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Report by the
Comptroller and Auditor General

Ministry of Defence

Sales of the Royal Dockyards

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John Bourn
Comptroller and Auditor General

National Audit Office
13 May 1998

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For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 0171-798 7400

email:nao@gtnet.gov.uk

Web site address: http://www.open.gov.uk/nao/home.htm

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Executive summary

1 The Ministry of Defence (the Department) sold the Royal Dockyards at Devonport and Rosyth to Devonport Management Limited in March 1997 and Babcock Rosyth Defence Limited in January 1997. As the Royal Navy remain the major customer of the dockyards, the Department were primarily concerned with selling a business, where they remain the major customer, and achieving better refit prices. Another factor in the sales has been the need to provide upgraded facilities for submarines, and the Department have contracted the dockyard companies to provide these. Our main findings and our conclusions are set out in Part 1.

2 **What have the Department achieved?** As regards the Department's objective of achieving value for money from the sales, they have identified overall savings from selling, though the position on risks transferred and retained is more finely balanced. Another objective was to promote competition for surface shipwork (having decided in 1993 to concentrate all submarine refit work at Devonport). The Department have done this by not allowing one company to own both dockyards, and by allocating a programme of work to Rosyth, without competition, to smooth the transition from submarine work. To meet their objective of maintaining repair and refitting capability, the Department have set in train the work to upgrade dockyard facilities for submarines, and taken steps to ensure that they retain access to strategic assets. In more detail the key points are:

a) The Department's estimate is that the savings achieved by the sales total £158 million over 10 years (£40 million at Devonport and £118 million at Rosyth). Our analysis based on their estimate is that the total savings lie within a range from £56 million to £178 million.

b) The consideration received for each dockyard was lower than the Department's valuations. However, as they remain the main customer, the Department were negotiating an overall package, not just the up-front price.

c) To enable the new owners of Devonport dockyard to finance their capital expenditure programme, the Department agreed to the company taking the assets into their balance sheet at a value some £33 million higher than the consideration received. The effect is to increase the depreciation and profit elements of future refit prices, but they will still be lower than before.

d) At both dockyards the Department have agreed prices which commit the new owners to achieving long term cost reductions.

e) The new owners are now responsible for the future success of the dockyards. The Department will in time compete all surface ship refit work, and it will be up to the dockyard owners to ensure that they are able to compete successfully. The Department now expect to go to competition for all surface ship work by 2008-09, three years later than they planned.

f) The Department have put in place, and are directly funding, five projects to ensure that dockyard facilities for submarines meet safety requirements, at a cost they estimate to be some £530 million. The largest project is for refitting and refuelling facilities at Devonport.

3 **What key areas must the Department watch?** The key points are:

a) The assessed savings from selling the dockyards were based on an illustrative programme of work, and could be affected if the Department change the refit programme. The savings are dependent on the dockyard companies achieving target cost reductions, although some of the savings are guaranteed.

b) The additional cost, compared with competition, of allocating surface ship work to Rosyth may exceed £50 million. The aim is to promote competition, and the payback for the Department is dependent on Rosyth's commercial success.

c) Whilst the Department will, in time, be free of all obligations and incentives to provide each dockyard with a full programme of work, they have continuing obligations to meet redundancy costs at Rosyth to 2006 and indefinitely at Devonport in relation to work on nuclear submarines.

d) Whilst the Department have applied in part the lessons from their Trident Works programme in managing the major upgrade project at Devonport, they have experienced cost increases and delays on this and other upgrade projects, and there remains some uncertainty about the final scope of their requirement. They will need to exercise effective oversight of the project costs and timescales over the remaining life of the projects, and ensure that they meet operational requirements.

Part 1: Introduction, main findings and conclusions

1.1 In early 1997 the Ministry of Defence (the Department) completed the sales of the Royal Dockyards at Devonport (in March 1997) and Rosyth (in January 1997). The new owners, Devonport Management Limited and Babcock Rosyth Defence Limited respectively, had previously been contracted by the Department to manage the dockyards under Government Owned Contractor Operated arrangements. Under those arrangements ownership of the assets rested with the Department but they contracted out the management of the dockyards. Appendix 1 provides a detailed chronology of the sale.

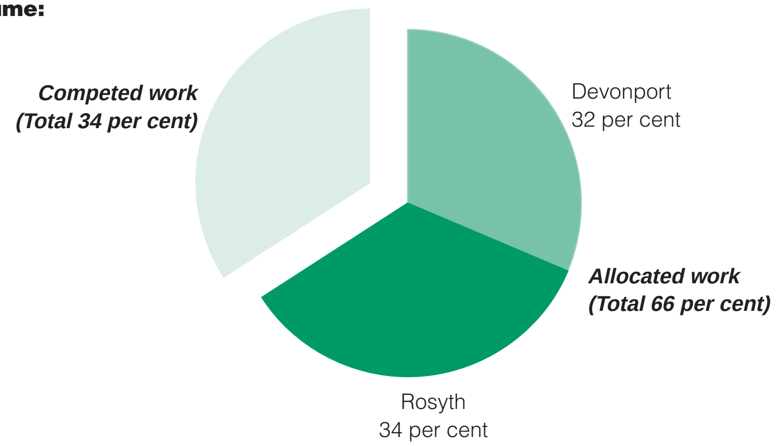
1.2 The dockyards carry out most of the Royal Navy's refit and repair work. The Royal Navy spend around £400 million a year on their refit and repair programme. The submarine programme is the largest element, accounting for some 42 per cent by value, with surface warships accounting for 36 per cent. The balance comprises the Royal Fleet Auxiliaries and other vessels. The value of refit work far exceeds the value of the dockyards' fixed assets - some £150 million in April 1996. So the Department were primarily concerned with selling a business, where they remain the major customer, and achieving better refit prices.

1.3 Under the Government Owned Contractor Operated arrangements established in 1987, the Department allocated the bulk of their refit and repair work to the dockyards without competition - 66 per cent of the workload in the three years 1994-95 to 1996-97 was under the 'allocated' programme, 76 per cent by value (Figure 1). The Department awarded the remaining work after competition between the dockyards and private yards - the 'competed' programme. While looking to increase the proportion of work competed, the Department considered that as they would pay for under-utilised dockyard resources through increased overhead charges and consequently higher refit prices, value for money would be obtained by utilising dockyard capacity to the full through the allocated programme.

The Department's allocated and competed programmes by volume and by value 1994-95 to 1996-97

Figure 1

By volume:



and by value:

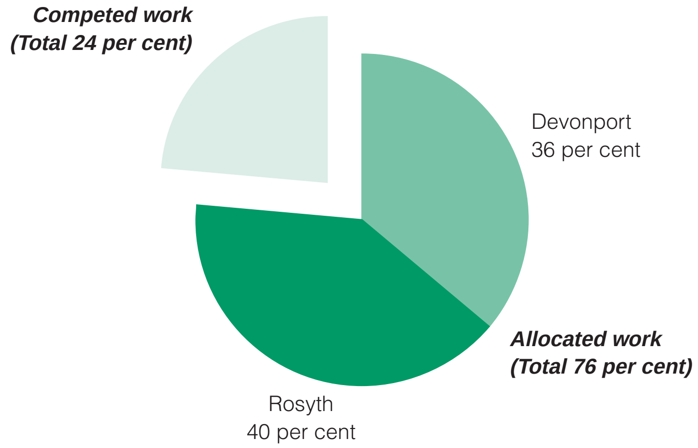


Figure 1 shows that in the three years 1994-95 to 1996-97 Devonport and Rosyth dockyards received 66 per cent by volume and 76 per cent by value of the Department's available refit and repair work through the allocated programme. The Department's allocated programme of work includes the costlier submarine work and major surface ship refits - hence allocated work accounts for a higher percentage of costs.

Source: Ministry of Defence - Statment of Ship Refitting and Repair Activity 1996-97

The background to the sale

1.4 In 1991 the Department identified potential savings of some £300 million to £700 million over 10 years by concentrating all submarine work at one dockyard and competing all surface ship work. Ministers decided that the Department should retain two dockyards, that both should be invited to provide indicative costs for taking over all the submarine work, and that in time the two dockyards should be sold.

1.5 In October 1993, the Department announced their intention to sell each dockyard by competitive tender. The then Secretary of State stated that sales would be a logical progression from the Government Owned Contractor Operated arrangements. They would allow the dockyards greater flexibility to operate in a commercial environment, would encourage private sector investment in the dockyard infrastructure, and would allow greater scope for diversification. The Department expected the Royal Navy to benefit from improvements in productivity and efficiency in future refit work.

1.6 The Department's objectives for the sales were to:

a) achieve value for money in terms of the consideration received, the costs to the Department of future work, and liabilities transferred;

b) promote competition for the refitting of surface ships; and

c) maintain the Royal Navy's refitting capability, in particular the capability to repair, refit, refuel and decommission submarines.

1.7 The sales have been complicated by the need to provide upgraded repair, refitting and refuelling facilities for nuclear powered submarines, including the new Vanguard class[1]. The Department have contracted the new owners of the dockyards to manage the upgrade projects, and are directly funding the work. They estimate that their costs will be some £530 million in the period 1995-96 to 2004-05. For the largest project - the refitting and refuelling facilities at Devonport - the Department and Devonport Management Limited considered that the sale and contract to manage the upgrade project were inextricably linked. Devonport Management Limited told us that given the importance of timely completion of facilities for their business, they would not have bought the dockyard without being contracted to manage the upgrade project. And they would not have taken on such a project unless they also owned the dockyard and could generate future income from using the upgraded facilities.

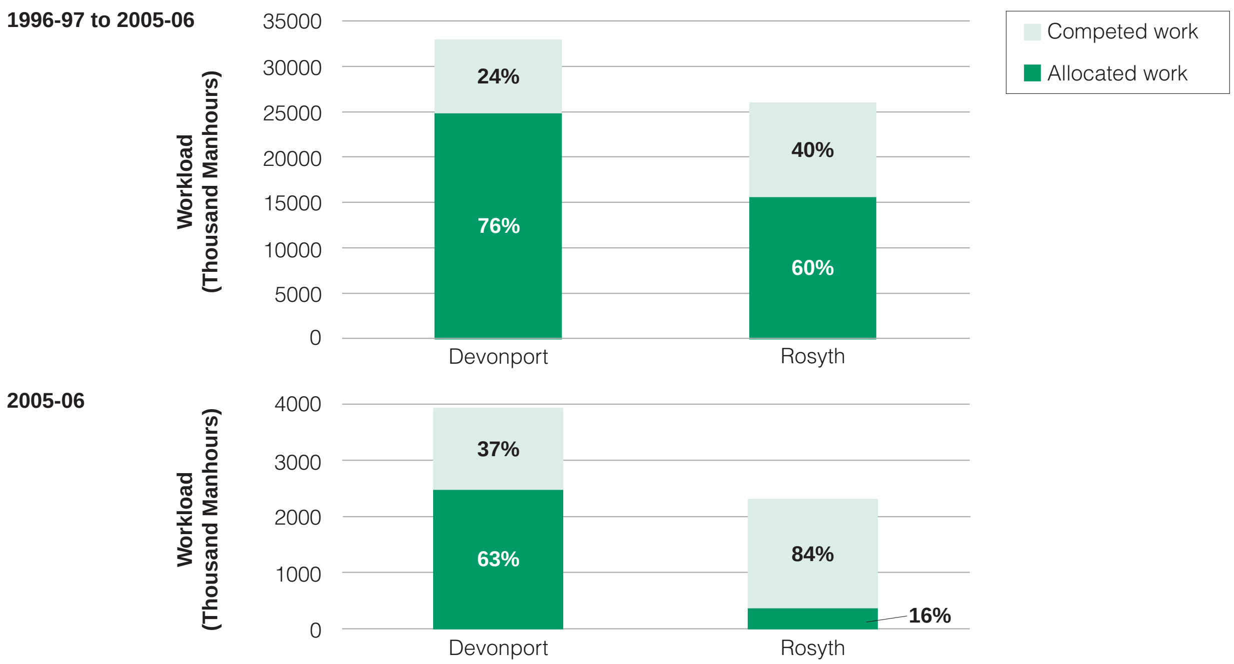
1 All the Royal Navy's submarines are now nuclear powered. The Trafalgar and Swiftsure classes of submarines are conventionally armed. The Vanguard submarines, with Trident missiles, maintain the strategic deterrent, and have replaced the Resolution class (Polaris) submarines.

1.8 A key factor in the sales has been the future business at each dockyard. In June 1993 the Department announced that by 1997 they would concentrate submarine refit work at Devonport - the work would be allocated to the dockyard without competition for as long as the Royal Navy had a requirement for submarines. Surface warship work would continue at both Devonport and Rosyth, with Rosyth initially being allocated a substantial programme of work without competition to help them adjust to the loss of submarine work. Both dockyards would have the opportunity to bid, along with other firms, for the competed programme of work. From 2005-06 all surface warship work would be awarded on the basis of competition.

1.9 Taking account of subsequent adjustments in the work allocated to the dockyards, Figure 2 analyses the new owners' forecasts of activity over the ten year period to 2005-06. Devonport Management Limited forecast that by the end of the period the refit work allocated by the Department will provide 63 per cent of their workload. In contrast Rosyth's allocated programme tapers off towards the

Figure 2

The Dockyard owners' forecast workloads for the ten year period to 2005-06



Source: Dockyard Owners' Business Plans

Figure 2 shows the composition of the forecast workloads at the two dockyards for the ten years to 2005-06. At Devonport 76 per cent of the workload is allocated to the dockyard by the Department whereas at Rosyth the figure is 60 per cent. In 2005-06, the tenth year, the Department's allocated submarine work is forecast to provide 63 per cent of Devonport's workload. In contrast, at Rosyth allocated surface ship work is forecast to provide 16 per cent of the workload - with work won in competition, including non Ministry of Defence work, forecast to provide 84 per cent of the work load. This reflects the declining programme of allocated work at Rosyth where the intention is that by 2008-09 the dockyard's workload will be entirely dependent on competition.

end of the period, with Babcock Rosyth Defence Limited forecasting that refit work allocated by the Department will account for 16 per cent of their workload, the remaining 84 per cent needing to be won in competition from the Department and elsewhere.

What we did and how we did it

1.10 We looked at whether the Department have achieved their objectives for the sales. The report is structured as follows:

- **Part 2** examines the management of the sale and the steps taken by the Department to achieve value for money, including the implications for long term competition;

- **Part 3** examines the Department's arrangements for maintaining the infrastructure of the dockyards to provide the required repair and refit capability for the Royal Navy.

1.11 The main methods we used are set out in Box 1. Much of the analysis is based on criteria drawn from previous work by the Committee of Public Accounts. Appendix 2 sets out those recommendations by the Committee which are relevant for this Report, together with the Government's replies.

The main methods used in examining the sales of the dockyards

Box 1

- collection and evaluation of information from the Department relating to past performance of the dockyards, the sales, the refit programmes for the dockyards, and the capital programmes for upgrading the facilities;
- discussions with the Department's principal consultants, and review of the consultants' analysis of the forecast savings arising from the sales;
- visits to the dockyards and discussions with the dockyard owners on the sales and their future plans;
- discussions with some of the parties who expressed an interest in purchasing the dockyards;
- evaluation of the approach adopted for the sales, by reference to past reports by the Committee of Public Accounts and Treasury guidance.

1.12 We are grateful to Devonport Management Limited and Babcock Rosyth Defence Limited who co-operated fully in providing information on the sale. We are also grateful to the Department and Coopers & Lybrand - the Department's principal consultants on the sales.

Main findings and conclusions

1.13 Our main findings and conclusions are:

(a) On the Department's objective of achieving value for money from the sales

1.14 The Department sought competitive bids for the dockyards, but received only one bid for each - from the companies who previously managed the dockyards on behalf of the Department. In the absence of competition, the Department compared the likely costs and benefits of the sales with their assessment of what might have been the position had they not sold the dockyards. On this basis they estimated that the sales will generate gross savings of £158 million over 10 years - £40 million (3 per cent) at Devonport and £118 million (10 per cent) at Rosyth. The savings are dependent on the dockyard companies achieving target cost reductions, although some of the savings are guaranteed - under the sales the Department have agreed prices for allocated refit work which commit the new owners to achieving long term cost reductions. This, and other factors, suggest that the total savings, based on our analysis of the Department's estimates and after deduction of sales costs, range from £56 million to £178 million, there still being an overall saving at each dockyard (paragraphs 2.8 and 2.41 to 2.51)

1.15 Looking beyond the direct savings, the sales mean that the dockyard companies rather than the Department are responsible for all management decisions and the future success of the dockyards. In the past the Department had a direct interest in providing sufficient work to ensure that dockyard assets were being utilised. Following the sales, the Department will in time compete all surface ship refit work, and it will be up to the new owners of the dockyards to ensure that they are able to compete successfully (paragraph 2.70).

1.16 The sales have to be seen in the context of other factors:

a) the Department's assessed savings are based on the likely costs of an illustrative programme of work. In the event of changes to the refit programme, the Department may be required to compensate the dockyard companies for shortfalls in work, and the dockyard companies will be able to re-negotiate their refit prices for allocated work (paragraph 2.28);

b) the Department's valuations of the businesses were £91 million for Devonport and £30 million for Rosyth. These valuations were dependent on assumptions made about the owners' opening balance sheet figures and future cash flows. The consideration received was £40 million for Devonport and £19 million for Rosyth (including the value of a deferred payment of £6 million). The consideration reflected the dockyard companies' assessment that they were taking on significantly higher risks than those assumed by the Department's advisers (paragraphs 2.18 to 2.21);

c) the Department agreed to Devonport Management Limited taking assets into their balance sheet at a value some £33 million greater than the consideration received. With a higher balance sheet figure the company increase depreciation, which they recover in refit prices, and they increase their profit under the Government Profit Formula. The effect is to increase the depreciation and profit elements in future refit prices paid by the Department, whilst still resulting in lower overall prices than before. These factors enable the company to generate cash to finance their capital expenditure programme. However, the company's capital investment plans exceeded the Department's estimates of what was required (paragraph 2.32);

d) the higher balance sheet figure at Devonport also took account of a number of liabilities resting with the dockyard company. However, some of these liabilities reflect the commercial risks which, by implication, the dockyard company had taken into account in the consideration offered (paragraph 2.34);

e) at Devonport, the liabilities transferred to the dockyard company include those for redundancies among employees engaged on work won in competition. The Department also agreed to a £3 million reduction in the consideration for the company's assessed risk of redundancies among these employees in the event of the Department reducing their overall refit programme. The Department remain largely liable for redundancies among employees engaged on the allocated programme (paragraph 2.17);

f) for Rosyth, the Department have agreed to allocate a programme of refit work without competition, at an additional cost (compared with competition) which may exceed £50 million. By doing this the Department expect to end all responsibility for the dockyard in the long term and place work with them only on the basis of competition. The payback for the Department, however, is dependent on Rosyth becoming a dockyard dealing only with surface ships so that there is effective competition for surface ship refit work (paragraph 2.4);

g) the Department supported Babcock Rosyth Defence Limited in buying out part of the workforce's redundancy entitlement so that the company would accept liability for all redundancies from 2006. The Department estimated that their net costs of supporting these changes are £27 million (compared with the previous arrangements under which the Department estimated their redundancy liability in 2006 at £69 million). Assuming the dockyard's long term commercial success, the Department's liability would fall to zero as the dockyard company are liable for all new employees. However, for the company, changing the redundancy terms was a prerequisite for proceeding with the sale (paragraphs 2.54 to 2.57);

h) the Department also estimated what the possible impact of changing the redundancy arrangements at Rosyth might be on their costs in the event of wholesale redundancies. If these occur before 2001, the Department's costs may be up to £12 million greater than under the previous redundancy arrangements. Between 2001 and 2010, the Department estimate that their costs under the revised arrangements may be up to £20 million less than under the previous arrangements (paragraph 2.58).

1.17 While the Department's savings estimates are based on forecasts, the position on cash flows is more certain. At sale completion the Department received total consideration of £54.8 million for the two dockyards. At the same time, they paid £48.1 million to enable Babcock Rosyth Defence Limited to buy out part of the workforce's redundancy entitlement, and the Department's sale costs for the two dockyards were £15.7 million. Taking these things together there was a net cash outflow from the Department of £9.0 million. The Department are due to receive a further £6 million for Rosyth in 2001 (£4.9 million present value). However, they also expect to incur additional redundancy costs of £29 million at Rosyth before they transfer all responsibility for redundancies. So the Department forecast a further £24 million net outflow, some five years after the sales (paragraph 2.72).

1.18 The then Ministers approved the sales on the basis of the Department's advice that the sales provided value for money. The Department pointed to the overall savings at both dockyards, and included details of the business valuations undertaken. They highlighted the liabilities transferred to the owners, and those retained - particularly liabilities for nuclear contamination. They also emphasised that sales achieved the transfer of all responsibilities for the management of the dockyards, including future capital expenditure, following completion of the major upgrade projects (paragraph 2.67).

Conclusion 1

Despite the Department's efforts, they did not have the assurance that would have come from receiving competing bids. So comparing the sale with their assessment of what might have been the situation if they had continued the previous management arrangements, and not sold, was sensible.

Conclusion 2

The Department's assessment points to direct savings being achieved by the sale of each dockyard. The extent to which these are achieved will depend on how far the assumptions used by the Department in their assessment, including the delivery of the illustrative programme of refit work, are borne out in reality, and whether the dockyard companies achieve their cost reduction targets, although some savings are guaranteed.

Conclusion 3

The Department sold the dockyards for considerations which were lower than their own valuations. They were negotiating an overall package, not just the up-front purchase price. However, in the case of Devonport, the assessed £40 million saving flows largely from the £40 million consideration. And in agreeing a fixed asset value greater than the consideration received, resulting in higher profits and increased cash flow, the Department are in effect underwriting some of the company's risks.

Conclusion 4

Looking beyond the direct savings to the risks transferred and retained, these are finely balanced. On the one hand the Department will, in time, be free of all obligations and incentives to provide each dockyard with a full programme of work. On the other hand, they have continuing obligations to meet redundancy costs at Rosyth to 2006 and indefinitely at Devonport in relation to work on nuclear submarines. And the payback from continuing to place surface ship refit work at Rosyth depends on the dockyard's long term commercial success.

(b) On the Department's objective of promoting competition for surface ship work

1.19 To provide competition for surface ship refitting, the Department ruled out one company owning both dockyards. They agreed to allocate a programme of work to Rosyth to smooth the transition from having submarine work, which was due to end in 1997, and to provide an opportunity to establish a competitive environment for surface ship refit work - and hence lower prices for the Royal Navy - in the longer term. Their aim was to achieve full competition for all surface ship work by 2005-06 (paragraphs 2.3 and 2.4).

1.20 The work to upgrade submarine facilities at Devonport has taken longer than initially forecast, partly as a result of the need to meet civil nuclear safety requirements, and the complex contract negotiations on the major facilities at Devonport. Also, submarine refits now require more time than in the past to allow for repairs to propulsion systems. These factors have impacted on the Department's submarine refitting programme, and the Department accordingly extended submarine refitting at Rosyth to 2002. To ensure that this does not impact on Rosyth's transition to handling only surface ship refit work, the Department have extended the allocated programme of ship work too. They have also allocated surface ship refitting work to Devonport to utilise the dockyard's capacity whilst submarine facilities are being upgraded. The Department have therefore taken four major refits out of the competed programme, and surface ship refitting will not be fully competed until 2008-09, three years later than planned (paragraph 2.5).

Conclusion 5

The Department have taken steps to promote competition for surface ship refit work, although they do not expect to gain the full benefit until 2008-09, three years later than planned.

(c) On the Department's objective of maintaining repair and refitting capability

1.21 Before the dockyards were transferred to private ownership, the Department took steps to ensure that they would retain access to the strategic assets for the Royal Navy's nuclear powered submarines, including their eventual decommissioning (paragraphs 3.5 to 3.8).

1.22 In deciding to place future submarine work at Devonport instead of Rosyth, the Department identified a £64 million cost advantage, in addition to the savings they expected from concentrating submarine work at one dockyard (paragraph 1.4). Achievement of these savings has been postponed following the five year extension of submarine work at Rosyth in response to the time taken to upgrade docks at Devonport and the additional time required for refitting submarines (paragraph 1.20). To accommodate the work at Rosyth, the Department are spending £45 million in upgrading existing facilities at Rosyth, and they are incurring additional costs at Rosyth by having to maintain the capacity to carry out nuclear work, and disruption costs at Devonport, totalling £70 million. There is of course no knowing how the costs might have turned out had the Department chosen to concentrate their submarine work at Rosyth rather than Devonport (paragraphs 3.11 to 3.13).

1.23 The Department are directly funding five projects to ensure dockyard facilities meet safety requirements and to support the Department's extended submarine refitting programme at Rosyth. They have contracted the dockyard companies to manage four of these projects - the fifth, the contingency docking facility at Rosyth has been managed by the Department and started before the other projects. The Department estimate that the cost of the programme is some £530 million, and on three of the five projects there have been total cost increases of £193 million (57 per cent) and delays of 76, 29 and 17 months. The projects are taking place in a regulatory environment where the dockyard companies, as the nuclear site licensees, are having to demonstrate more rigorously how they can meet civil nuclear safety requirements, and the Department consider that this is a feature in all their licensable nuclear engineering projects and within civil industry (paragraphs 3.12 and 3.16 to 3.21).

1.24 The largest of the projects is the refitting and refuelling facilities for submarines at Devonport. Before letting the contract the Department estimated that the total *project* costs, excluding their own contingencies, were likely to be £417 million - their estimate of £315 million for the contract cost, plus the dockyard company's fees, Value Added Tax and other costs. This was an increase of £156 million (60 per cent) on their earlier estimate, partly as a result of increasing nuclear engineering costs and changes in specification, and partly because some costs were excluded from earlier estimates. The Department consider that the detailed contractual negotiations have now resulted in a full appreciation of the likely costs and are confident that the project will be delivered within budget. Construction is due to be completed in January 2002, 29 months later than originally planned. The contract will continue until April 2004 as it will only be after using the facilities that the Department will be able to assess whether the facilities are 'fit for purpose' (paragraphs 3.22 to 3.31).

1.25 The Department have transferred to Devonport Management Limited a number of risks covering the project's design and construction. They have negotiated a maximum *contract* price of £410 million, and the company's fee is dependent on how far their costs are below this ceiling. However, uniquely for this type of pricing arrangement, for some £24 million of costs spanning the Department's and the company's most likely estimates, the fee is fixed. Also the Department have agreed to limit Devonport Management Limited's liability to some 13 per cent of the company's estimate of the most likely costs. So if the company were to breach the contract, there is a risk that the Department may have to bear the cost of completing the facilities (paragraphs 3.22 to 3.31).

1.26 On this project the Department have applied in part the lessons learned from their Trident Works Programme, including contracting the dockyard owner as prime contractor. However, there were cost increases and delays before the contract was signed. In managing this and the other upgrade projects, the Department have had to respond to the need to meet safety standards and pressing operational requirements, leading to cost increases and delays. Thus, between the 1993 decision to concentrate all submarine work at Devonport and contracting Devonport Management Limited as prime contractor for the major facilities, the Department did not have a full appreciation of the overall scale and costs of the work needed to provide future facilities and maintain short term capability for their submarines. In addition, the Department are contractually committed to providing one permanent repair facility at Devonport, and they are considering whether they need a second facility. Hence there remains uncertainty about the overall scale of their requirement (paragraphs 3.32 to 3.37).

Conclusion 6

The Department are continuing to invest in the strategic facilities they require. However, there have been substantial cost increases and delays on the work to upgrade refit facilities, and the dockyard companies are having to demonstrate more rigorously how they can meet civil nuclear safety standards. These delays, together with the increased time required for refits, have impacted on the refit programme.

Conclusion 7

The Department identified a £64 million cost advantage from concentrating submarine work at Devonport rather than Rosyth. By having to extend Rosyth's involvement in refitting submarines, the Department are incurring additional costs of £115 million and this has delayed the achievement of savings from moving to one submarine dockyard. There is of course no knowing how the costs might have turned out had the Department chosen to concentrate their submarine work at Rosyth rather than Devonport.

Conclusion 8

The Department have had to respond to changing circumstances and have experienced cost increases and delays on their various upgrade projects. This suggests that they have not applied all of the lessons from their earlier experience on the Trident Works Programme. They will need to exercise effective oversight of the project costs and timescales over the remaining life of these projects, and ensure that they meet operational requirements.

Part 2: Management of the sales

2.1 This Part looks at the Department's management of the sale process, and how successful they were in achieving their objectives of gaining value for money and promoting long term competition for surface ship refitting.

The aspects of the sales examined in this Part

- the promotion of long term competition for refit work
- the sales process
- how the Department decided to proceed with the sales

Promoting long term competition for refit work

2.2 In June 1993 the Department decided to concentrate all submarine work at Devonport. Although the Department spend more on submarine refitting than on surface ship refitting (paragraph 1.2), they consider that operational requirements and economies of scale outweighed the possible benefits of competition in placing submarine work and that only one dockyard is needed because:

a) as the Department have reduced the size of their submarine force following 'Options for Change', and consequently their requirement for submarine refitting, one dockyard will have the capacity to handle all the Royal Navy's submarine refit work;

b) all of the Royal Navy's submarines are nuclear powered. The refitting process incorporates refuelling and is particularly complex, requiring special facilities and new investment to meet civil nuclear safety requirements; and

c) given the forecast volume of work - one submarine refit a year, and each lasting more than two years - it would not be possible for both dockyards to maintain the capacity to compete for work. As there is minimal alternative use for the specialist refitting and refuelling facilities, the dockyard losing the first competition would have to maintain idle capacity until the next competition, which would drive up their refit prices and make them non competitive.

2.3 In October 1993 the Department announced that they intended to sell the two dockyards. To maintain competition for surface ship refitting Ministers decided at the outset that no one company would be allowed to own both dockyards. Their intention was to achieve competition for all surface ship refit work from 2005-06.

2.4 The Department recognised that they might achieve better refit prices by going to full competition straightaway, and considered that Devonport had a cost advantage over Rosyth, although they did not quantify this. However, the Department considered that they needed to assist Rosyth through the transition to provide an opportunity to establish a competitive environment in the longer term, by allocating them a programme of work to 2005-06 on a tapering basis rather than requiring them to win work in competition from the outset. The expected payback for the Department is lower refit prices for the Royal Navy. In the meantime, the Department recognise that they may incur additional costs at Rosyth in excess of £50 million compared with the costs based on competing the work. This figure is based on the forecast costs of the allocated surface ship refit work, and an estimate of the degree to which the owners plan to reduce costs in line with targets agreed with the Department, which are designed to achieve broadly competitive levels.

2.5 During 1994 and 1995 the Department experienced difficulties at Devonport in carrying out the planned refit programme for two reasons. The Department recognised the need for improvements in docking facilities to meet civil nuclear safety requirements, and this was confirmed by the Health and Safety Executive's Nuclear Installations Inspectorate. The Department therefore extended the programme to upgrade the docks. Also, previous submarine refits had identified a need to increase the time allowed for repairs to propulsion systems. As a result, in August 1995, before the sales, the Department made a number of changes to the allocated programme of work at the dockyards (Figure 3):

a) they transferred some submarine work to Rosyth, extending Rosyth's involvement in nuclear refitting to January 2002 - it was previously due to end in 1997. They are upgrading dock facilities at Rosyth to accommodate this refit work;

b) they transferred some of Rosyth's allocated surface ship work to Devonport. The Department recognised that while they might achieve better prices by competing the surface ship work at Devonport, allocating the work would enable dockyard capacity to be utilised as fully as possible. This would avoid the dockyard workforce being under-utilised during the period when the dock facilities for submarines were being brought up to standard;

c) they took four ships out of the competed programme and allocated them, without competition, to the dockyards;

d) they extended Rosyth's allocated programme for minor ships from 2005-06 to 2007-08.

The Department have not, therefore, achieved the progress they intended in moving to full competition for surface ship work. They now expect to compete all surface ship refitting in 2008-09, three years later than planned. This will delay the payback to the Department from allocating work to Rosyth without competition.

Figure 3

The Department's allocated programme at Devonport and Rosyth

	Devonport	*Rosyth*
Original Allocation June 1993	12 Submarine Refits + 1 Decommissioning	18 Major Warship 49 Minor Warships Submarine Refit to end in 1997
Changes to the allocated workloads	2 Submarine refits + 1 Decommissioning transferred from Devonport to Rosyth 6 Major Warships transferred from Rosyth to Devonport. In addition, 4 major Warships originally expected to be competed are allocated to the dockyards - 1 to Devonport and 3 to Rosyth.	
Final Allocation August 1995	10 Submarine Refits 7 Major Warships	2 Submarine Refits + 1 Decommissioning 15 Major Warships 49 Minor Warships Submarine work extended to January 2002

Source: Ministry of Defence

Figure 3 shows the Department's initial programme of allocated work at the two dockyards and the changes following the decision to extend Rosyth's involvement in submarine work. The Department have also reduced the size of the competitive programme, taking four major warships out of the competitive programme and allocating them to the dockyards.

2.6 Under the previous management arrangements for the dockyards, the Department had set a target of competing at least 30 per cent of refit work by volume. In 1993 they told the Committee of Public Accounts that they had made progress towards achieving this target. Figure 1 in Part 1 shows that the Department competed 34 per cent of their refit work, by volume, between 1994-95 and 1996-97, and the Department forecast that they will exceed the 30 per cent target in 1997-98 and 1998-99. Following the changes to the allocated programme between the dockyards, and the transfer of work from the competed programme, the Department do not expect to meet their target between 1999-00 and 2002-03, but from then they expect to achieve and maintain their 30 per cent target.

Key Points

2.7 **Key points on promoting long term competition for refit work:**

a) The Department decided that all submarine work should be carried out at Devonport from 1997, but in the light of difficulties with the facilities at Devonport, and the extra time now required to refit submarines, they decided before the sale to extend Rosyth's involvement in submarine refits to 2001.

b) To promote competition for surface ship refits, the Department ruled out one company owning both dockyards.

c) The Department agreed a programme of allocated work for Rosyth to smooth the transition to non-submarine work and to provide an opportunity to establish a competitive environment for surface ship refit work, and lower prices for the Royal Navy, in the longer term. The Department recognised that during this transitional period they would be paying higher prices for refits than if they competed the work. The cost may exceed £50 million over six years.

d) The Department forecast that they will not meet their original timetable for competing surface ship refitting. They now expect to achieve and maintain pre-sale levels of competition in 2003-04, and to compete all such work by 2008-09 - three years later than planned.

The sale process

2.8 The Department used external advisers from the start of the sale process. With the help of their principal advisers, Coopers & Lybrand, the Department tried to stimulate interest in the sale through advertising and direct contacts with potential bidders. They provided an information pack for potential bidders, and a Data Room to which potential bidders were given access. Despite interest from a number of potential buyers (12 for Devonport and 11 for Rosyth), only the incumbent contractors tendered - each for the dockyard they were already operating. The Department attribute the absence of competition to four main factors, and these factors were also acknowledged in our discussions with parties who had expressed an interest in purchasing the dockyards:

a) the perceived advantage held by the two companies already managing the dockyards;

b) potential bidders' unfamiliarity with warship and submarine refitting, and the scale of potential redundancies and environmental liabilities;

c) potential bidders' concerns over the stability of the refit programme, and the Department's long term aim to end the allocated programme of work at Rosyth; and

d) a number of potential bidders were deflected from pursuing bids for the dockyards because of other priorities - undertaking rationalisations and mergers in response to change in the defence industry following the end of the Cold War.

2.9 When the Department originally announced their intention to sell the dockyards, they planned to complete the sales by late 1995. In the event the Rosyth sale was completed in January 1997, and the Devonport sale in March 1997. The main reasons were:

a) in the absence of competition for the sales, the Department had to establish whether the single tenders provided value for money;

b) the negotiations were highly complex as the Department were selling not just the assets but a business, and they were to remain the major customer;

c) the negotiations raised sensitive personnel and environmental issues;

d) the difficulties encountered in upgrading docks at Devonport to meet nuclear safety requirements caused the Department to change their refit programmes (paragraph 2.5), and this affected the sale negotiations; and

e) at Devonport the sale negotiations were complicated by parallel negotiations on the contract for the major project to upgrade submarine refitting and refuelling facilities.

2.10 Although the sale took longer than expected the Department continued to benefit from efficiency improvements at the dockyards. The Department's figures show that hourly rates at both dockyards had fallen between 1992-93 and 1995-96.

2.11 We also sought the views of the new owners about the time taken to finalise the sales. They considered that although the sales had required significant management time, the length of the sale process had not, in itself, adversely affected their ability to attract work from sources outside the Department. The extension of the submarine work at Rosyth has delayed the dockyard's transition to working mostly on surface ship work. However, Babcock Rosyth Defence Limited fully expect to achieve their targets of winning major warship refits from the turn of the century, and providing fully competitive rates for all surface ship refits by 2005-06, when the allocated programme was originally scheduled to end. The Department will continue to allocate some work to Rosyth after the dockyard has achieved targeted cost reductions as the Department agreed an overall programme for Rosyth when announcing that submarine work would be concentrated at Devonport.

The costs of the sales

2.12 The costs of the sale process to the Department were £15.7 million, £4.4 million more than they originally estimated (Figure 4). The costs include £13.7 million for the Department's external advisers, and recorded in-house staff costs of £2 million.

2.13 The Department's costs for consultants were, in total, £3.4 million (33 per cent) higher than estimated. The Department told us that as well as the sales taking longer than expected, they required additional financial advice from Coopers & Lybrand to examine a number of revisions to the dockyard companies' business plans in the light of changes to the refit programme, and the impact on forecast savings arising from the sales. They also required financial advice from Coopers & Lybrand and legal advice from Brodies on the proposals for buying out redundancy entitlement at Rosyth, and legal advice from Brodies and Simmons and Simmons for the proposals at both dockyards for the management of the pension fund surpluses.

Figure 4

Analysis of the Department's sale costs

	Estimate £m	*Actual £m*	*Variance £m*
Consultancy costs			
Coopers & Lybrand (principal financial advisers)	3.3	8.6	5.3
Kleinwort Benson (merchant bank advice)	2.5(1)	0.1	(2.4)
Brodies (legal advice - Rosyth)	2.5(2)	2.0	2.2
Simmons & Simmons (legal advice - Devonport)		2.7	
Fuller Peiser (asset valuations)	2.0	0.1	(1.9)
Miscellaneous	0.0	0.2	0.2
Total external costs	**10.3**	**13.7**	**3.4**
Departmental staff costs	1.0	2.0	1.0
Total costs	**11.3**	**15.7**	**4.4**

Notes: 1. In estimating their costs, the Department considered that they would require significant merchant bank advice. In the event, Coopers & Lybrand, undertook this work.

2. The Department's estimate for legal advice covered both sales.

Source: Ministry of Defence

Figure 4 shows the Department's total sale costs were £15.7 million, some 40 per cent greater than the original estimates.

2.14 All of the Department's advisers were appointed following competition. The Department agreed daily rates for all personnel used by their advisers, agreed the cost required for each task, and paid following completion of each task. The Department tried, but were unable, to negotiate the relevant consultants' fees on the basis of success in attracting bids for the dockyards or as a percentage of the consideration.

Key point

2.15 **Key point on the sales process:**

The Department tried to generate competing bids for the dockyards, though in the event they sold them without competition. With other factors, this extended the sales process, and the sale costs of £15.7 million were 40 per cent greater than the original estimate.

How the Department decided to proceed with the sales

2.16 In the absence of competition to buy the dockyards, the Department considered a number of factors in determining whether the offers from the incumbent dockyard operators represented value for money, and whether they should proceed with the sales. These factors included:

- the consideration;
- prices for the allocated programme of refit work;
- the expected savings compared with continued Government Owned Contractor Operated arrangements; and
- the basis on which the Department could transfer their liabilities to the dockyard companies.

It is important to note that the Department were negotiating an overall package with the dockyard companies, not simply looking to maximise sale proceeds.

The consideration

2.17 Figure 5 shows the consideration received by the Department for the two dockyards:

a) For **Devonport** the consideration was £40.3 million after deduction of £3 million. Devonport Management Limited accepted liability for redundancies on commercial work and work won in competition from the Department, and as they considered that they were at risk from changes in the Department's overall refitting programme, they reduced their consideration for this risk.

b) For **Rosyth** the gross consideration was £27.0 million. This was abated by £6.5 million in return for Babcock Rosyth Defence Limited accepting all redundancy liabilities outstanding in 2006. A further £6 million will not be paid to the Department until the company have received 70 per cent of the allocated work programme, which is scheduled to be achieved in 2001-02. Babcock International Group, the parent company, have provided the Department with guarantees for the future payment. On completion then, the Department received a cash payment of £14.5 million. In addition the deferred payment of £6 million scheduled for 2001-02 has a present value[3] of £4.9 million, giving the consideration at completion a value of some £19.4 million.

Consideration received at Devonport and Rosyth

Figure 5

	£m
Devonport	
Consideration received after £3 million reduction for additional risk of redundancies linked to changes in the Department's overall refit programme	**40.25**
Rosyth	
Gross consideration	27.01
less redundancy abatement	6.50
less deferred payment	6.00
Net consideration	**14.51**
Cash received at sale completion	14.51
Present Value of deferred payment	4.90
Value of consideration at completion	**19.41**

Figure 5 shows the Department received consideration at completion of £40 million for Devonport and £14.5 million for Rosyth. The Rosyth sale included a deferred payment equivalent to £4.9 million at completion. Hence, the value of the consideration for Rosyth is some £19.4 million.

Source: Ministry of Defence

Note: This table does not include the Department's £48.1 million payment to buy out part of the Rosyth workforce's redundancy entitlement.

2.18 The Department commissioned two sets of independent valuations to help them evaluate the offers for the dockyards. They commissioned Fuller Peiser to carry out two valuations of the fixed assets - in 1994 and in March 1996 (the later valuation being £97 million for Devonport, £50 million for Rosyth). However, the Department considered that what would determine the sale price was not so much the valuation of the assets, as the potential for revenue generation for the new owners through the Department's refit programme. So to help them test the reasonableness of the bids actually received, in 1994 Coopers & Lybrand provided valuations of the businesses (£90.8 million for Devonport, £30.3 million for Rosyth). For both dockyards, the actual consideration (£40 million for Devonport, and the £19.4 million value at completion for Rosyth) was less than either valuation - 44 per cent of the valuation for Devonport and 64 per cent for Rosyth.

3 This provides an estimate of the present day value of receiving a payment in the future. It is calculated by discounting the future payment by an annual percentage rate - in this case 6 per cent.

2.19 When undertaking the valuations of the business, the Department assumed that there would be competition for the two sales. In the event, however, each dockyard was sold by single tender. The valuations were also dependent on a number of factors such as the companies' opening balance sheet figures and their forecast capital programmes. With a higher opening balance sheet the dockyard companies would recover more depreciation, so generating additional cash flow. A higher balance sheet figure might also increase profit rates under the Government profit formula for non-competitive contracts. Hence the dockyard companies might increase their consideration in the expectation of higher cash flows and profits. However, as recovery of depreciation and higher profits would increase the overall prices paid by the Department for their refit work, in determining whether the sales provided value for money, the Department were having to balance the cost of the refitting programme against the consideration received from the dockyard companies.

2.20 Given the difference between the Department's valuations and the consideration offered, the Department tested the reasonableness of the consideration by examining the bidders' assumptions underpinning their offers. For both the Devonport and Rosyth sales the Department concluded that the bidders had adopted conservative assumptions when valuing the business. Whereas the Department's own business valuation used an 11 per cent discount rate, the Department estimated that the bidders had in effect discounted forecast cash flow and profits using the discount rates of 15 per cent to 20 per cent, suggesting that they saw a higher level of risk in operating the dockyards. The Department concluded that the consideration was adequate given the single tenders and the overall sales packages - they would transfer responsibility for managing the dockyards and benefit from lower refit prices compared with continuing the existing arrangements.

Key points

2.21 Key points on the consideration:

a) The Department considered that the sale price would be determined by the potential for revenue generation rather than the valuation of the assets. Their business valuations were dependent on a number of factors such as the companies' opening balance sheet figures, and assumed competitive sales. Faced with single tenders, the Department tested the reasonableness of the consideration by examining the bidders' assumptions about future cash flows and profits and their required rates of return.

Clawback arrangements

2.22 The Department sought clawback from the outset of the sales, and highlighted their aim in the Invitation to Tender documents. Under the sale terms, the Department will share in profits on future sales of the assets or the businesses by incorporating clawback clauses in both sale contracts. The arrangements, which extend to the dockyard owners' parent companies, are:

a) In the event of the owners selling any assets for non-industrial use, the Department will be entitled to a share of any enhanced value. At Devonport, clawback starts at 80 per cent and reduces to zero over 10 years. At Rosyth, clawback starts at 65 per cent and reduces to zero over 12 years. The owners would arrange for an independent valuation of the assets and the enhanced value would be determined by the higher of the selling price or valuation.

b) There is no clawback entitlement if the owners sell the assets for continued industrial use. As the major customer, the Department did not want to do anything which would discourage the current owners from continuing to invest in the dockyard facilities. This means that although the Department sold the assets for less than their valuations, they would receive no clawback if the dockyard owners were to sell the assets for continuing industrial use at a price higher than the consideration;

c) The Department would be entitled to a share of any profit made by the dockyard owners if they were to sell their shares in the dockyards within three years of the sale - 75 per cent in the first year after the sale, reducing to 50 per cent in the second year and 35 per cent in the third;

d) If the dockyard owners were to sell assets or shares, the remaining clawback provisions would be transferred to the new owner, enabling the Department to share in future gains.

2.23 The Department did not seek formal bids with and without clawback provisions to assess whether clawback was affecting the bids. As clawback had not been a major factor in the negotiations, they considered that dispensing with clawback would not have produced higher bids.

Key points

2.24 Key points on clawback:

a) The Department negotiated clawback clauses in each sale agreement, so that they would benefit if the new owners were to sell the dockyards or particular assets for non-industrial uses at a profit.

b) The Department did not quantify the effect of the clawback provision on the bids, although they concluded that it was unlikely to be significant.

Prices for the allocated programme of refit work

2.25 In selling the dockyards, the Department were looking to secure lower prices and better contractual arrangements for their allocated programme of refit work. Under the pricing arrangements for the sales, the dockyard companies have agreed a series of charge out rates for labour and some overheads. Additional arrangements were made for other overheads, such as depreciation, where actual costs may be uncertain. For these items, the dockyard companies include estimates of costs in pricing refit work - actual costs are substituted later. The Department apply the Government profit formula which aims to provide a fair return to the contractor.

2.26 For refit work at **Devonport**, the sale contract provides for firm hourly rates for the two years commencing 1 April 1996 (firm rates mean the company bear all the risk of inflation) and fixed prices for the following three years (fixed prices are increased in line with inflation). These arrangements give the Department cumulative minimum savings of 9 per cent over the first five years, and there are incentives for Devonport Management Limited to make additional savings, greater than the guaranteed level through a savings sharing arrangement. The contract provides for Devonport Management Limited to negotiate a further incentivised arrangement at the end of five years.

2.27 For refit work at **Rosyth**, the sale contract sets out agreed hourly rates for the first four years to 1999-2000 (firm for the first year and fixed for the following three years). For the six years from 2000-01 there are target hourly rates which reflect planned productivity improvements in the labour hours for each class of ship, and overhead reductions. Over the ten years to 2005-06, achievement of the target rates would be equivalent to overall reductions in hourly rates of some 40 per cent. If Babcock Rosyth Defence Limited were unable to achieve the targets rates, the Department could withdraw work from the allocated programme.

2.28 Before the sales, the refit pricing arrangements were negotiated annually. Indeed, when the Committee of Public Accounts last examined the dockyards there were instances where prices were not agreed until the end of the financial year to which they related. Under the sales of **Devonport and Rosyth**, the Department have achieved longer term pricing agreements. However, the companies are able to renegotiate terms with the Department for allocated work, as they were required to quote rates based on an illustrative work programme, with no guarantees that the work would materialise.

2.29 The Department consider that similar arrangements for long term pricing and the shared savings incentives at Devonport may have been available had they continued with Government Owned Contractor Operated arrangements instead of selling the dockyards. However, such arrangements had not been proposed by either the Department or the contractors during the previous nine years of contracted out management. And Devonport Management Limited told us that they would not have been prepared to commit to contractually binding cost reductions without taking ownership of the dockyard.

Key points

2.30 **Key points on prices for the allocated programme of refit work:**

a) Under the sales the Department have agreed prices for allocated refit work which commit the new owners to achieving long term cost reductions. However, prices were based on an illustrative programme and are subject to renegotiation if the programme changes.

b) At Devonport there are incentives for the company to make additional savings while at Rosyth the Department may withdraw the allocated programme of work if the company do not achieve target rates.

c) The long term pricing arrangements and shared savings incentives are not necessarily the result of the sales, although no such arrangements had been proposed under the previous Government Owned Contractor Operated arrangements.

Fixed asset values and depreciation

2.31 As the Department were selling an income stream where the purchasers would generate profit from future business, projected profit and cash flows were essential to the value purchasers placed on the dockyards. An important part of that equation was agreeing fixed asset values as the purchasers would then recover the cost of depreciation from the Department and other customers through refit prices. The higher the fixed asset figure, the more depreciation purchasers would recover, so increasing their cash flows and profits, since their profits are based on the ratio of capital employed to costs of production under the Government profit formula. With more cash being generated, the bidders would place a higher value on the business and increase their consideration.

2.32 For **Rosyth**, Babcock Rosyth Defence Limited and the Department agreed an opening fixed asset figure of £27 million - the same as the gross consideration. For **Devonport**, the Department agreed an opening fixed asset value of £73 million - some £33 million (83 per cent) more than the consideration received. The Department accepted the difference because they considered that the profitability of the business, and the cash flows that would have been generated from a lower fixed asset value, were not sufficient to fund the capital expenditure levels anticipated by the company. In addition Devonport Management Limited took on the following potential liabilities and contingencies which total some £46 million to £51 million, although the Department consider it unlikely that all of these will mature:

a) liability for redundancies of £15 million arising on competed and commercial work. In addition the Department agreed to a £3 million reduction in the consideration to reflect Devonport Management Limited's assessment of the risk they faced should the Department change the size of their overall refit programme (paragraph 2.17);

b) potential losses of £16 million arising from the Company's force majeure risks such as storm damage (£10 million), and the linking of contracts for refit work and the major project to upgrade submarine facilities at Devonport (£6 million) - if the company were late in completing facilities and were not therefore able to accept planned refits, they would be liable for their unrecoverable costs during the first three months;

c) Devonport Management Limited's funding of future capital investment on strategic assets, and the subsequent funding of maintenance and improvements. The Department estimate that the cost to Devonport Management Limited of funding their capital programme, including some projects which had been the Department's responsibility, is £10 million; and

d) Devonport Management Limited have guaranteed the Department reductions in refit prices irrespective of their actual costs, presenting the company with a liability which the Department estimate to be in the range £5 million to £10 million.

Profit rates

2.33 The rate of profit on non-competitive Government contracts is designed to give contractors a fair return on capital employed, equal on average to the overall return earned by British industry. Under the Government Profit Formula[4], the ratio of costs of production to capital employed determines the rate of profit. At **Devonport**, the capital employed of £73 million (ie the fixed asset valuation) enables the dockyard company to earn a higher rate of profit (8.3 per cent) than if the capital employed equated with the £40 million consideration, which would have allowed a rate of profit of 5.65 per cent (the minimum under the Government Profit Formula). At **Rosyth**, the capital employed provides a 5.65 per cent rate of profit.

Key points

2.34 Key points on the fixed asset values and profit rates:

a) At Devonport the Department agreed a fixed asset figure £33 million (83 per cent) greater than the consideration as they concluded that the profit and cash flow generated from a lower fixed asset value would not have been sufficient to fund the company's ongoing capital expenditure. They estimated that Devonport Management Limited took on potential liabilities of some £45 million to £51 million. However, it is unlikely that all the liabilities will mature and some of the liabilities reflect the commercial risks taken on by the dockyard company. The agreed fixed asset figure also had the effect of increasing the profit rate under the Government Profit Formula from the minimum 5.65 per cent to 8.3 per cent.

b) At Rosyth the Department agreed a fixed asset figure of £27 million - the same as the gross consideration. The profit rate is 5.65 per cent - the minimum under the Government Profit Formula.

Contractual arrangements

2.35 The contract arrangements for refit work at **Devonport and Rosyth** following the sales are similar to the previous arrangements. If the Department change the programme of allocated work, either by cancelling or delaying the start of a refit, the companies will be able to charge the Department their unrecovered

4 In 1968 the Government and industry agreed arrangements to provide contractors with a fair return on capital employed for non-competitive contracts - the Government Profit Formula. An independent Review Board for Government Contracts periodically reviews the profit formula and recommends target rates of profit.

costs and a disruption fee. Both companies are required to use their best endeavours to minimise unrecovered costs. Their ability to do so depends on how far they can absorb the costs of the workforce required for the Royal Navy's refit work by winning major contracts from other customers.

2.36 The Department have, as before, negotiated exclusion arrangements to mitigate their potential costs under the above arrangements. Before the sales the exclusion was £250,000 for each of up to three claims a year at both dockyards, and this remains the position at Devonport. At Rosyth the exclusion is now £100,000 for up to two claims a year.

2.37 Both owners can claim dislocation costs arising from delays caused by the Department during refits. There were no such provisions under the previous arrangements, but the Department state that they would have had to agree such terms if they had continued the Government Owned Contractor Operated arrangements.

2.38 A previous concern of the Committee of Public Accounts was the scale of specification changes and problems emerging during refit work, leading to cost escalations. These circumstances could also result in the dockyard companies over recovering overheads as hourly rates were determined in advance, based on the estimated hours to undertake the required work. If additional work was identified, the Department would pay for that work at the same hourly rate.

2.39 While it is ultimately for the Department's project managers to control refit costs, as part of the sale negotiations on future refit prices, the Department looked to limit their risks. On the Devonport sale, the Department have reduced their exposure by agreeing percentage limits on the costs of specification changes and emerging work for which Devonport Management Limited can make claims - 15 per cent on surface ships and 7.5 per cent on submarines. Where emerging work exceeds these limits, the company have agreed to re-calculate the hourly rates on the basis of actual hours worked rather than those initially forecast. Similar arrangements apply if the actual hours are less than those forecast. The Department have not agreed such arrangements at Rosyth.

Key points

2.40 Key points on the contractual arrangements:

a) If the new owners incur costs as a result of changes and delays to the refit programme caused by the Department, they are able to recover from the Department a greater proportion than under previous arrangements. However, the Department consider that they might have had to agree similar terms under continued Government Owned Contractor Operated arrangements.

b) Where there are major changes in workloads, the Department have agreed arrangements for substituting actual hours worked for initial estimates at Devonport. This reduces the risk of over-recovery of overheads. The Department have not agreed similar arrangements at Rosyth.

The expected benefits compared with continued Government Owned Contractor Operated arrangements

2.41 In the absence of competition for the sales, the Department produced a theoretical base case for each dockyard to assess what might happen if, instead of selling, they were to continue, following competition, the Government Owned Contractor Operated arrangements. The Department used the base cases to estimate the savings arising from the sales.

2.42 For **Devonport** the Department's comparison of the sale arrangements with the base case of continuing with Government Owned Contractor Operated arrangements shows that there is a potential gross saving of £40 million (some 3 per cent) over 10 years. The Department described the savings as modest in recommending that Ministers should approve the sale. Some £30 million of the saving occurs in 1996-97, largely as a result of the consideration itself (Figure 6). The savings are the result of:

a) **a saving of ¼30 million on labour costs** as part of the pricing arrangements for refit work. However, this is more than **offset by the additional depreciation costs and higher profits for the company of ¼52 million**, largely arising from the £73 million fixed asset figure (paragraph 2.32); and

b) **¼62 million benefit on capital related items** - these comprise the consideration received, and the timing benefit to the Department resulting from the owners bearing the initial financing cost of future capital programmes.

Figure 6

Savings forecast at Devonport to 2005-06

Figure 6 shows that the Department are forecasting savings of £39.6 million to 2005-06. £30 million of the savings take place in 1996-97, largely as a result of the consideration. In the next three years the Department forecast that they would achieve more savings by not selling the dockyard. The forecast savings include a guaranteed element and Devonport Management Limited are incentivised to reduce costs further (paragraph 2.43).

Source: Coopers and Lybrand

2.43 The Department's financial advisers (Coopers & Lybrand) identified a number of risks to the forecast savings and quantified the possible impact. They considered that there could be some erosion of the forecast savings in the years 2001-02 to 2005-06 if the forecast labour rates proved unrealistic. However, they also considered that on different assumptions for capital spend and productivity there could be additional savings of £25 million:

a) The Department's analysis assumed that the dockyard owners would achieve no more than the minimum cost reductions, but they are incentivised to reduce costs further. If they were to achieve these incentivised targets, the Department might gain an additional £10 million saving.

b) The Department and their advisers considered that the dockyard owners had overestimated their requirements for capital expenditure. If the dockyard owners reduced their capital expenditure in line with the Department's own estimates, the Department might save an additional £5 million.

c) The base case incorporates a 1.5 per cent annual productivity improvement for continued Government Owned Contractor Operated arrangements, which the Department's advisers considered may be optimistic and, as the base case was hypothetical, was not guaranteed. If the Department had assumed a productivity increase of 0.5 per cent for the base case, the assessed saving from the sale would have increased by £10 million.

2.44 For the **Rosyth** sale, the Department's comparison of the sale arrangements with the base case shows a potential saving of £118 million (some 10 per cent) over 10 years (Figure 7). The savings arise in two main areas:

a) **a saving of ¼70 million on labour costs, partially offset by ¼10 million depreciation costs and profit.** However, these savings arise largely in the latter half of the 10 year period, for which the Department do not have fixed prices, and they depend on the new owners achieving target cost reductions; and

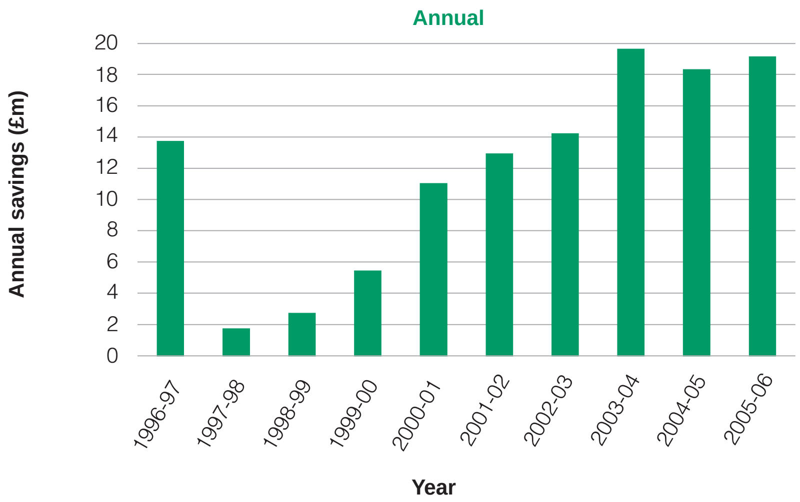
b) **¼58 million benefit on capital** related items - the consideration and the timing benefit to the Department resulting from the owners bearing the initial financing cost of future capital programmes.

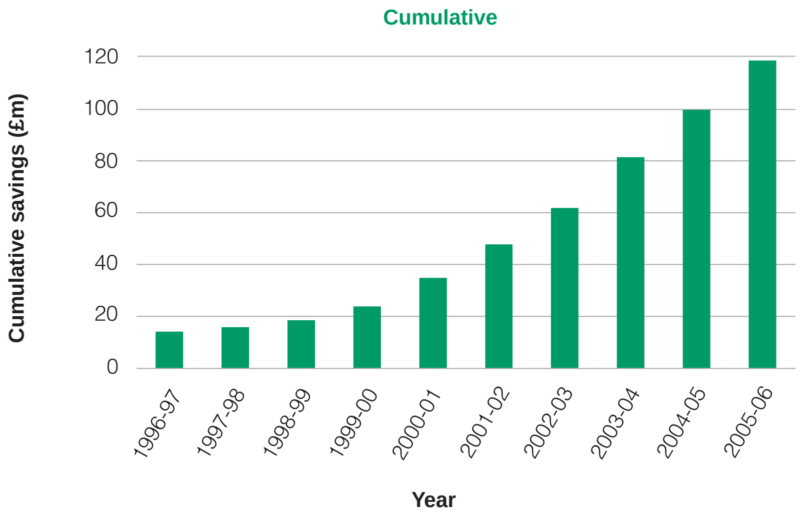
2.45 The sensitivity analysis undertaken by the Department's financial advisers highlighted a number of factors:

a) The base case incorporates a 1.5 per cent annual productivity improvement for continued Government Owned Contractor Operated arrangements, which the Department's advisers considered may be optimistic and which exceeded the average productivity provided under the sale. If the Department had assumed a productivity improvement of 0.5 per cent for the base case, the assessed savings for the sale would have increased by £11 million.

Savings forecast at Rosyth to 2005-06

Figure 7





Source: Coopers and Lybrand

Figure 7 shows that the Department are forecasting savings of £118 million to 2005-06. Seventy per cent of the savings are forecast to take place in the second half of the period.

b) The forecast savings from the sale are highly dependent on the dockyard owners achieving their target reductions in costs from 2000-01. If these targets were not met, the Department could withdraw the allocated work. However, the mechanisms for operating the targets are complex, and there is a risk that this would prevent the Department from taking this course. Also, it would put at risk the commercial viability of the dockyard and the Department's payback from allocating work to Rosyth without competition (paragraph 2.4). If the Department chose not to exercise the option of withdrawing allocated work, there could be increases in costs which could affect the forecast saving.

c) The Department's financial advisers considered that Babcock Rosyth Defence Limited had not provided full explanations to support a major reduction in non-labour costs, and that the company would require a clear implementation plan. If these cost reductions were not achieved, the assessed benefits of the sale would reduce by £18 million.

2.46 Although the Department put a precise figure on the likely savings from the Devonport and Rosyth sales, they recognised, as shown above, a number of factors which could impact on the savings actually achieved. In addition, we identified the further factors set out below:

a) While the Department's sensitivity analysis looked at a one per cent decrease in the productivity assumed in the base cases (paragraphs 2.43(c) and 2.45(a)), the effect of a one per cent increase would be to reduce the overall savings provided by the sale by £10 million at Devonport and £11 million at Rosyth;

b) The Department's base cases for continued Government Owned Contractor Operated arrangements did not allow for any reductions in indirect costs and overheads. If they had assumed an average one per cent annual reduction, the assessed savings provided by the sales would have fallen by £13 million at Devonport and £3 million at Rosyth;

c) For Rosyth, the Department based their forecast of capital spend on recent spend, which may not be a reliable basis for determining future spend as there has been significant investment in recent years and the workload at the dockyard is expected to fall by one third. The dockyard owners considered that substantially less investment is required than was assumed in the base case. If the Department had assumed that capital spend would be proportional to workload, the assessed savings arising from the Rosyth sale would have fallen by £6 million.

2.47 Having taken Treasury advice, the Department used a 6 per cent discount rate to compute the savings in terms of net present values. Although the Treasury were content overall with the Department's approach, as a general rule they recommend that departments identify the risks associated with the cash flows involved in the transaction and weight them for the risk. The Department did not analyse the cash flows in this way:

a) For Rosyth, the Department expect to receive the deferred payment in 2001, but the payment is dependent on a number of factors, including the Department delivering the agreed programme of refit work and the dockyard remaining commercially viable. The Department did not weight the deferred payment to reflect any uncertainty, but they consider that no additional risk should be attached to the deferred payment as they are responsible for delivering the programme of refit work.

b) Both dockyards forecast significant cost reductions in the latter half of the investment appraisal period, but by definition there is uncertainty attached to these forecasts. And as the Department do not have fixed or firm prices for these years, the extent to which the Department might benefit from any cost reductions is uncertain. The Department consider that the pricing arrangements agreed provide them with a measure of assurance and are confident that they can maintain taut prices beyond the period of firm and fixed prices.

2.48 Rather than weighting cash flows for risk, an alternative approach is to look at the sensitivity of the discount rate used in the investment appraisal - indeed for some commercial activities and high risk projects the Treasury recommend that departments use a higher discount rate than the standard 6 per cent. For illustrative purposes, we examined the impact of using a 10 per cent discount rate in our sensitivity analysis. For the Rosyth sale, as most of the benefits are in the later years, using a higher discount rate reduces the potential saving by £21 million. For the Devonport sale there would be a £4 million reduction in savings.

2.49 The results of our overall analysis are set out in Figure 8. For Devonport, more optimistic assumptions about cost reductions and capital expenditure levels following the sale increase the assessed savings from £40 million to £65 million, although under alternative assumptions they fall to £13 million. For Rosyth, assuming lower productivity improvements in the base case increases the assessed savings from £118 million to £129 million, although under alternative assumptions they fall to £59 million.

Analysis of the forecast savings arising from the sales 1996-97 to 2005-06

Figure 8

			£m
Devonport			
	Department's estimate of savings		40
Optimistic	achievement of cost incentives		10
add	reduced capital investment		5
	lower productivity in base case		10
		Total	**65**
	Department's estimate of savings		40
Pessimistic	cost reductions in base case for indirect		(13)
deduct	labour and overheads		
	improved productivity in base case		(10)
	effect of higher discount rate		(4)
		Total	**13**
Rosyth			
	Department's estimate of savings		118
Optimistic	lower productivity in base case		11
add		**Total**	**129**
	Department's estimate of savings		118
Pessimistic	cost reductions not sufficiently supported		(18)
deduct	cost reductions in base case for indirect		(3)
	labour and overheads		
	reduced capital investment in base case		(6)
	improved productivity in base case		(11)
	effect of higher discount rate		(21)
		Total	**59**

Figure 8 shows the range of forecast benefits arising from the sales during the 10 years 1996-97 to 2005-06. For the Devonport sale, while the Department forecast a £40 million benefit, the range could lie between £65 million and £13 million. At Rosyth, while the Department forecast a £118 million benefit, the range could lie between £129 million and £59 million.

Source: Coopers & Lybrand, and National Audit Office analysis

2.50 The overall saving arising from the sales is less than the sum of the savings from the individual sales. The Department analysed the value for money arising from the two sales independently, taking the owners' business plans as the starting point. Both companies included forecasts of their refits won in competition. However, there is some overlap in these forecasts - both companies forecast they would win some of the same major refits. The Department's analysis also estimated the gross savings. They did not include in the base case the costs they would have incurred in recompeting the Government Owned Contractor Operated arrangements had they not sold the dockyards. Nor did they take account of the £15.7 million costs of the sales. Allowing for the costs of the sales, our estimate of the total net savings ranges from £56 million to £178 million.

Key points

2.51 Key points on the expected benefits of the sales compared with continued Government Owned Contractor Operated arrangements:

Faced with the challenge of deciding whether the sales represented value for money in the absence of competition, the Department prepared a detailed base case by which to estimate the likely savings arising from the sale compared with the alternative of continuing with the existing arrangements whereby contractors operated the yards. The Department's assessment is that over the next ten years the savings from the sales will be £40 million (3 per cent) at Devonport and £118 million (10 per cent) at Rosyth. However:

a) At Devonport, the savings are projected to arise as a result of capital related items - principally the consideration received. Improvements in labour and overhead rates are more than offset by increased depreciation costs and profit.

b) At Rosyth, the efficiency improvements following the sale are largely forecast to arise in the latter half of the period when the Department do not have fixed or firm prices. The savings on capital items may be overstated. Although the Department had already invested in facilities for refitting surface ships, and planned refit workloads taper significantly after five years, they continued to project high levels of investment in their base case assumptions. In contrast the new owners planned lower capital investment.

c) The Department assumed that had they continued to run the dockyards on a Government Owned Contractor Operated basis, the arrangements would not have included incentives to reduce indirect costs.

d) In arriving at their ten year estimate of savings the Department did not adjust cash flows to reflect risks, or examine the impact of using a higher discount rate. The Department considered that these future cash flows did not require any adjustments for risks.

e) Our overall sensitivity analysis suggested that the gross savings for Devonport may range from £13 million to £65 million, underlining the Department's conclusion that the financial benefits were modest. For Rosyth the range is from £59 million to £129 million. After the deduction of sales costs, the total net savings from the two sales may range from £56 million to £178 million.

f) Also, as both companies have forecast they will win some of the same major refits in competition, the overall value for money to the Department is likely to be less than the value for money estimates for the individual sales.

Transfer of liabilities

2.52 The Department's aim was to transfer liabilities for personnel costs and environmental costs to the companies, ideally achieving a 'clean break'. Negotiations on some aspects were tied into the sale and impacted on the consideration - for example redundancy liabilities, where the Department looked to extinguish existing liabilities and transfer responsibility for future liabilities. The Department consider that they might have transferred some of the liabilities if instead of selling the dockyards they had continued the Government Owned Contractor Operated arrangements.

Redundancies

2.53 Under the contractorisation of the dockyards in 1987 the dockyard employees transferred from the Ministry of Defence to the dockyard companies, retaining their Civil Service redundancy entitlements. For **Devonport** the Department estimated the total liability for redundancies to be £147 million. Devonport Management Limited believed the figure was higher but were prepared to accept full liability for those employees engaged on work won as part of the Department's competed programme and commercial work, a liability estimated by both parties at £15 million. In addition they reduced their consideration by £3 million to reflect their assessment of the risk of changes to the size of the Department's overall refit programme (paragraph 2.17). The Department estimate that they retain a redundancy liability of £132 million for those employees working on the allocated programme. Given Devonport's monopoly on nuclear refit work from 2001, the Department consider that the risk of significant redundancies is small, based on the programme at the time of the sale.

2.54 For **Rosyth**, the Department estimated that the liability facing a potential owner was some £118 million. Babcock Rosyth Defence Limited would not accept such a liability, so the Department agreed to postpone the transfer of responsibility for redundancies to 2006, and to support Babcock Rosyth Defence Limited's proposals to buyout part of the workforce's redundancy entitlements. After the buyout, the new owners still have a liability of some £16 million at 2006, so the Department agreed to the consideration being abated by £6.5 million to reflect this (paragraph 2.17). Babcock Rosyth Defence Limited would only pay this sum to the Department in the event of wholesale redundancies in the wake of company failure before 2006 - the Department would initially meet the cost of these, and then claim the abatement from proceeds from the sale of the business or assets alongside other creditors.

2.55 The buy-out was designed to reduce the redundancy liability to a level which more closely matches normal commercial levels, and was achieved by the Department paying Babcock Rosyth Defence Limited £48 million on completion of the sale. The Department confirmed that the company have paid out the £48 million to the 3,300 strong workforce, and that average pay outs were £8,000 to £10,000, with some employees (less than one per cent) receiving £100,000. The buyout arrangements are stepped - initially the workforce give up 45 per cent of their entitlement in return for the pay out. They retain 55 per cent of their entitlement, and this falls to 27.5 per cent by 2006 (Figure 9).

Figure 9

The Rosyth redundancy buyout scheme

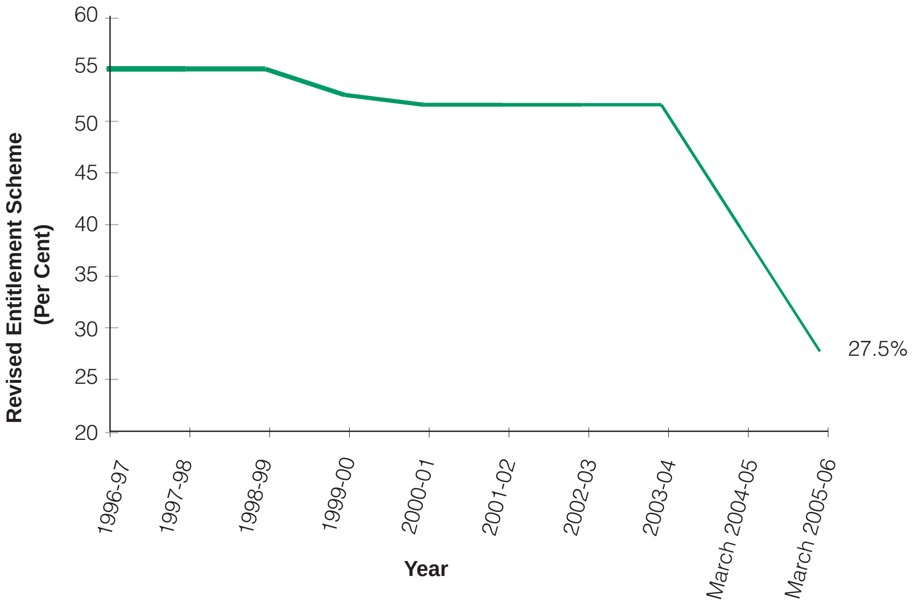


Figure 9 shows the phasing of the buyout of employee redundancy entitlements. At sale completion redundancy entitlements were reduced to 55 per cent of the previous arrangements. These reduce to 27.5 per cent in March 2006.

Source: The Ministry of Defence

2.56 The Department are liable for redundancy costs up to 2006 and Babcock Rosyth Defence Limited are forecasting some 1,200 redundancies before then, mostly among the workforce engaged on Royal Naval submarine work. The Department estimate that the cost will be £29.2 million (after the buyout), which together with the £48.1 million buyout payment, and the £6.5 million abatement of the consideration, means that the changes in redundancy terms are likely to cost the Department almost £84 million. However, the Department's analysis shows that without the buyout, payments for the 1,200 forecast redundancies before

2006 could be some £57 million. Hence the net cost of the changes in redundancy terms might be £27 million - £84 million less £57 million. For this cost the Department expect to extinguish their liability for redundancies after 2006 - an estimated £69 million (Figure 10).

A comparison of the Department's expected costs for redundancies under the original and revised schemes

Figure 10

Costs to the Department	*Original Scheme before sale £m*	*Revised Scheme after sale £m*
Up-front payment to buy out part of the workforce's redundancy entitlement	-	48.1
Redundancy payments for forecast 1,200 redundancies following the ending of Rosyth's nuclear submarine work	56.8	29.2
Reduction in consideration	-	6.5
	56.8	**83.8**
Liability at 2006	68.8	-

Figure 10 shows that the Department are incurring costs of about £84 million, including consideration foregone, to support changes in the Rosyth's workforce's redundancy terms. Against this should be offset the costs of redundancies which the Department would have incurred under the previous arrangements, estimated at some £57 million. The Department also expect to extinguish all liability for redundancy in 2006, an estimated liability of £69 million under the previous arrangements.

Source: The Ministry of Defence

2.57 In developing these arrangements, the Department placed equal weight on the costs of transferring the liability and the value of the liability. However, this does not take account of the probability of the liability maturing. As part of the sale, the Department are looking to secure lower refit prices in the future from a competitive market for surface ship refit work, and they are providing Rosyth with an allocated programme of such work to assist the dockyard in the transition to refitting surface ships only. Assuming the dockyard are successful in the long term, the Department's liability would reduce to zero as the dockyard company are responsible for all new employees.

2.58 The Department also estimated what effect the changed redundancy arrangement might have on their costs in the event of wholesale redundancies. They compared their costs under the revised redundancy arrangements with their costs under the original arrangements. If all redundancy liabilities mature within five years, the Department estimated that they could face an additional cost of up to

£12 million, plus pay in lieu of notice, compared with the previous arrangements. This is because in the event of redundancies in the first five years, the workforce would receive their pre-buyout entitlement, less the buyout compensation payments already received. However, if redundancies were to occur between 2001 and 2010 the Department estimated that their costs under the revised arrangements are likely to be less than under the previous arrangements, by some £20 million in 2006 falling to £5 million in 2010.

Key points

2.59 Key points on transferring responsibility for redundancies:

a) At Devonport, the Department remain largely liable for redundancies among employees engaged on their allocated work, or resulting from an extraordinary loss of allocated work. No significant redundancies on this work are forecast. Devonport Management Limited are, however, responsible for redundancies for those employees engaged on work won as part of the Department's competed programme and commercial work.

b) At Rosyth, the Department will not achieve a clean break from all redundancy liabilities until 2006. The net cost to the Department of transferring these liabilities is £27 million, and they estimate that for this they have extinguished a redundancy liability in 2006 of £69 million.

c) Assuming the dockyard are successful in the long term, the Department's liability would fall to zero as the dockyard company are responsible for all new employees. When considering the effect of the changed redundancy arrangements on their costs in the event of wholesale redundancies, the timing of redundancies is crucial. If wholesale redundancies occur before 2001, then the Department estimate they might incur additional costs of up to £12 million but between 2001 and 2010 their costs are likely to be up to £20 million less. However, wholesale redundancies would impact on their objective of achieving a competitive market for surface ship refitting, and changes in the redundancy terms was a prerequisite for the dockyard company to proceed with the sale.

Pensions

2.60 At the two dockyards, the pensions funds were in substantial surplus at the time of the sale - some £100 million for the two. The Department considered that the surpluses were largely a result of their contributions, through paying the labour costs on refit contracts, and that they should receive some benefit from a managed reduction of the pension fund surplus.

2.61 Initially the Department sought additional consideration as part of the sale, but agreed instead to lower refit prices flowing from employers' contributions holidays for the new owners. These arrangements were not necessarily dependent on the sale - they might also have been negotiable under the previous Government Owned Contractor Operated arrangements, although they had not been considered when there were previous surpluses. Hence these are not included in the analysis of savings resulting from the sales, and are in addition to the savings incorporated in the pricing arrangements (paragraphs 2.26 and 2.27). However, the Department consider that the sales accelerated the recovery of the pension fund surpluses.

2.62 At **Devonport** the pension fund was £63 million in surplus. Devonport Management Limited agreed to a reduction in refit prices equivalent to two thirds of the pension fund surplus, and to members' benefits being enhanced. The Department estimate that the arrangements ensure they benefit by some £20 million over the first three years, and provide a firm prospect of a further £20 million benefit over the following three years.

2.63 At **Rosyth** the pension fund was some £37 million in surplus. Babcock Rosyth Defence Limited agreed that the Department should benefit from reduced refit prices following contributions holidays and a cap on employer contributions recoverable from overheads. The Department have estimated the value of the lower refit prices to be £24 million - some two thirds of the pension fund surplus.

Key point

2.64 **Key point on the management of pension fund surpluses:**

The Department expect to benefit from a managed reduction in the £100 million pension fund surpluses. The benefit will take the form of lower refit prices - equivalent to some two thirds of the pension fund surplus. While similar terms might have been negotiated under Government Owned Contractor Operated arrangements, the Department consider that the sales accelerated the recovery.

Environmental liabilities

2.65 Environmental issues were an important factor in the sales. The Department and the new owners have agreed to share responsibilities as set out below. The Department did not make an assessment of the extent to which liabilities transferred to the new owners have led to reduced consideration. In negotiation the Department considered that the dockyard companies had set a ceiling on their considerations, so the Department looked to transfer those liabilities they could without the dockyard companies reducing their consideration:

a) The Department remain liable for the costs associated with nuclear contamination arising from submarine refitting work, and have provided the dockyard companies with an indemnity. At Rosyth, the Department retain the liability for decommissioning the site. Both dockyard owners are, however, liable for the first £250,000 cost of any individual incident caused by omission or deliberate act. The Department also may insist on the owners taking out insurance for environmental costs and recovering premiums through overheads, if an insurance market were to be established.

b) As regards employee compensation for possible nuclear related diseases, the Department joined the nuclear industry's no fault Compensation Scheme for Radiation Linked Diseases in 1994 and both dockyard companies are also members. The Scheme enables employees working in the nuclear industry and past employees to submit claims for compensation. The Department have publicised the scheme and are considering a number of options for advertising the scheme more widely to former employees and their families.

c) At Devonport, the Department retain any non-nuclear environmental liabilities attributable to the period before they contracted out the management of the dockyard in 1987. To assess respective liabilities the Department and Devonport Management Limited are jointly funding a survey to be carried out during 1998 to establish the level of contamination. The Department expect that they will continue to be liable for most contamination identified during this survey.

d) At Rosyth, the Department retain liability for the risk of contamination arising from the non-nuclear West Tip. This tip contains unknown quantities of waste materials arising from dockyard operations going back some 50 years. The tip has been capped to contain the materials and there are no proposals to remove it in the future. All other non-nuclear environmental liabilities (including some pre-1997 liabilities) have passed to the new owners.

Key points

2.66 Key points on environmental liabilities:

a) The Department retain liability for all past and future nuclear related contamination - save for the first £250,000 cost of future incidents, for which the dockyard owners are liable - and have provided the dockyard owners with an indemnity.

b) As regards non-nuclear contamination, the Department remain liable for all pre-1987 pollution at Devonport and the worst affected area at Rosyth.

c) The Department did not assess what the effect of transferring liabilities to the dockyard owners had on the consideration. They considered that to have pressed for transferring additional liabilities would have reduced the consideration.

The Department's decision

2.67 The then Ministers approved the sales on the basis of the Department's advice that the sales provided value for money. The Department pointed to the overall savings at both dockyards and recognised that the savings were more modest at Devonport. They attributed this to their assessment at the time of Devonport Management Limited's relative cost advantage (paragraph 2.4). The Department included details of the business valuations undertaken and how the original assumption which underpinned these valuations had changed. They highlighted the liabilities transferred to the owners, and those retained - particularly liabilities for nuclear contamination. They also emphasised that sales achieved the transfer of all responsibilities for the management of the dockyards, including future capital expenditure, following completion of the major upgrade projects.

Concluding comments

2.68 This Part of the report deals with the many and inter-related aspects of the sales packages, including the consideration received, future refit prices (and how valuation of fixed assets affects these), the assessed savings compared with what might have been the position if the Department had not sold the dockyards, and the liabilities transferred and retained. These closing paragraphs draw together the key elements.

2.69 Overall, the Department's analyses show that the sales will generate gross savings of £158 million at the two dockyards over 10 years - £40 million (3 per cent) at Devonport, and £118 million (10 per cent) at Rosyth. The savings are dependent, however, on the dockyard owners achieving target cost reductions, although some of these are guaranteed. This, and other factors, suggest that the total savings, after deduction of sales costs, may range from £56 million to £178 million, there still being an overall saving at each dockyard.

2.70 The Department have negotiated prices for future allocated refit work at both dockyards. At Devonport, the Department are guaranteed savings irrespective of Devonport Management Limited's costs over the first five years, and the company are incentivised to reduce costs further - in the event of additional savings there is a sharing arrangement between the Department and the company. Further incentivised arrangements are to be negotiated after five years based on actual costs. At Rosyth, the Department have negotiated firm and fixed prices for the first four years and target prices for the next six years - they will be able to withdraw work from the allocated programme if targets are not met.

2.71 Looking beyond the direct savings, there were wider factors which influenced the Department's decision to sell:

a) the sales mean that the dockyard companies are responsible for all management decisions and the future success of the dockyards. In the past the Department had a direct interest in providing sufficient work to ensure that dockyard assets were being utilised, as under-utilisation resulted in higher unit costs for refit work. Hence the Department allocated work to the dockyards without competition. Following the sales, in time the Department will compete all surface ship refit work, and it will be up to the dockyards to ensure that they are able to compete successfully;

b) for Devonport, their monopoly on submarine refit work means that the Department will continue to allocate work to them without competition. But the sale means that if the Department were to reduce their requirement for submarine work, they would not be required to compensate the company (although they would be liable for redundancy costs);

c) for Rosyth the sale means that once the allocated programme of surface ship refit work comes to an end, the Department will place work at the dockyard only on the basis of competition. The Department retain responsibility for redundancies for existing employees on major refit work up to 2006. From then, Babcock Rosyth Defence Limited will be responsible for all redundancies;

d) the owners of the dockyards are responsible for financing and managing all capital expenditure once the current programme of work to upgrade facilities at the dockyards is complete. In the past the Department have funded such expenditure.

2.72 The Department recognise, however, that the benefits of the sale have to be seen in the context of other factors:

a) in the absence of competition the Department took the precaution of assessing the savings against their best estimate of what might have happened if they had continued, after competition, with Government Owned Contractor Operated arrangements. By definition, however, this 'base case' analysis is uncertain. Also, the assessed savings are based on the likely costs of an illustrative programme of work. This programme can alter, as it has done in the past, depending on the Royal Navy's operational requirements. In the event of changes to the refit programme, the Department may be required to compensate the dockyard companies for shortfalls in work and the dockyard companies are able to re-negotiate their refit prices;

b) the Department's valuations of the businesses were £91 million for Devonport and £30 million for Rosyth. These valuations were dependent on assumptions made about the owners' opening balance sheet figures and future cash flows. The consideration received was £40 million for Devonport and £19 million for Rosyth (including the value of a deferred payment of £6 million). The consideration reflected the dockyard companies' assessment that they were taking on significantly higher risks than those assumed by the Department's advisers;

c) the Department agreed to Devonport Management Limited taking assets into their balance sheet at a value some £33 million greater than the consideration received. The effect is to increase the depreciation and profit elements in future refit prices paid by the Department, whilst still resulting in lower overall prices than before. Devonport Management Limited considered that this was necessary to generate sufficient cash to finance their capital expenditure programme, including some projects which had been the Department's responsibility. The Department considered that the company's capital investment plans were higher than necessary, but accepted the consideration as part of an overall package, including lower refit prices;

d) in agreeing to the higher balance sheet figure for Devonport, the Department had regard to the fact that the dockyard owners were taking over a number of liabilities. However, some of these liabilities reflect the commercial risks which, by implication, the dockyard company had taken into account in the consideration offered. The liabilities transferred include those for redundancies among employees engaged on work won in competition. In addition the Department agreed to a reduction in the consideration as Devonport Management Limited assessed that there was a risk of redundancies among these employees arising in the event of the Department reducing their overall refit programme;

e) for Rosyth, the Department have agreed to allocate a programme of refit work without competition, at a cost which may exceed £50 million. By doing this the Department expect to end all responsibility for the dockyard in the long term and place work with them only on the basis of competition. The payback for the Department, however, is dependent on Rosyth becoming a dockyard handling only surface ships so that there is an effective market for surface ship refit work;

f) transferring liability for redundancies at Rosyth to Babcock Rosyth Defence Limited from 2006 has cost the Department money. The estimated net cost is £27 million and the Department expect to extinguish a liability estimated at £69 million. Assuming the dockyard's long term commercial success, the Department's liability would fall to zero as the dockyard company are liable for all new employees. In the event of wholesale redundancies before 2001 the Department's costs may exceed those which might be incurred under the previous redundancy arrangements by up to £12 million. Between 2001 and 2010, the Department estimate that their costs under the revised arrangements would be up to £20 million less than under previous arrangements. However, for the dockyard company changing the redundancy terms was a prerequisite for the sale.

2.73 The actual cash flows associated with the sales are complex, involving not only the consideration received by the Department and their sale costs, but also their payments in respect of redundancy liability. On completion of the sale the Department received total consideration of £54.8 million for the two dockyards. They paid £48.1 million to enable Babcock Rosyth Defence Limited to buy out part of the work force's redundancy entitlement. The Department's sale costs were £15.7 million. There was therefore a net cash outflow from the Department of £9.0 million on completion. The Department are due to receive a further £6 million for Rosyth in 2001-02 (£4.9 million net present value). However, they also expect to pay additional redundancy costs at Rosyth of £29 million before they transfer all remaining responsibility for redundancies. Hence, five years after the sales, the Department expect a further £24 million net outflow.

2.74 Summary details of the cash flows and other key figures for the Devonport and Rosyth sales are set out in Box 2.

Box 2

Summary details of sales of Devonport and Rosyth Dockyards

	Devonport £ million	*Rosyth £ million*	*Total £ million*	*£ million*
Department's estimate of savings				
Expected savings	40.0	118.0	158.0	
Expected savings as a percentage of the cost of refit work	3%	10%	6%	
National Audit Office estimate of savings				
Upper estimate [net of sales costs]	65.0	129.0	194.0	[178.0]
Lower estimate [net of sales costs]	13.0	59.0	72.0	[56.0]
Value of consideration				
Sale proceeds at completion	40.3	14.5	54.8	
Value of deferred payment	–	4.9	4.9	
Total	40.3	19.4	59.7	
Adequacy of consideration				
Consideration as a percentage of:				
commercial valuation	44%	64%	49.2%	
asset valuation	41%	39%	40.6%	
Liabilities transferred: costs:				
Redundancy costs				
Reduction/abatement in consideration	3.0	6.5	9.5	
Department's payments:				
redundancy buyout	–	48.1	48.1	
expected redundancy costs	–	29.2	29.2	
Redundancy costs avoided	–	(56.8)	(56.8)	
Redundancy liability transferred	–	(68.8)	(68.8)	
Other costs				
Fixed assets figure in excess of consideration	30.0	–	30.0	
Cost of allocated work	–	50.0	50.0	

Continued

Box 2 **Summary details of sales of Devonport and Rosyth Dockyards *continued***

	Devonport	*Rosyth*	*Total*
Shared liabilities			
Redundancy liabilities	Employees on major refit work	Existing employees on major refit work to 2006	
Transferred liabilities	Employees on competitive work	All new employees; employees on competitive work; and all employees from 2006	
Environmental liabilities			
Department's liabilities	All nuclear and pre 1987 non-nuclear	All nuclear and worst affected non-nuclear	
Transferred liabilities	Post 1987 non-nuclear	Pre and post 1987 non-nuclear, excluding designated areas	

Cash flows at completion	£m	£m	£m
Consideration received	40.3	14.5	54.8
Buy out of redundancy	–	(48.1)	(48.1)
Cost of sales			(15.7)
Total			(9.0)
Future value of cash flows			
Deferred payment	–	4.9	4.9
Expected redundancy costs	–	(29.0)	(29.0)
Total	–	(24.1)	(24.1)

Part 3: Maintaining and upgrading the dockyards' infrastructure

Introduction

3.1 One of the Department's key objectives for the dockyard sales was to maintain the Royal Navy's refitting capability - in particular, the capability to repair, refit, refuel and decommission nuclear submarines. This Part examines the Department's achievements against this objective.

The aspects of the Department's repair and refit capability examined in this part

- how the Department safeguarded strategic assets, and ensured their continued access to these facilities; and
- the programme to upgrade facilities for handling nuclear submarines.

3.2 The sales have taken place against a background of the attention being paid to safety standards in the civil nuclear industry. This has placed an emphasis on the dockyard owners to analyse and understand the complete range of risks which could result in the release of nuclear material. One measure to reduce risks is the improvement of dock structures - and this was recognised by the Department and the dockyard companies before the sales were completed.

3.3 The Department therefore embarked on a series of capital projects involving the strengthening of dockwalls, and the construction of new caissons (specialised dock gates) and anchors. This has proved a significant challenge to the Department and the dockyard companies who have had to operate a repair and refit programme without compromising the Royal Navy's operational capability while undertaking the programme of improvements to dockyard facilities. When dock facilities are being improved, they cannot be used for undertaking the repair and refit of submarines. And the refit work itself has increased as more work has been required to take account of problems identified in earlier refits.

3.4 The largest project is D154 at Devonport which will provide the permanent facilities for the refitting and refuelling of all submarines including the Vanguard submarines - a £400 million investment. The sale of Devonport and D154 were inextricably linked. The Department needed to ensure that the dockyard owner, as nuclear site licensee, had sufficient control of D154 to fulfil their legal duties. They therefore contracted the dockyard owner as prime contractor for D154. Also the Department wanted to avoid the position where the dockyard company and prime contractor for D154 could each blame the other for any delays. And Devonport Management Limited took the strategic view that they would only proceed with the sale and D154 together - their future income is dependent on successful completion of D154 and they told us that they would not have taken on the risks of managing D154 without the prospects of future profits from using the facilities.

Safeguarding strategic assets

3.5 The Department need facilities for repairing, refitting, refuelling and decommissioning nuclear submarines as they are essential for maintaining the Department's operational capability, and unique - there are no alternative facilities available to the Department. For surface warship refitting, however, the Department consider there is potential for a competitive market - the two dockyards, and the Department's recently contractorised Fleet Maintenance Repair Organisation at Portsmouth, and commercial ship builders' yards.

3.6 The sales contracts for both dockyards include safeguards to ensure that the Department will have access to facilities for their nuclear submarines. The facilities are designated strategic assets, and the dockyard owners are contractually committed to maintaining them to the Department's specified standards. At Devonport these safeguards apply indefinitely - at Rosyth they will last until the dockyard's involvement in the nuclear submarine programme, including decommissioning of some submarines, comes to an end.

3.7 In addition, the Secretary of State retains a 'Special Share' which can be used to prevent the sale of shares in the dockyards where this might conflict with the national interest. The Department also have the right to re-purchase any or all of the strategic assets in the event of the owners becoming insolvent, and to prevent disposal or destruction of the assets in the normal course of business.

Key point

3.8 **Key point on safeguarding strategic assets:**

Before the dockyards were transferred to private ownership, the Department took steps to ensure that they would retain access to the strategic assets for the Royal Navy's nuclear powered submarines, including their eventual decommissioning.

The programme to upgrade repair and refitting facilities

3.9 One of the reasons for selling the dockyards was for the Department to transfer responsibility for capital works management and investment decisions to the dockyard companies. The Department are, however, funding the upgrade projects themselves, and they have contracted the dockyard companies to manage the projects. Work on most of the upgrade projects began before the sales were completed and there were pressing operational reasons for the Department to push ahead with the upgrades. On D154 the Department considered attempting to transfer the financing risks to the dockyard companies under the Private Finance Initiative but concluded that this would further complicate the sales and the contractual negotiations on the major upgrade project.

3.10 The dockyard owners own all the assets. They will also own, when they are completed, the new major facilities being built at Devonport and funded by the Department. Under the contract, the owners will not, therefore, include depreciation on upgraded facilities being funded by the Department in their charges for Royal Navy refit work.

The submarine repair and refit work at Devonport and Rosyth

3.11 The Department estimated that they would save £300 million to £700 million over 10 years by concentrating all submarine work at one site and competing all surface ship work (paragraph 1.4). In 1993 they selected Devonport to be the site for future submarine facilities, having assessed that there would be a cost advantage of £64 million over Rosyth. This meant abandoning the construction of new docks at Rosyth (RD57) where they had invested £107 million. The Department included RD57 in the Rosyth sale. If Babcock Rosyth Defence Limited are not able to make commercial use of the facility and the local authority require restoration of the site, then the Department will be liable for restoring the site - the cost of which the Department estimate at some £7.5 million - or continuing to maintain the facility. Since 1993 the Department have paid the cost of further work to stabilise the walls, and annual maintenance costs, totalling £3.5 million.

3.12 As mentioned in paragraph 3.3, the Department and Devonport Management Limited have faced significant logistical challenges in upgrading existing docks and improving other nuclear facilities at Devonport, as they have had to operate the dockyard at the same time. They have also faced the need to meet civil nuclear safety requirements, in particular the need to provide safeguards for hazards external to the nuclear reactor such as seismic hazards. Since 1993 the dockyard companies, as the nuclear site licensees, are having to demonstrate more rigorously how they can meet civil nuclear safety standards, and the Department consider that this is a feature in all their nuclear engineering projects, and within civil industry.

3.13 In addition to the difficulties in upgrading docks, the refit work itself is taking longer as more time is required to take account of problems identified in earlier refits. In 1995 the Department found that they were not able to manage the competing demands of the refit and works programmes at Devonport, and decided to place further submarine refit work at Rosyth - extending the refit work at Rosyth until January 2002. This has resulted in the Department incurring additional costs at Rosyth by having to maintain the capacity to carry out nuclear work, and dislocation costs at Devonport, totalling £70 million. The Department are also having to invest £45 million in upgrading facilities at Rosyth, and estimate that they will have to pay £8 million for decommissioning when nuclear refitting ends.

3.14 In July 1995, around the time of the transfer of submarine work to Rosyth, Babcock International Group, Babcock Rosyth Defence Limited’s parent company, submitted unsolicited proposals for resurrecting the project to build new nuclear refitting facilities at Rosyth - RD57. The Department did not pursue the Babcock proposals as they considered there was no prospect of better value for money. They also considered that there was the risk of significant delays to the completion of the new facility for submarines. The Department were concerned that the company would require considerable time to reach the same point in detailed negotiations that had been reached with Devonport Management Limited (which had taken more than two years), and that the offer could change considerably as the company gained a greater understanding of the risks and the contract terms. The Department were also concerned that to re-run the competition for the nuclear facilities would delay the sales, requiring further interim measures to be put in place.

Key points

3.15 **Key points on the submarine repair and refit work at Devonport and Rosyth:**

a) In 1993 the Department decided that all submarine work should be undertaken in Devonport on the grounds that this was the lowest cost option by some £64 million.

b) Since abandoning the RD57 project at Rosyth, where they had invested £107 million, the Department have incurred costs of £3.5 million stabilising the walls and in maintenance costs. They remain liable for restoring RD57 if Babcock Rosyth Defence Limited have no commercial use for the incomplete facilities and if the local authority require restoration of the site (at an estimated cost of £7.5 million).

c) The Department have had to extend the period during which Rosyth will undertake submarine refitting as they have experienced significant logistical problems in upgrading existing docks at Devonport and because they require more time to undertake the refits. This has meant additional costs at Rosyth in maintaining the capacity to carry out nuclear work, and dislocation costs at Devonport (totalling £70 million), and £45 million investment in temporary facilities at Rosyth. In addition the Department will pay the £8 million costs of decommissioning.

d) The Department considered that Babcock International Group's unsolicited proposals for resurrecting the new build docks (RD57) at Rosyth offered no prospect of better value for money, and would have delayed the start of operationally critical work, and delayed the sales.

Management of the upgrade programme and the contingency docking facility

3.16 Given the need to do refit work on submarines whilst at the same time upgrading the docks, the Department decided that the dockyard companies would be responsible for the four projects to upgrade facilities at Devonport and Rosyth, and made the Devonport sale conditional on the owner being prime contractor for the D154 project. Also, because the upgrade work is on nuclear licensed sites, the dockyard owners as licensees are responsible for meeting the licence conditions and legislative requirements, and they must have sufficient control of the work carried out on the sites. Thus the Department awarded the prime contractor contracts for the upgrade work without competition, although the dockyard companies are required to compete most of the sub-contracts.

3.17 A fifth project, the contingency docking facility being constructed at Rosyth, predates the Department's initiatives to contract the dockyard company as prime contractor and has been managed by the Department's defence estates organisation. Also, the Department have a contractual commitment to Devonport Management Limited under the sale to provide a permanent facility for minor repair work and they are looking at a number of options for the possible provision of a second permanent facility for minor repair work.

3.18 Figure 11 shows that the Department currently estimate that two of the five projects underway will be completed on time and within budget. Overall, the latest cost estimate for the five projects totals £530.9 million, compared with the Department's original estimate of £338.0 million - an increase of £192.9 million (57 per cent), with the highest individual increase being 90 per cent. The cost increase is forecast on three projects where there are delays of 76, 29 and 17 months.

Figure 11

Capital projects for submarine facilities at Devonport and Rosyth

	Completion estimate			*Cost estimate*				
	Original	**Current**	**Months late**	**Original £m**	**Current £m**	**Cost increase £m**	**Contract type**	**Comment**
Devonport								
10 Dock	97/98	97/98	0	25.5	25.5	0	Fixed price design and build	Short term upgrade - facilities for repair work
D154	99/00	04/05 (1)	29	261.0	417.0 (2)	156	Fixed price Incentive Fee	Major facilities for refuel + refit
Rosyth								
RD 46	91/92	97/98	76	25.4	43.3	17.9	Fixed price	Contingency docking facility
RD 102	97/98	99/00	17	21.1	40.1	19	Series of fixed price contracts	Short term upgrade - facilities for refuel + refit
RD 104	97/98	97/98	0	5.0	5.0	0	Fixed Price Incentive Fee	Short term upgrade - facilities for repair work
Totals			**122**	**338.0**	**530.9**	**192.9**		

Notes: 1. The contract runs to April 2004 to enable the Department to assess if facilities meet operational requirements. The 29 months delay is a comparison of the Department's initial estimate of project completion and the estimated completion date for construction of the facilities as set out in the D154 contract.

2. The cost estimates exclude the Department's contingencies.

Source: Ministry of Defence and National Audit Office analysis

Figure 11 shows delays on three projects of 76, 29 and 17 months, with total cost increases of £192.9 million (57 per cent).

3.19 The cost increases and delays have occurred on three projects:

a) **The contingency docking facility at Rosyth (RD46)** The Department began construction of this facility (required for emergency repairs) before their decision to concentrate submarine refit work at Devonport. The Department's latest cost estimate is £43 million compared with an original estimate of £25 million - largely a result of the work necessary to satisfy the nuclear safety requirements, which involve replacing the caissons and installing rock anchoring. The facility should have been ready in 1991-92 but the Department now expect it to be fully operational in 1997-98 - 76 months later. After 2001, when all submarine refitting work will transfer to Devonport, the Department may continue to designate RD46 as a strategic asset for emergency docking - they have yet to decide whether to build such a facility in Devonport.

b) **The project to support the extension of the nuclear submarine programme at Rosyth (RD102)** Before contracting the dockyard company to manage this project, the Department initially thought that the series of upgrades required to support submarine work would be completed in tandem and that the entire project could be completed by November 1997. The upgrades are having to be carried out in sequence and the project is now expected to be completed in April 1999, 17 months later than their initial forecast. The individual project components have been completed to schedule and there has been no impact on the submarine refitting programme. The Department estimate that the project cost has increased from £21 million to £40 million.

c) **The upgrade of existing docks at Devonport (D154)** This project, to provide permanent facilities for the refitting and refuelling of the Royal Navy's submarines, including the Vanguard submarines, is examined below.

3.20 The remaining two projects, 10 Dock at Devonport and RD104 at Rosyth, provide facilities for undertaking repair work on submarines in between scheduled refits and refuelling work. These upgrades are required to ensure that the facilities meet safety standards in the short term - for up to five years. In addition to these facilities, the Department's ship lift at Faslane provides a facility for undertaking minor repairs to submarines.

Key point

3.21 **Key point on the management of the upgrade programme:**

The Department have experienced a total cost increase of £192.9 million on three of their major projects, partly as a result of nuclear safety requirements. There have also been significant slippages with the Department forecasting that the delays on the three projects are likely to be 76, 29 and 17 months late.

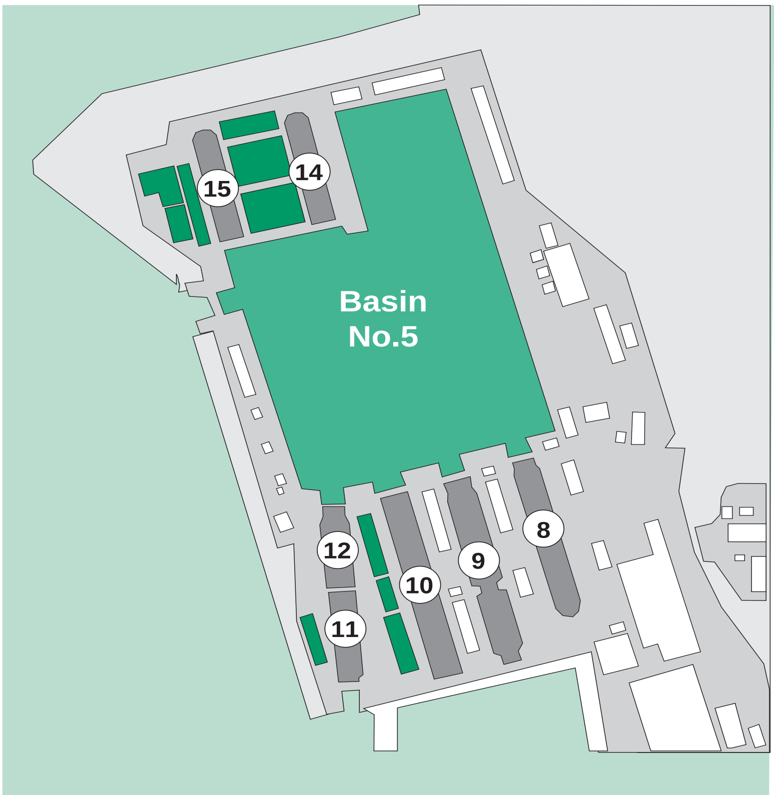
The Devonport facilities project - D154

3.22 The programme to upgrade the dockyard facilities for nuclear submarines is dominated by the D154 project at Devonport (Figure 12). The project is a major and complex undertaking. Devonport Management Limited are the prime contractor, responsible for the totality of the project - design, nuclear safety requirements, construction, commissioning and licensing of the facility. To give one simple illustration of the scale of the activity, Devonport Management Limited estimate that at the peak of construction work in 1998-99, the movements of trucks carrying spoil and delivering concrete will exceed 50 an hour. At the same time the company will be operating the dockyard and undertaking major refits for the Royal Navy.

3.23 After an initial design phase, the Department first issued an Invitation to Tender to Devonport Management Limited in July 1994. Before awarding the contract the Department needed to be confident that Devonport Management Limited, who had no previous experience of managing a project of this kind, had acquired the right skills, and put in place appropriate management structures. The Department's concerns in this respect were such that at one stage they considered postponing the sale and appointing a new management contractor. They conducted three Pre-Contract Award Evaluations before they were satisfied that the company had the capability to manage the project. In October 1996, they concluded that the company had made sufficient progress, though the Department required further action by the company before contracts could be signed (Box 3). The contract was signed in March 1997.

The upgrade project at Devonport - D154

Figure 12



D154 comprises the following:

9 Dock	- refuelling and refitting of Vanguard submarines
14/15 Docks	- refuelling and refitting of other submarines

In addition the Department are providing temporary facilities for minor submarine repairs in 10 Dock

Figure 12 shows the principal features of the D154 project with major construction work scheduled for the Vanguard facilities in 9 Dock and the other submarine refuelling and refitting facilities in 14 and 15 Docks.

The Department's 1996 Pre Contract Award Evaluation recommendations and progress statement

Box 3

Key Recommendations	*Action*
1. Devonport Management Limited should appoint a full time experienced Project Manager prior to the placement of the Contract.	Capital Projects Director post created to supervise project managers directly responsible for construction and delivery of D154 facilities. In November 1997 a new post of D154 Facilities Director was created to lead the prime contractor organisation.
2. Devonport Management Limited should re-examine the composition and experience of the Design and Safety Management Team.	Director of Design and Safety was appointed. Suitably qualified and experienced Safety Case Manager was appointed. Both the design and safety teams were strengthened by qualified staff. In November 1997 Devonport Management Limited established the Design Authority consisting of the Director of Civil Engineering, the Director of Mechanical Engineering and the Safety Case Manager who are supported by suitably qualified teams.
3. The performance of the key post holders in the Design and Management Team should be reviewed three months after the placement of the contract.	The project team organisation was kept under review and re-organised in July 1997 to strengthen the project management function. Additional resources were injected in November 1997. The new organisation has been subject to a number of audits and reviews internally by Devonport Management Limited, by the project sponsor team and by the Nuclear Installations Inspectorate.
4. Rapid progress in the development of procedures and resources for construction management is required - Devonport Management Limited's proposals in respect of Construction (Design and Management) regulations require urgent attention.	Devonport Management Limited's management of construction with respect to Construction (Design and Management) regulations was considered satisfactory to the Department at the time of contract award. During 1997 major recruitment campaign undertaken to address resourcing. Project teams contain experienced construction managers, led by an experienced Director of construction.

3.24 The main construction work is scheduled to begin in March 1998 - some 26 months later than originally planned. The Department originally planned to have the facilities fully operating by August 1999. However, under the contract, the construction of the submarine facilities will not be completed until January 2002, 29 months later than the Department originally planned. The contract will continue to April 2004 as it will only be after using the facilities that the

Department will be able to assess whether they meet operational requirements. The main causes of the delays were the complex contract negotiations, and the Department's need to ensure that Devonport Management Limited would take on the full responsibilities of prime contractor, and as nuclear site licensee, take on some nuclear safety requirements formerly the responsibility of the Department.

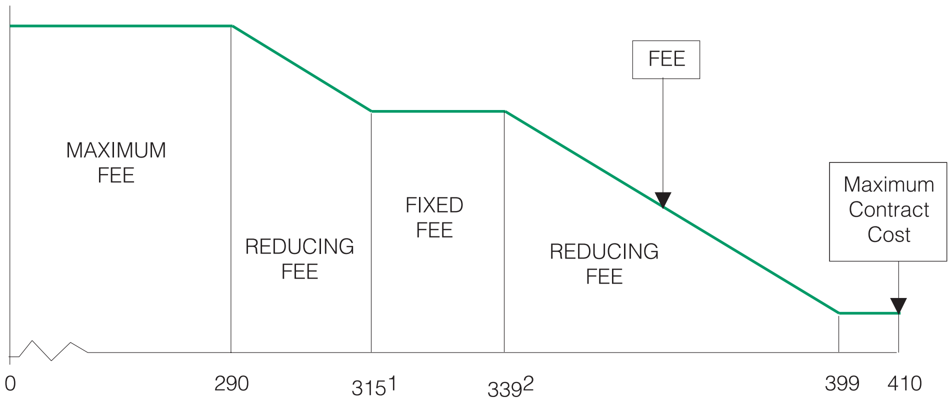
3.25 Before the sales of the dockyards the Department experienced some disruption to their refit programme, having postponed the start dates for Vanguard and Trafalgar class refits, and the delays on D154 have been a contributory factor. Vanguard submarines have extended commissions - more time spent on operations - before refitting, and this has resulted in the need for more maintenance work using the ship lift at Faslane (paragraph 3.20). The Department are also planning to undertake additional work when refitting their Trafalgar class submarines, requiring more time in dock.

3.26 The Department's initial aim was to let a fixed price contract for D154. Given the level of uncertainty in the design and construction, they instead decided to use Fixed Price Incentive Fee arrangements - a maximum price and the opportunity for the contractor to receive a higher fee by containing costs below the target cost. As with all non-competitive contracts, the maximum fee (or profit) is limited by the Government Profit Formula, and the Department have open access to the contractor's financial records. They undertook a number of price investigations as part of the contract negotiations.

3.27 The Department's estimate of the **most likely contract cost** is £315 million, but Devonport Management Limited's own estimate is £339 million. Throughout this cost range, the Department will pay Devonport Management Limited the same fee - although for this cost range there is an incentive for the company to contain costs so as to maximise their fee as a percentage of costs. The Department believe that this arrangement is unique to D154, with none of their other Fixed Price Incentive Contracts having a range of costs where the fee remains constant. Devonport Management Limited's fee will increase the further their costs fall below the Department's estimate of the most likely contract cost. And their fee will decrease the further their costs exceed their own estimate of the most likely cost, and reduce to nothing should the **maximum contract cost** £410 million be reached. The company are liable for cost increases above this figure (Figure 13).

Figure 13

How the Department have incentivised Devonport Management Limited to contain costs for the upgrade project at Devonport - D154



Notes: 1. The Department's estimate of the most likely contract cost

2. Devonport Management Limited's estimate of the most likely contract cost

Figure 13 shows the target cost arrangement for the Devonport refitting and refuelling facilities project - D154. There is a maximum contract cost of £410 million and Devonport Management Limited are incentivised to contain costs below this ceiling. While the Department estimated that the most likely costs would be £315 million, Devonport Management Limited considered that the most likely costs would be £339 million. The Department have agreed that between these two cost estimates they will pay a fixed fee - in this cost range Devonport Management Limited's incentive is to contain costs so as to maximise their return as a percentage of costs.

Source: Ministry of Defence

3.28 The Department have transferred a number of risks, and Devonport Management Limited are liable for all costs incurred over the maximum contract price which are not due to breach or default. However, the contract limits the company's liability for breach or default, and for liquidated damages - in total some 13 per cent of the company's estimate of the contract value. So if the company were to breach the contract, there is a risk that the Department may have to bear the cost of completing the facilities.

3.29 The potential total cost to the Department comprises the contract price, together with the costs of the nuclear adviser and other fees, and their own contingencies (additional costs which the Department may incur in certain circumstances). In analysing the Department's costs, we have excluded their own contingencies as this information could compromise possible negotiations with the company. As Figure 14 shows, when the Department originally sought Treasury approval for the project in 1994, their estimate of the total project costs for D154 was £236 million (£261 million in 1997 prices). In April 1997, following final contract negotiations, the Department estimated the most likely cost to be £417 million - this comprises the Department's £315 million estimate of the contract price, Devonport Management Limited's fees, the costs of the nuclear adviser and Value Added Tax. The Department have obtained Treasury approval for these costs, together with their retained contingencies.

Figure 14

Department's estimates of costs for D154 October 1994 and April 1997

	£m	£m
October 1994 project estimate		**236**
General inflation	25	
Additional inflation for nuclear costs	23	
Profits not included in 1994 estimate	23	
Project management overheads not included	47	
Specification changes and other costs	63	181
Total/April 1997 estimate		**417**

Estimated costs have increased by £181 million, with inflation accounting for £48 million (26 per cent). The original estimate was understated by £70 million (39 per cent) for profits and project management costs. Specification changes and other factors account for the remaining £63 million (35 per cent).

Source: Ministry of Defence

3.30 The Department attribute the cost increase to a number of factors:

a) In taking account of inflation, there are two elements - £25 million for general inflation as measured in the Treasury's inflation index (the GDP deflator), and £23 million for the additional inflation associated with nuclear costs as measured by a separate index covering the nuclear civil engineering sector.

b) The 1994 project estimate was understated by £70 million - £23 million for profits and £47 million for nuclear safety project management costs. The project management costs had previously been included in overheads which the dockyard company would have recovered in their charges for refits. In drawing up their revised cost estimate, the Department wanted to ensure that they had full visibility of all costs, and therefore included these nuclear safety project management overheads.

c) Changes in specifications and other factors account for the remaining £63 million costs increase. Specification changes included making the two non Vanguard submarine docks suitable for refuelling as well as refitting, though the Department deleted the requirement for a contingency docking facility - this is provided at Rosyth (paragraph 3.19(a)). During the design stage additional requirements were identified as the dockyard company sought to demonstrate that the upgraded facilities would meet civil nuclear safety requirements. Also the Department undertook a full risk assessment, and for those risks transferred this is reflected in the contract costs.

Key points

3.31 Key points on the major Devonport project - D154:

a) On D154 contract negotiations have been protracted and have deferred the start of the project by 26 months. The main facilities are expected to be completed in January 2002 - a slippage of 29 months.

b) The Department's most likely cost estimate is £417 million, compared with their estimate of £261 million at the time of the decision to locate the facilities in Devonport. Some £70 million of the cost increase was because the Department excluded profit and project management costs from their 1994 estimate.

c) The Department have transferred significant risks. For example, Devonport Management Limited are the prime contractor and are responsible for ensuring that the nuclear safety requirements are met. The Department have agreed a maximum contract cost and there are incentive arrangements for Devonport Management Limited to contain costs below this ceiling. However, the Department retain some risks, particularly:

1. The Department were not able to negotiate a fixed price contract and the contract is not wholly incentivised - uniquely for the Department's Fixed Price Incentive Fee contracts. The Department will pay a fixed fee throughout the cost range £315 million to £339 million - the Department's and the dockyard owner's estimates of the most likely costs.

2. The Department retain responsibility for the financing of the project up to the maximum price.

3. The Department have agreed an overall limit of some 13 per cent of the company's estimate of the contract costs for Devonport Management Limited's liability. In the event of breach of contract, the Department would bear the additional costs to complete the facilities.

4. The Department have experienced disruption to their refit programme and have had to postpone some refits. They have extended the length of operations and are undertaking more routine repair work.

Lessons learned from earlier work on the Trident Works Programme

3.32 Although the main focus of this report is the dockyard sales, they are inextricably linked with the work to improve refit capability, and that is why we conducted what is a broad review of progress on the related capital projects at both dockyards. In drawing together the results, we noted similarities with the Department's Trident Works Programme (providing operational facilities for submarines on the Clyde, including a shiplift and an explosives handling jetty) which the Committee of Public Accounts reported on (26th Report 1994-95 HC486). Both the Trident Works Programme and the upgrade work at the two dockyards are major capital projects with expenditures of £100s millions. There are similar nuclear safety issues, and the nuclear safety requirements for both have evolved during design. The capital works are also having to dovetail with continuing operations, and there is an operational requirement to have facilities available.

3.33 The Committee of Public Accounts were concerned that the Trident Works programme had not been managed as a strategic whole, that there was not, from the outset, a clearer view of its overall scale and costs, and that the management structures were not suitable. As regards the management arrangements, when contracting for the major upgrade project at Devonport (D154), the Department specifically aimed to apply lessons from the Trident Works Programme (Box 4):

D154 and key lessons learned from Trident Works Programme

Box 4

Safety requirements
Detailed safety report prepared. Devonport Management Limited responsible for ensuring safety requirements met

Interface with operations
Dockyard owner contracted to manage project

Single point of authority
Department appointed single project sponsor as point of contact

Extensive design development
Three years of design development before construction commenced

Identification and management of contingencies
Analysis of risk during contract negotiations. Arrangements to manage contingencies during project

Appointment of nuclear works adviser
Department appointed external nuclear works adviser

3.34 As regards the strategic view on repair and refitting capability, the Department have identified the need to concentrate submarine work at one dockyard and determined that Devonport should be that dockyard. They have sought to transfer risk through the sales of the dockyards, and they have recognised the need to achieve safety standards. Also, the Department see D154, with Devonport Management Limited as prime contractor, as their long term strategic response to providing facilities for submarine refitting.

3.35 On the overall scale and costs of the submarine facilities, the Department have experienced some problems on D154 and related projects which are similar to those experienced on the Trident Works programme. For example, there have been cost increases and delays on some projects (paragraph 3.18), although on the largest project - D154 - the Department consider that they have teased out the cost increases before construction begins, and are confident that the project will be delivered within the target cost. The work to upgrade submarine facilities at Rosyth reflects pressing operational requirements, the need to meet safety standards, and delays in upgrading facilities at Devonport (paragraph 3.12). Thus between the 1993 decision to concentrate all submarines at Devonport and the signing of the D154 contract in 1997, the Department did not have a full appreciation of the overall scale and costs of the work needed to provide future facilities and maintain short term capability for their submarines.

3.36 The Department also have a contractual commitment to provide a permanent non-refuelling facility at Devonport, and are considering whether they need a second facility. In providing permanent facilities, the Department are considering whether there is scope to use those facilities which are already being upgraded for short term use. Hence, there remains uncertainty as regards the overall scale of their requirements.

Key points

3.37 **Key points on lessons learned from the Trident Works project:**

a) Project D154 at Devonport provides the Department's long term strategic goal for permanent refitting and refuelling facilities for submarines. While the Department have sought to learn lessons from previous projects and have contracted Devonport Management Limited to manage the project as prime contractor, there have been cost increases and delays before construction work has commenced.

b) In response to pressing operational requirements, the need to meet safety standards, and delays in facilities at Devonport, the Department have had to change track, extending Rosyth's involvement in submarine work and incurring additional costs for refitting work and upgrade projects. This, together with the cost increases and delays on D154, suggests that the Department have not applied all of the lessons from their Trident Works programme.

Appendix 1

Date	Event	Summary
29 Nov 84	Secretary of State announcement on the location of Trident submarine refitting	Decision to locate new facilities at Rosyth
Feb 85	RD57 approved in principle	Go -ahead for commencement of works brief for new two dock complex, known as RD57, at Rosyth
6 April 87	Seven year term contracts commence	New commercial managers, Devonport Management Limited (Devonport) and Babcock Thorn Limited (Rosyth) take over the running of the dockyards
3 March 88	National Audit Office Report on the Transfer of the Royal Dockyards to Commercial Management	Primarily looked at the changeover process and the prospects for the future
30 Nov 88	Committee of Public Accounts 2nd Report 1988-89 - Transfer of Royal Dockyards to Commercial Management	Made a number of recommendations affecting both the dockyards and refitting generally
July 91	Proposals for future nuclear refitting invited	Reductions in forces and end of cold war led to conclusion that all submarine refitting could be carried out at one site
Nov 91	Initial proposals for future nuclear refitting received November 91	Devonport Management Limited and Babcocks both respond with comprehensive plans. Refinements and revisions are called for before final decisions can be made
21 May 92	National Audit Office Report on the Operation of the Royal Dockyards under Commercial Management	Primarily looked at the performance of the dockyards and the Department's management of the refitting programme
24 May 93	Committee of Public Accounts 39th Report 1992-93 - Operation of the Royal Dockyards under Commercial Management	Made a number of recommendations regarding the management of the refitting programme
24 June 93	Secretary of State statement of proposals for future refitting arrangements	Announcement of proposals for concentrating nuclear refitting at Devonport and surface ship work at Rosyth
8 July 93	Consultation period commenced	Consultation document 'The Royal Dockyards - Future Arrangements for Ship Refitting' issued
11 Aug 93	House of Commons Defence Committee 7th Report 1992-93	Report on the Royal Dockyards focusing on the issue of concentrating nuclear refitting at Devonport

continued ...

Chronology and synopsis of key events and activities

Date	Event	Summary
29 Sept 93	Secretary of State proposals on nuclear refitting venue confirmed	Press notice issued
18 Oct 93	Secretary of State statement on the Future of the Royal Dockyards	Announcement of intention to seek competitive tenders for the sale of both dockyards to the private sector as separate and independent commercial entities
6 April 94	Extension of Term Contracts to present commercial managers	Initial up to two years extensions pending completion of dockyard sales
21 April 94	Secretary of State approval of Sale process	Approval to invite tenders from pre-qualified bidders for the sale of Rosyth and Devonport dockyards as separate entities

Date	Sale of Rosyth Dockyard	Sale of Devonport Dockyard	Major upgrade project at Devonport - D154
July 94	Eleven Stage I Invitations to Tender issued to potential bidders at Rosyth	Twelve Stage I Invitations to Tender issued to potential bidders at Devonport	D154 Phase 2 Invitation to Tender issued
Oct 94	Stage I tender received for Rosyth only from Babcocks	Stage I tender received for Devonport only from Devonport Management Limited	Tender response from Devonport Management Limited and commencement of negotiations. First Pre-Contract Award Evaluation report finds need for considerable improvement in the company's corporate and project management
Dec 94	Evaluation of Babcocks' Stage I Tender	Evaluation of Devonport Management Limited Stage I Tender	Identification of major deficiencies in tender response and protracted negotiations continue
Jan 95	Stage II Invitation to Tender issued to Babcocks	Stage II Invitation to Tender issued to Devonport Management Limited	
Mar 95	Stage II tender received from Babcocks	Stage II Tender received from Devonport Management Limited	Conclusion that company response did not form a suitable basis for further contract negotiations. Second Invitation to Tender issued for D154 and high level meetings emphasise the need for compliance with requirements

continued ...

Date	Sale of Rosyth Dockyard	Sale of Devonport Dockyard	Major upgrade project at Devonport - D154
May 95	Review of Docking Programme and changes to Illustrative Programme - submarine work transferred to Rosyth extending nuclear programme there beyond 2000. Stage III tender requested to reflect new programme	Review caused by docking programme problems at Devonport. In return for losing some submarine refits, the dockyard receives surface warship work. Stage III Tender requested to reflect new programme	
June 95	Formal negotiations commenced with Babcocks		Devonport Management Limited response to second Invitation to Tender. Some improvements but significant non-compliances remain
July 95	Rosyth buy-out of redundancy Terms and Conditions first considered	Formal negotiations commenced with Devonport Management Limited	Department review options on D154, whether to continue with Devonport Management Limited. Unsolicited bid from Babcocks offering revised RD57
Aug 95	Approval of changes to refitting programme and issue of revised Illustrative Programme to Babcocks	Approval of changes to refitting programme and issue of revised Illustrative Programme to Devonport Management Limited	Department continue negotiations with Devonport Management Limited
" "	Stage III tender received from Babcocks	Stage III tender received from Devonport Management Limited	
" "	Rosyth redundancy Buy-out Proposals issued in support of Stage III Tender		
Nov 95			Way ahead for D154 considered. Intensive round of negotiations required with Devonport Management Limited to determine whether it is possible to proceed further
Dec 95		Department decide to continue with sale	Department decide to continue with contract negotiations
Jan 96	Decision to proceed with Babcocks' redundancy and buy-out proposals		
Apr 96		Approval of Devonport Heads of Agreement for sale	Second Pre-Contract Award Evaluation report. Satisfactory progress and Heads of Agreement signed

continued ...

Date	Sale of Rosyth Dockyard	Sale of Devonport Dockyard	Major upgrade project at Devonport - D154
May 96	Babcocks accept Department's right to approve terms of final buy-out terms and that implementation is dependent on completion of sale		
July 96	Workforce ballot accepts redundancy buy-out		End of negotiations on second Invitation to Tender
Oct 96			Third and final Pre-Contract Award Evaluation report.Final contract agreement dependent on compliance with recommendations
Nov 96	Submission advising Ministers of final negotiated agreement for sale and recommending acceptance. Includes Value for Money assessment (5th)		Department make offer of contract to Devonport Management Limited
" "	Final Illustrative Programme issued for Rosyth providing start and completion dates for projects over years 1996-97 to 2005-06 (26th)	Final Illustrative Programme issued for Devonport providing start and completion dates for projects over years 1996-97 to 2005-06 (26th)	Intensive negotiations resulting in pricing agreement for D154
Dec 96	Rosyth Royal Dockyard - Principal Agreement signature (12th)		
Jan 97	European Union clearance for sale (22nd)	Submission advising Ministers of final negotiated agreement for sale of the dockyard and recommending acceptance. Includes Value for Money Assessment (22nd)	
" "	New Vesting Day - Rosyth - Sale complete (30th). Department receive £14.5 million for sale and pay £48.1 million to workforce for redundancy buy-out		
Feb 97		Principal agreement signature (11th)	
Mar 97		European Union clearance for sale (12th)	
" "		New Vesting Day - Devonport - sale complete (13th), Department receive £40 million	Contract award for D154 (13th)

continued ...

Date	Sale of Rosyth Dockyard	Sale of Devonport Dockyard	Major upgrade project at Devonport - D154
May 97			Construction of main Trafalgar and Swiftsure facilities commence
Feb 98			Upgraded Trafalgar and Swiftsure facilities available for first refit
Mar 98			Construction of main Trident facilities commences
Apr 00	End of fixed price agreement for refits. Commencement of target line arrangement for pricing		
00/01	£6 million payment by Babcocks to the Department if 70 per cent of planned allocated workload is delivered to the dockyard and the refit of the aircraft carrier, Invincible, is confirmed		
Apr 01		End of Fixed price agreement for refits, including incentive arrangement for cost reductions. New pricing arrangement based on actual costs to be put in place	
01/02	Nuclear submarine refitting ends	Last allocated major surface warship refit ends	
Jan 02			Facilities available for refitting and refuelling
Apr 04			Contract completion - facilities tested against operational requirements following their use
04/05	Last allocated major surface warship refit ends		
Mar 05			Consents for continued operation
Apr 06	End of Department's liability for redundancy costs and Babcocks retain £6.5 million abatement		

Appendix 2

Summary of Committee of Public Accounts recommendations

Recommendations	Government response	Paragraph reference
A. Operation of the Royal Dockyards under Commercial Management (39th Report 1992-93)	***Treasury Minute Cm 2354***	
1. We note that there have been significant reductions in the Navy's refitting programme since the first term contracts were let and changes to the programme have often occurred at short notice; and these reductions and uncertainty have made it difficult for the commercial managers to operate on a fully commercial basis and improve efficiency (conclusion i); 2. We note that when workloads are reducing, there can be a conflict between the need to obtain value for money by keeping Dockyard resources fully employed and the objective of obtaining greater competition. We also note the Department's view that, faced with a choice, they should pursue value for money before the competition objective (conclusion ii); and 3. We endorse the Department's view that a more stable naval programme would lead to greater efficiencies in the Dockyards, and we recommend that the Department should do all that is practicable to provide the Dockyards in future with the maximum notice for unavoidable changes (conclusion iii).	1-3. The Ministry of Defence shares the Committee's view that there have been significant reductions in the Royal Navy's refitting programme since the first Term Contracts were let and that the Department should aim for a more stable programme. Programme changes have mainly been attributable to Options for Change and to a lesser extent, operations in the Gulf and have led to planning difficulties and labour under-utilisation. This, in turn, has caused conflict between the separate aims of putting 30 per cent of naval refitting work out to competition, and seeking value for money by utilising available Dockyard capacity to the full. The Committee has recognised this dilemma. Nevertheless, the 30 per cent target, albeit on a reduced volume of refitting work, has been met.	1.3, 1.8 and 1.9 2.2 to 2.7 2.35 to 2.40 2.70 3.9 to 3.15
4. We are concerned that poor specification of the work to be undertaken in refits has contributed to difficult contract negotiations, excessive extra work, delays and cost increases. We note the Department believe that tighter control of refit specifications could minimise extra work and their assurance that progress is now being made with new procedures. We consider that faster progress should have been made in nearly six years of commercial arrangement, and we stress the importance of developing tauter specifications without further delay (conclusion vi).	4. The Ministry of Defence notes the Committee's concern regarding the standard of refit specifications. It does not agree, however, that faster progress towards tighter control of refit specifications could have been achieved earlier. Prior to Vesting Day (6 April 1987), neither the Ministry of Defence nor the contractors had a great deal of experience in writing complex warship refit specifications, and improvements therefore had to be made from a very low baseline. The Ministry of Defence now has in hand two specific initiatives which will involve the contractor in pre-refit planning by giving him broader guidance of the end product and allowing him to provide the detail of how work should be carried out. These initiatives are in the course of being applied and evaluated.	2.35 to 2.40
5. The system recovering Dockyard labour and overhead costs has not been effective. We recommend that the Department's first priority should be to ensure that overhead recovery rates are agreed in advance of the start of each year (conclusion viii).	The Ministry of Defence shares the Committee's view that late agreement of the Dockyard companies' rates works to the companies' advantage by minimising risk. However, rates have to be agreed based upon the total forecast workload and attendant costs for the year and a balance must be drawn between the need for early agreement and the availability of information on which to reach such an agreement. Disagreements on the size of the workload, in the face of a reducing programme, have also made it difficult to agree rates before the financial year of application. The rates for 1993-94 were agreed in May 1993 and it remains our objective to agree rates before the start of each financial year.	2.25 to 2.34

continued ...

Recommendations	Government response	Paragraph reference
B. Management of the Trident Works Programme (26th Report 1994-95)	***Treasury Minute Cm 3013***	
1. We are gravely concerned at the scale of the cost increase which has occurred on the Trident Works Programme (conclusion i). 2. We note the Department's explanation that the projects were commenced in the greater hurry ... and that this haste proved to be unwise; that ... risks involved were clearly under-estimated at the start; and that risk management was poor by current standards (conclusion ii).	1-2. The Ministry of Defence (the Department) regrets the scale of the cost increase over the original estimate and would not seek to excuse it. The programme was launched with a sense of urgency which was heightened by the various external delays to which it was subjected.	3.16 to 3.37
3. We are seriously concerned that the Department and the Property Services Agency did not take timely action to introduce adequate management structures and practices (conclusion iv). 4. We are concerned that the programme … was not managed as a strategic whole and that there was not, from the outset, a clearer view of its overall scale and content (conclusion v).	3-4. The Department accepts the thrust of the Committee's conclusions. It acknowledges that the structures and systems set in place for running the technologically and managerially challenging Trident Works Programme, although an advance on the arrangements normally adopted at that time for more orthodox projects, were less satisfactory than present day methods and did not facilitate the management of the programme as a strategic whole.	3.23 and 3.32 to 3.37
5. We note that contractors frequently failed to provide full visibility or explanation of increases to their original estimates. We are very concerned that the contractors were not generally constrained by any pre-agreed maximum final price (conclusion vii).	5. The Department welcomes the Committee's acknowledgement of the failure of contractors to provide full visibility or explanation to their original estimates. It regrets that on this occasion it was not possible to hold contractors to a pre-agreed price because of the need, inter alia, to meet evolving safety standards during construction.	3.27
6. We are not convinced that the way that the large contingency fund was managed was conducive to strong financial control or to the achievement of value for money (conclusion viii).	6. The Department notes the Committee's conclusion. The purpose of retaining a central contingency was to enable calls upon it to be scrutinised independently of the management of the individual projects, thereby, it was hoped, conducing to financing control and value for money. The Department considers that the systems of control now in place offer a more effective means of achieving those objectives.	3.29
7. We note the Department's assurance that they would now exercise financial control in a substantially different way. But it is clearly necessary that better arrangements are put in place from the outset on future work programmes to identify and control time, cost and quality aspects (conclusion xi).	7. The Department accepts the Committee's conclusion. Existing guidance to project sponsors on works programmes includes the need for arrangements to be in place from the outset to identify and control time, cost and quality aspects.	3.22 to 3.31
8. We are surprised that ... the Property Services Agency continued to use a form of contract acknowledged to be inappropriate for such circumstances. ... We note the Department's assurance that they would not adopt such a contract strategy on future works programmes; and we look to them to ensure that future contract strategies clearly address risk management (conclusion xii).	8. The Department and the Property Services Agency note the Committee's conclusion. The form of contract used was familiar to industry as the standard one for Government works contracts and no other form appropriate to the circumstances existed at that time. The Department confirms that risk management is now an integral feature of both its equipment and work project arrangements.	3.22 to 3.31

continued ...

Recommendations	Government response	Paragraph reference
B. Management of the Trident Works Programme (26th Report 1994-95)	***Treasury Minute Cm 3013***	
9. We are concerned that control over design changes ... was weak and that the Department's efforts to introduce a design freeze had only limited effect. We look to the Department to ensure that adequate arrangements are established to prevent this problem from occurring on future works programme (conclusion xiii).	9. The Department accepts generally the Committee's conclusion and regrets that control over design changes was not fully effective.	3.22 to 3.31
10. We recognise the importance of meeting target operational dates but we are not convinced that there was a proper and continuous evaluation of the costs of trying to achieve those dates compared with the operational disadvantages of not meeting them (conclusion xvi).	10. The Department notes the Committee's conclusion but would observe that when, in 1990, it became clear that the costs of completing the works programme in phase with the in service date of Trident would exhaust the contingency, the Department did consider whether the in service date should be deferred. Such a measure would have necessitated the retention in service of the ageing Polaris system. The conclusion was reached that such a course would carry with it potential safety and financial consequences which were less acceptable than the costs of proceeding with the existing programme.	3.22 to 3.31
C. Asset Sales - Various Reports Relevant to the Dockyard Sales	***Sale of the Scottish Bus Group Cm 2602*** ***English Estates: Disposal of Property Cm 2618*** ***The Sale of the British Technology Group Cm 2677*** ***Disposal of New Town Assets Cm 177***	
1. We note that the trustees not only secured significant benefit improvements for members but generated a large surplus which will be paid into the Exchequer. To protect the taxpayer's interest in future sales where pension funds are involved we recommend that departments take early professional advice on all relevant matters such as members' benefits and the disposal of any actuarial surpluses. (21st Report 1993-94, paragraph 4(x), HC 97 - Sale of the Scottish Bus Group)	1. The Department accepts that early professional advice should be taken on all relevant pension matters. The Government Actuary's Department was appointed in April 1989 and was fully involved in all aspects of pension arrangements from that date. This enabled the Government Actuary's Department to advise on the proposed arrangements for the pension funds and to confirm final decisions. The Department considers that the date of the appointment did not adversely affect the outcome of these matters and, in particular, is satisfied that the entitlements of members have been safeguarded and that the position of the taxpayer was protected.	2.60 to 2.64
2. We are concerned that £787,000 was spent on work which was not subjected to competitive tender. While we note the Department's reasons for dispensing with competition in this case, we emphasise the need for proper control of costs in the sale of public assets. In particular we look to departments to demonstrate propriety and the achievement of value for money through competitive tendering. (21st Report 1993-94, paragraph 4(xiii), HC 97 - Sale of the Scottish Bus Group)	2. The Department strongly endorses the Committee's view on controlling the costs of the sale of public assets and the use of competitive tendering. The Department appointed its advisers in open competition and in accordance with Treasury guidance. The £787,000 spent which was not subject to competitive tendering related to additional work connected with the main contracts which required a high degree of familiarity with the Group's business and which were inappropriate for parcelling into larger contracts for competitive tendering. The Department believe that, in these circumstances, efficiency and value for money were achieved through the Group's limited use of such firms.	2.8 to 2.15

continued…

Recommendations	Government response	Paragraph reference
C. Asset Sales - Various Reports Relevant to the Dockyard Sales	***Sale of the Scottish Bus Group Cm 2602*** ***English Estates: Disposal of Property Cm 2618*** ***The Sale of the British Technology Group Cm 2677*** ***Disposal of New Town Assets Cm 177***	
3. We reiterate the principle that assets should be sold in competition unless there are compelling reasons to the contrary. It is not only that this is generally the best way of securing the highest price: it also helps demonstrate that public assets have been sold transparently with due regard to probity. (22nd Report 1993-94, paragraph 3(iv), HC 210 - English Estates: Disposal of Property)	3. The Government fully accepts the principle that public assets should be sold in competition unless there are overriding reasons for not doing so....	2.8 and 2.9
4. We ... recommend that the case for selling property subject to clawback conditions should be considered on its merits in each case. (22nd Report 1993-94, paragraph 3(v), HC 210 - English Estates: Disposal of Property)	4. The Department accepts this recommendation which accords with the practice being adopted by English Partnerships...	2.22 to 2.24
5. We note that English Estates calculated the costs of sale to be a very low percentage of proceeds. However, their estimate is an approximate one. We therefore emphasise, without wishing to add to administrative burdens, the importance of a record of sale costs that is sufficiently accurate for management to be able to identify main trends. (22nd Report 1993-94, paragraph 3(vii), HC 210 - English Estates: Disposal of Property)	5. The Department accepts the importance of identifying main trends in the costs involved in selling the portfolio. External costs of sales through agents are monitored and kept to a minimum, and the costs of the overall estates management function are monitored within the management accounting system and reviewed in line with changes in the size of the portfolio. This enables management to identify main trends. Separate internal costs of sales could not be split out without administrative effort and cost disproportionate to the value of the information to management.	2.12 and 2.13
6. . . . we are concerned that it was only the two consortia that the Department invited to proceed to the final bidding stage who were subsequently given access to the revenue projections for certain technologies ... we consider it an important principle that all serious bidders should, as far as possible, be given as much information as is needed to ensure that there is fully informed competition among bidders. (32nd Report 1993-94, paragraph 2(iii), HC 273 - The Sale of the British Technology Group)	6. The Department agrees with the Committee's conclusion. The Department believes that all serious bidders should be given as much information as is necessary to encourage informed bids. A balance must be struck ... Initially, only general information is given to enquirers. Later, those who are asked to submit final bids are given as much information as can be released, within any legal constraints. Where management participation in a bid occurs, the Department strives to release as much information as possible to ensure fairness.	2.8
7. We underline the importance that sales are backed up by up-to-date valuations, particularly in marriage value transactions and in cases where delays occur in the course of negotiations. (10th Report 1986-87, paragraph 17, HC 234 - Disposal of New Town Assets)	7. The revised guidance makes clear that revaluations should be undertaken where negotiations become protracted or where the market shifts significantly.	2.18 to 2.21

Photographs and maps of the Royal Dockyards

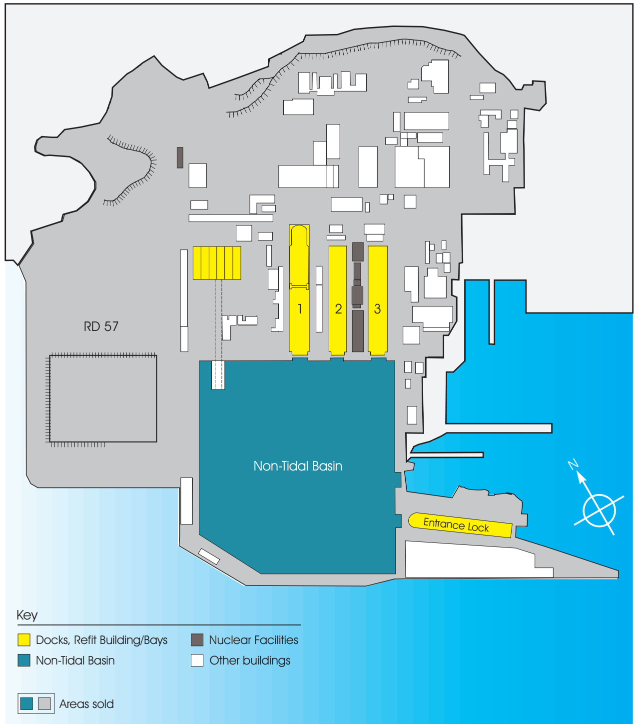
All maps and photographs courtesy of the Ministry of Defence

Devonport Royal Dockyard

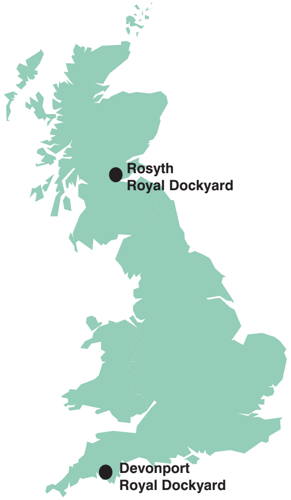
A submarine entering a dock at Devonport Royal Dockyard.

Aerial view of Devonport Royal Dockyard looking south east. The submarine refit complex and refuelling crane are shown astride two dry docks (Nos 14 and 15) in the middle of the photograph in the bottom right hand corner of the main basin (No 5 basin). The frigate refit complex and covered dry docks are in the top of the photograph. A number of frigates and destroyers can be seen berthed on the jetties of the Naval Base, not part of the dockyard, in the bottom of the photograph.

Aerial view of No 5 basin looking north showing the largest dry docks at Devonport Royal Dockyard. The D154 project embraces the upgrade of the middle dry dock (No 9), together with the two dry docks (Nos 14 and 15) partially visible in the top left hand corner of the photograph. Upgrade work is also underway on No 10 dock, on the left of the photograph.



Aerial view of Rosyth Royal Dockyard looking east towards the Forth Road and Rail bridges. The photograph shows the main basin, the entrance lock (RD 46), and the large excavations which were part of the discontinued RD 57 project.



HMS Newcastle, a type 42 destroyer, undergoing a refit at Rosyth Royal Dockyard.

Aerial view of the main basin at Rosyth Royal Dockyard looking north. The existing submarine refit complex is between the two dry docks (Nos 2 and 3) in the top right. The ship lift and refit sheds are in the top left.