member of Deloitte LLP. Within the UK public sector, he is a member of HM Treasury's Financial Services Trade and Investment Board. From 2012-2015, Gerry served as the Chairman of TheCityUK, the representative body for the financial and professional services industry in the UK.

Gerry has a long history serving the Ministry of Defence. He served on the Board of RAF Strike Command (subsequently Air Command) from 1999-2007, chaired the RAF Audit Committee and was a member of the Defence Audit Committee. He is a trustee of the RAF Museum. In 2010-2011, he carried out a major study on Civilians in Defence for the Prime Minister and the Secretary of State for Defence. Gerry was a member of the Defence Reform Steering Group chaired by Lord Levene. Since 2011, he has sat on the Defence Board chaired by the Defence Secretary as its Lead Non-Executive. The Defence Board is the senior decision-taking body in the MOD.

He was previously a senior investment banker at Schroders and ran businesses in London, North America and Asia Pacific. He specialised in mergers and acquisitions and capital-raising for major companies worldwide. Prior to that, he was an official in HM Treasury where he was responsible for privatisation and policy towards nationalised industries.

### Paul Everitt

Paul Everitt joined ADS at the beginning of February 2013 as Chief Executive ADS and Chairman of Farnborough International Ltd. He has more than 25 years' experience of public policy and media campaigns in the manufacturing and transport sectors. He represents ADS members on the Aerospace Growth Partnership, the Defence Growth Partnership and the Security and Resilience Growth Partnership. He is well known across Westminster, Whitehall and Brussels as a champion of UK manufacturing and respected advocate of industry issues and concerns.

Paul was previously Chief Executive of SMMT, the national trade association for the UK motor industry and Director of Civil Air Transport and Communications at the Society of British Aerospace Companies (SBAC). Paul began his career in furniture manufacturing, before moving into public policy research and economic analysis with the British Road Federation.

### Les Mosco

Les Mosco was the Commercial Director for Defence Equipment and Support (DE&S) from 2007 to 2014. From 2011 he was also Director Commercial for the whole of the Ministry of Defence (MOD), functionally responsible for DE&S but also with direct Commercial responsibility for the rest of the MOD. In this role he was responsible for around 1700 commercial staff and an annual spend of over £20 billion, covering extreme complex acquisition, and engagement at the highest levels of Government.

Before the MOD, Les worked in similar commercial roles for British Coal, The Scottish Office, NatWest Bank, Amerada Hess (oil and gas), Network Rail, and as a self-employed consultant. Since leaving the MOD, Les has continued to provide expert advice targeting Non-Executive Director roles, consultancy and charity work as owner and CEO of his independent consultancy, Commercial Strategies Limited.

### Professor Matthew Uttley

Professor Uttley has held the Chair in Defence Studies at King's College London since 2005. He was formerly the Academic Adviser to the Commandant of the Royal College of Defence Studies (2014-2015) and the Academic Director of the King's Policy Institute at King's College London (2012-2014). He was also previously the Head of the Defence Studies Department and Dean of Academic Studies at the Joint Services Command and Staff College, Shrivenham (2006-2012). Before joining King's in 2000, Professor Uttley held academic posts at the Centre for Defence Economics, University of York (1992-1994) and the Department of Politics, Lancaster University (1989-1992).

### Professor Andrew Dorman

Andrew Dorman is a Professor of International Security. His research focuses on the interaction of policy and strategy, utilising the case studies of British defence and security policy and European Security. He has held grants with the ESRC, British Academy, Leverhulme Trust, Ministry of Defence and US Army War College.

Professor Dorman trained as a Chartered Accountant with KPMG, qualifying in 1990 before returning to academia. He has previously taught at the University of Birmingham, where he completed his masters and doctoral degrees, and the Royal Naval College Greenwich.

### Dr. Benedict Wilkinson

Dr Benedict Wilkinson is a Senior Research Fellow in the Policy Institute at King's. He completed his PhD under the supervision of Professor Sir Lawrence Freedman at King's College London in 2013. Upon completing his PhD, Benedict joined the Policy Institute first as a Research Associate (2013), and then Research Fellow (2014), before being appointed as a Senior Research Fellow in 2015. From 2013 to 2015, Benedict also held a Lectureship in the Defence Studies Department and taught at the Royal College of Defence Studies. Between 2010 and 2011, Benedict worked as Head of Security and Counter-Terrorism at Royal United Services Institute (RUSI) where he continues to hold an Associate Fellowship. He became an Associate Fellow of the International Centre for the Study of Radicalisation (ICSR) in 2013 and a Fellow of the Royal Society of Arts in 2014.

### Professor John Louth

Professor John Louth is Senior Research Fellow and Director for Defence, Industries and Society at RUSI. He served as an officer in the RAF for sixteen years before working as a consultant and programme director extensively throughout the defence and energy sectors, employed in both the BMT Group and QinetiQ.

His work has included the audit and governance of the UK strategic deterrent, the implementation of risk-based governance regimes into energy businesses, UK Ministry of Defence and industry partnering initiatives, especially within the air domain, and the development of chemical, biological and radiological protection and responses.

He spent part of his career in the Middle East running separate national programmes to develop commercial and defence capabilities across a number of Gulf states. Dr Louth has also worked as a senior adviser to the European Defence Agency on the development of pan-European procurement policies and practices.

He teaches at Roehampton University Business School in London and is also a specialist adviser to the House of Commons Defence Select Committee. John's work is published across a broad spectrum of outlets and he is a regular commentator on the BBC, ITN, Sky News and Al Jazeera networks.

## Professor Keith Hartley

Professor Keith Hartley BSc (Econ), PhD (Hull) is a defence economist and Emeritus Professor of Economics at the University of York. His research expertise spans: defence economics including procurement, economics of alliances, industrial policy, EU defence policy, collaboration, the costs of conflict (e.g. Iraq) and military outsourcing. Professor Hartley was Founding Editor, Defence and Peace Economics (1990-2007) and is the Special Advisor to the Editor, Defence and Peace Economics (2008-present). He was Special Adviser to the House of Commons Defence Committee (1985 – 2001) and has also presented written and oral evidence to the Committee.

He was the Chair of the Finance Group, Aerospace Innovation and Growth Team, reporting to Secretary of State of the former Department of Trade and Industry, and has been a consultant to government bodies and international multilateral organisations, including the: United Nations, European Commission, European Defence Agency, UK Ministry of Defence, Department of Trade and Industry, HM Treasury, Korean Defence Agency and Korean Development Institute. He was also awarded the Visiting Fellowship Award, QinetiQ.

## Regina Dornieden

Regina Dornieden is chief of branch “Price Audit Policy” in the Federal Office of Bundeswehr Equipment, Information Technology and In-Service Support. There she is in charge of fundamental aspects of pricing law, price escalation and economic principles. In addition she coordinates cooperation on the fields of pricing and price audit with NATO procurement bodies and other international organisations. She holds a Master’s degree in economics.

## Hans-Peter Müller

Hans-Peter Müller joined federal administration in 1983. In his current post at branch “Public procurement, procurement review office, real estate sector” in the Federal Ministry for Economic Affairs and Energy he is in charge of public procurement law and public pricing law. Additionally he is the author of several publications on public procurement law and public pricing law. He holds degrees in public administration, labour law and business law.

## Ludwig Lennartz

Captain (Navy) Ludwig Lennartz joined the Federal Armed Forces in 1978. He served in several posts in the logistics and planning domain. Since 1996, interrupted by a tour of duty within NATO in the UK, he has served in the German Ministry of Defence. Currently he is chief of branch “Cost-Effectiveness in Procurement and In-Service Support of Defence Equipment” in the Equipment, Information Technology and In-Service Support Directorate within the German Ministry of Defence. He holds a Master’s degree in economics.

## Martin Ditzer

Martin Ditzer joined Bundeswehr administration in 1999. In his current post as a desk officer in Captain Lennartz' branch he is in charge of cost effectiveness in contractual matters, formation of prices and principles of public pricing law. As such, he carries out supervisory control on the field of all economic issues relating to contracts in procurement, especially those in contracts beyond €25 million as these contracts have to pass parliamentary approval. He holds a Master's degree in economics.

**Biographies for our Canadian contributors were unable to be provided prior to publication.**

