Ministry of Defence:
Transfer of the
Royal Dockyards to
Commercial Management
This report has been prepared under Section 6 of the National Audit Act, 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

John Bourn
Comptroller and Auditor General

The Comptroller and Auditor General is the head of the National Audit Office employing some 900 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies use their resources.
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Summary and conclusions

Background

1. Between 1971 and 1982 the Ministry of Defence (MOD) considered five major reports on the issues and difficulties involved in improving the efficiency of the Royal Dockyards. A further review in 1984 led to the announcement by the Secretary of State for Defence (Secretary of State) on 23 July 1985 that the Government’s preference for the future operation of the Royal Dockyards was commercial management rather than a trading fund or privatisation. Subsequently, under the provisions of the Dockyards Services Act 1986, the Dockyards at Devonport and Rosyth were transferred from MOD management to commercial management on 6 April 1987. The commercial managers, Babcock Thorn Ltd (at Rosyth) and Devonport Management Ltd (at Devonport), were appointed in January and February 1987 respectively, following competitive tender exercises. A new customer organisation was established in the MOD under the Director General Ship Refitting (DGSR).

2. In their 21st Report of Session 1985–86 (HC 286), the Committee of Public Accounts (PAC) followed up their earlier Reports on Dockyards matters by reviewing the progress made by the MOD in improving the efficiency and cost-effectiveness of the Dockyards under existing management. They also noted, in connection with the proposals for commercial management, that there were still considerable uncertainties in the castings produced by the MOD in support of this course; at PAC’s request the MOD supplied them with further castings in December 1986 and January 1987.

3. The National Audit Office (NAO) have examined the introduction of commercial management to determine:
   - whether it was properly managed so as to protect the taxpayer’s interests; and
   - whether the Government’s objectives of greater Dockyard efficiency, maximum competition and better value for money (VFM) are likely to be achieved.

I intend to provide the PAC with further details to supplement this Report on a confidential basis.

Implementation of commercial management

Constraints and difficulties

4. The MOD’s planning for the introduction of commercial management necessarily began before legislation was enacted. In April 1985 they established a Dockyard Planning Team and set up Working Groups to make recommendations on nineteen areas affected by the proposed changes (paragraph 3.3). The planning and consequent action had to be carried out in the restricted time allowed by the Government’s decision that Vesting Day should be in April 1987. They had to contend with opposition and non-cooperation from the Trade Unions in the Dockyards, while interim management measures were in progress to improve efficiency and productivity. Moreover, during the planning period, significant reductions were made in the future Naval refit and repair
programme and the Dockyards suffered serious losses of experienced staff to meet urgent requirements on the Trident programme or to fill new MOD posts created to deal with commercial management (paragraph 1.9).

Selection of managers
5. The process of selecting and appointing commercial managers began in January 1986 and took over a year to complete. A pre-tender qualification exercise was followed by tendering and the evaluation of responses by a specially constituted Tender Board and Tender Panels. Their reports to Ministers were followed by contract negotiations with the selected potential managers. For Rosyth these concentrated on Babcock Thorn but negotiations for Devonport involved two consortia. The NAO found that some information required by the Invitation to Tender and relevant to evaluation was missing from some bids and was not obtained during negotiations. In selecting the eventual contractors the Ministry had to exercise an element of subjective judgement and although they had devoted much effort to the evaluation of the potential managers, changes in the composition of one consortium resulted in a different management group from that which tendered. However, all members of the final consortium are substantial companies of international repute (paragraphs 2.1 – 2.12).

Outcome of implementation

Situation at Vesting Day
6. Commercial management was introduced on the date planned, but because of the short lead-time, some of the new procedures and information systems necessary to control work and place fixed and incentive price contracts were not fully operational at Vesting Day; early in 1986 the MOD had estimated that some of the systems involved would normally take three or more years to plan and introduce. Moreover, the commercial managers had a shorter period of working alongside the existing Dockyard management prior to Vesting Day than the MOD thought necessary (paragraphs 3.10 – 3.13).

Risks to the taxpayer from implementation problems
7. Delays and poor quality of work during the preparation period were reported on many projects. A formal Board of Inquiry on one submarine refit was told by Dockyard Management that their overriding concern with the transfer to commercial management, and skilled staff shortages, had contributed to serious deficiencies which occurred during the refit. However the Board concluded that these factors had not caused deficiencies but might have contributed to failure to identify the problem (paragraphs 3.16, 3.17).

8. Unreliable records and staff shortages made it impracticable for the MOD to assess accurately the work remaining to be done by the Commercial Managers on jobs in progress at Vesting Day and the Ministry therefore found it difficult to negotiate risk prices for the relevant high value contracts (paragraph 3.14). There were also deficiencies in the records of the MOD owned assets, although the MOD informed the NAO in January 1988 that these had been corrected (paragraphs 5.3 – 5.5). MOD’s internal auditors reported that large quantities of MOD-owned materials remaining in the Dockyards at Vesting Day had not been formally accounted for (paragraph 3.15). The MOD informed the NAO that they had now taken action to remedy this. Staff shortages impaired DGSR’s ability to monitor satisfactorily the quality of Dockyard work (paragraph 3.7).
9. Former Dockyard management considered that the initial absence of new procedures and information systems (paragraph 6) would add to the time needed to achieve efficiency improvements and the introduction of full risk pricing. This will be reflected temporarily in the prices of Dockyard work but it should have been taken into account in the commercial managers’ business plans and financial projections (paragraph 3.13). A computerised system developed to meet DGSR’s internal planning and control requirements was not fully operational during 1987. This seemed likely to restrict temporarily the effectiveness of DGSR as the customer organisation (paragraph 3.8).

10. The risks arising from the initial problems described above must, of course, be weighed against the benefits of allowing the commercial managers to make an early start on introducing the changes which the MOD expect to produce greater efficiency in the long term.

**Impediments to good value inherent in commercial management arrangements**

11. Taking account of staff attached from other parts of the MOD, the new customer organisation, DGSR, is more than three times the size of the previous Dockyards headquarters organisation. Nevertheless, the NAO noted that MOD staff at one Dockyard felt that DGSR was not always able to respond quickly to problems arising on MOD work in the yards because most of the staff were in Bath; the MOD are reviewing the balance between headquarters and local staff (paragraphs 3.4–3.7).

12. The commercial managers’ freedom of action is limited by their being partly tied to MOD support organisations. Like other yards, they must obtain ships’ weapons systems through the Navy procurement organisation and certain materials for MOD work from the Dockyards’ traditional suppliers, the Navy supplies organisations, on free issue. They have agreed to obtain other material and stores from the supplies organisation on repayment, unless they can show that they can secure terms elsewhere which the supplies organisation cannot match, in which case arrangements satisfactory to the MOD must be agreed for running down Navy stocks (paragraphs 4.2–4.4). The MOD also provide material management, transport and marine services on repayment (paragraphs 4.5, 4.7, 4.8).

13. The commercial managers pay annual licence fees for use of the Dockyards’ fixed assets. These are based on commercial hiring rates, although the Treasury would have preferred them to be based on the costs of ownership of the assets to avoid giving the commercial managers, in effect, a subsidy and a possible advantage over their competitors. The MOD do not accept however that there is a subsidy to the commercial managers, who themselves regard the licence fees as excessive (see paragraphs 18, 5.8–5.9). On the customer side, the NAO believe that the arrangements adopted for charging for unprogrammed Dockyard work do not tell the Naval customers the full costs of their demands (paragraph 4.10).

14. It appeared to the NAO that in entering into voluntary agreements with the MOD organisations the commercial managers had recognised the advantages of initially making use of existing supply organisations. Such arrangements are also of benefit to the organisations concerned. In the
NAO’s view, the terms of the agreements are such that while they operate, the commercial managers will be restricted to some extent in obtaining better value for money through competitive procurement. The MOD see these agreements as beneficial to them and the Navy. However, their longer term value remains to be seen and there are provisions for their termination. The MOD considered the possible transfer of materials management staff to the commercial managers along with Dockyards staff, but rejected it because of its effect on the service provided by the Royal Naval Supply and Transport Service (RNSTS). In the NAO’s view the transfer option might have allowed the most effective arrangements for purchase of materials, which constitute a large element of Dockyard expenditure (paragraphs 4.4 – 4.6).

Achievement of objectives

Dockyard efficiency

15. The term contracts specify performance improvement targets. The contractors are not contractually committed to these but they will be taken into account in the pricing negotiations of contracts for individual jobs (paragraph 6.2). The prospects for improving efficiency have been made more difficult by significant reductions in the future Naval repair and refit programme. Those made before the term contracts were let will have been taken into account in the commercial managers’ business plans on which the term contracts were based (paragraphs 6.6 and 6.7). Those arising since Vesting Day and the longer time now expected to be needed to move to full incentive pricing (paragraph 6.3) will make it more difficult for the commercial managers to achieve the productivity and efficiency gains suggested in tendering and pre-Vesting Day castings.

Competition

16. The competition for the commercial management contracts resulted in three tenders for each Dockyard after the initial stages. In the NAO’s view the value of the competition was limited by the impracticability of obtaining contractual guarantees of improved Dockyard performance, although the arrangements outlined in paragraph 15 should enable the MOD to exert pressure in individual contract negotiations to obtain improvements in efficiency.

17. For the foreseeable future, most of the Dockyards’ workload will be allocated to them on a non-competitive basis, with only one warship refit planned to be open to competition during the term contracts. The scope for competition has been severely restricted by the falling workload and in the NAO’s view is likely to remain restricted unless the MOD reduce the size of the core programmes and are prepared to have genuine competition involving privately owned yards for a substantial part of the Naval refit programme. The Department of Trade and Industry have expressed concern at the MOD’s decision to give the Dockyards some work previously undertaken by private shipyards (paragraphs 6.5 – 6.10).

Value for money

18. The castings supporting the choice of commercial managers which the MOD supplied to the PAC compared the estimated differences in costs between the alternative management options from Vesting Day and continued MOD management. Those for commercial management were based on the contractors’ forecasts of efficiency improvements. They contained many uncertainties and some assumptions which may no
longer be valid in view of programme changes. The costings assumed savings in the cost of Dockyard assets under commercial management of £96 million over seven years. This was on the basis that: it would have been unfair to have charged the commercial managers, who are in competition with other private sector firms, more than the commercial value of the assets; MOD investment in fixed assets, as proposed by the commercial managers, will be in future, and would have been in the past, limited to the business value of those assets; and the MOD expect this to produce substantial savings. In the NAO's view this assumption was unjustified since the commercial managers will continue mainly to use assets which have already been paid for by the MOD and future savings on the scale claimed will be difficult to achieve. Some other costs and savings, which in the NAO's view could have been regarded as counting against the commercial management option, were not included in the costings (paragraphs 6.11–6.23).

19. The NAO concluded that these factors threw considerable doubt on whether savings would have been achieved on the scale forecast, unless the commercial managers achieved greater improvements in efficiency than expected. The picture underlying the costings has now been overtaken by further reductions in workload; and a current assessment of the value for money likely to be obtained from commercial management would require such a degree of speculation about what would have happened under alternative, including MOD, management as to make it not worthwhile (paragraph 6.23).

Monitoring of performance

20. The MOD told the PAC in 1986 that they intended to produce an Account that showed a proper comparison between the costs of Dockyard operations under different management regimes. The MOD have encountered difficulties in devising statements which would allow worthwhile comparisons to be made (paragraphs 6.24–6.28). A refits comparison exercise involving commercial yards carried out by the MOD has illustrated the difficulties of making comparisons of individual ship refits (paragraph 3.2).

General conclusions

21. The MOD, in face of serious difficulties, succeeded in introducing commercial management on time. Legislation was enacted. Term contracts were negotiated on the basis of competitive proposals. Contracts for provision of supplies and services to and from the Dockyards were let. MOD organisations and procedures were established or revised. Personnel problems were overcome. However there were some immediate difficulties and reductions in Naval workload have now made it much more difficult for the expected benefits of commercial management to be achieved, especially at Devonport, without substantial commercial orders, which may be difficult to secure. The reduction in programmes would, of course, have affected any option for management of the Dockyards. The MOD have invested substantial amounts in setting up commercial management and have significant continuing commitments on customer and other support organisations. For this to pay off, these costs must be saved by increased efficiency on a diminishing Dockyard turnover: a formidable task, but one that has been achieved or surpassed in the past by some other parts of UK industry.
Part 1: Introduction and Background

1.1 Between 1971 and 1982 the Ministry of Defence (MOD) considered five major internal or independent reports dealing with the issues and difficulties involved in improving the efficiency of the Royal Dockyards. These arose from the need to satisfy the Navy’s operational requirements whilst achieving the objectives of efficient Dockyard management and use of resources; from the special factors inherent in the nature of warship refit and repair; and from the problems of assessing Dockyard productivity and performance. In their 22nd Report of Session 1983-84 (HC 342) the Committee of Public Accounts (PAC) noted that there appeared to have been little real progress or effective action on the basic issues involved and yet a further review had begun.

1.2 The further review was by the then Secretary of State’s personal adviser, Mr P K Levene, who stated in his report in February 1984 that his preferred solution to the problems was to keep Dockyard capital under Government control whilst moving the operation into the private sector by means of an agency arrangement. Such an arrangement would be somewhat along the lines of the United States Government Owned/Contractor Operated system for defence industries. This report led to the publication of Defence Open Government Document (DOGD) 85/01 in April 1985, which made clear that the Government was not prepared to leave the Dockyards under their present structure and system of management and considered the options for their future operations.

1.3 In their 24th Report of Session 1984-85 (HC 440) the PAC reviewed the progress being made by the MOD in improving performance under MOD management and expressed doubts about the MOD’s costings of the options set out in DOGD 85/01. The Secretary of State announced on 23 July 1985 that the Government was not prepared to leave the Dockyards under their present structure and system of management and considered the options for their future operations.

1.4 In their 21st Report of Session 1985-86 (HC 286), the PAC further reviewed the progress made by the MOD in improving the efficiency and cost-effectiveness of the Dockyards under existing arrangements and MOD’s costings in support of the proposed introduction of commercial management. The Committee noted that there were still considerable uncertainties in the costings and asked to be supplied with further costings as they were produced.

1.5 The Dockyard Services Act 1986, providing for the transfer to contractor provision of Dockyard services, was passed on 25 July 1986. On 4 December 1986 and 20 January 1987 respectively the Secretary of State informed Parliament that there existed the basis for advantageous contracts to be placed with Babcock Thorn Ltd (BTL) and Devonport Management Ltd (DML) for the future operation of Rosyth and Devonport Dockyards. Both were transferred from the MOD to commercial management on 6 April 1987.

1.6 At each Dockyard an Employing Company employs the workforce and holds the licence to operate the assets, while an Operating Company, BTL or DML, holds a seven year term contract for the commercial management of the Yard. During the period of each term contract the Employing Company becomes a wholly owned subsidiary of the Operating Company. Individual jobs for the MOD are each the subject of a separately negotiated contract with the Operating Company. The Secretary of State has a nominal holding in the Employing Companies to allow him to exercise certain control in their affairs and to give him a veto on any action that he may feel would be against the national interest.

1.7 In their 21st Report 1985-86 the PAC noted my intention to produce a Report for Parliament on the MOD’s arrangements for implementing commercial management. This Report records the results of the National Audit Office (NAO)’s examination of these arrangements. The NAO looked for evidence of

- whether the MOD organised the introduction of commercial management so as to protect the taxpayer’s interests; and
- whether the Government’s objectives of greater Dockyard efficiency, maximum competition and better value for money (VFM) are likely to be achieved.

1.8 The NAO do not have access to the commercial managers’ accounts and costing records; their examination was based mainly on examination of MOD records and discussions with MOD officials, including those located at Devonport and Rosyth.
The NAO had full access to local Dockyard management until Vesting Day; after this they had access only for the purpose of auditing the final Dockyard Operating Accounts for 1986-87.

1.9 The MOD's planning and action to introduce commercial management were carried out against the background of the Government's decision that Vesting Day should be in April 1987, allowing the Ministry less than two years to introduce all the necessary changes. These included the establishment of a customer organisation in the MOD, and affected other organisations in the MOD and the Property Services Agency (PSA). The Dockyard Trade Unions refused to co-operate in making the changes and significant reductions in the Navy's future refit programme occurred during the planning period. In addition a large proportion of the staff for new MOD posts resulting from commercial management were transferred from the Dockyards, which were also required to provide technical staff to overcome shortages elsewhere of key staff for the Trident project. This led to shortages in the Dockyards among the most skilled and experienced staff. Despite these problems, the MOD achieved their objective of implementing commercial management in April 1987. However, as indicated in this Report, the MOD were unable to complete all the necessary actions to ensure a fully satisfactory situation both for the MOD and the commercial managers at Vesting Day.
Part 2: Selection and Appointment of Managers

2.1 The process of selecting and appointing commercial managers began in January 1986 and took over a year to complete. It started with a pre-tender qualification exercise involving 19 firms who had previously expressed an interest in managing the Dockyards. Following evaluation of the 12 responses and elimination of unsuitable proposals, the MOD were satisfied with the degree of competition at Rosyth but considered that the overall prospects for competition at Devonport were "worryingly low". However the position changed in Summer 1986, as two firms withdrew and two were added to the tender list, leaving three potential tenderers for each Dockyard. The MOD appointed management consultants to develop proposals for Government Owned public limited companies (GO plcs) to be used for comparison with commercial tenders and as potential fallback positions if satisfactory agreements could not be negotiated with commercial managers.

The Tender exercise

2.2 The invitation to tender was issued to potential bidders on 3 April 1986 for reply by 1 August 1986, subsequently extended to 29 August 1986 for Devonport to allow a late entry, which was accepted for consideration. The invitation documents included planned maintenance schedules, which were to be fully priced, and two alternative production programmes showing a declining workload at each yard. The invitation requested quotations for manhour rates by trades, tariff rates for a variety of tasks and a seven year business plan, with an assessment of commercial market potential. It emphasised that the principles of VFM, competition, and a commitment to the introduction of risk pricing for all defined packages of work as quickly as possible were essential elements of MOD's strategy and tender evaluation.

2.3 Samuel Montagu and Co Ltd, the merchant bankers advising the MOD, recognised that obtaining VFM was one of the Government's main objectives and suggested that a scoring system under four broad categories, one of which was VFM, be used to serve as a focus for discussion about the relative importance of each evaluation criterion. The detailed marking scheme actually used differed significantly from that recommended by the consultants. The MOD decided that VFM would not be assessed separately but be picked up under other categories. In the NAO's view the development of the final weightings led in general to more weight being given to compliance with the required contract terms and less to financial standing. The MOD told the NAO that the bidders had already informally indicated that they would be unable to produce a full financial response to the Invitation to Tender, and this influenced the weighting given to this factor, but the MOD were satisfied that the selected contractors were financially robust enough to support the contracts.

2.4 The categories finally used were: Corporate, Financial and Organisation (25 per cent weighting); Dockyard Programme and Operation (40 per cent); Personnel (15 per cent) and Contractual and Pricing (20 per cent).

The Tender Board and Tender Panels

2.5 The tenders were evaluated by a specially constituted Tender Board and Tender Panels. The former consisted of four senior MOD officials, each of whom chaired a Tender Panel responsible for assessing tenders under one of the four evaluation categories (paragraph 2.4). The Panels, including eight consultants, a PSA representative and 40 MOD officials, evaluated the submissions in closed session from 4 August 1986 until the exercise was completed in early October 1986. Overall up to some 80 people were involved, including ancillary staff, some on a part-time basis.

2.6 Some of the information required by the Invitation to Tender and relevant to evaluation was missing from some bids. The MOD sought written clarification on certain aspects of the bids from the tenderers, who also gave presentations on their tenders. Nevertheless, there remained certain deficiencies, such as the precise ways in which efficiency improvements were to be secured. The MOD agreed that such information deficiencies could be rectified after award of contract when better access to the Dockyards could be obtained during parallel running. However, compression of this period (paragraph 3.10) reduced the ability of the successful contractors to obtain the necessary information. Moreover, the MOD informed the NAO that the Trade
Unions had refused, throughout the tender period and up to Vesting Day, to allow any detailed access to Dockyard facilities by the companies. The Ministry confirmed that all these constraints had caused them to exercise an element of subjective judgement in selecting the eventual contractors.

**Tender Board conclusions**

2.7 The Tender Board produced a report on the evaluation for each Dockyard and a recommendation on the further negotiations it considered necessary. For Rosyth, the conclusion was that BTL offered a much better prospect of a satisfactory commercial operation than the other tenderers, Balfour Beatty Weir Ltd and Press Offshore Group, although some further hard negotiations, mainly on pricing, were necessary.

2.8 For Devonport the Tender Board recommended negotiations with Devonport Management Ltd (DML) and Devonport Operations Ltd (DOL), although they considered both needed to make improvements in their approach to the operation of the Dockyard. The Board decided that Devonport Dockyard Ltd (DDL), formed by existing local management, were significantly behind the leaders and unlikely to make sufficient improvement to allow them to be treated as an equal competitor, although they were exploring the possibility of additional commercial support. Two areas in which DDL scored poorly were their financial standing and lack of commercial experience, although other factors were taken into account in the final decision. The MOD had decided before the tendering that DDL should not be allowed to take an industrial partner because that consortium would then be in an unfairly advantageous position.

**Post Tender Board events**

2.9 For Rosyth, contract negotiations lasting five weeks were concentrated on BTL and led to the signing of a seven year term contract on 27 January 1987. There has been no change in the composition of the BTL consortium but its major partner, Babcock International, was taken over in August 1987 by FKI Electrical who had taken no part in the competition.

2.10 For Devonport, negotiations with DML and DOL lasted two months and resulted in the selection of DML; this represented a reversal of the position at the start of negotiations, reached without the MOD considering a formal Tender Board marking exercise to be necessary. During the negotiations the composition of the DML consortium — led by a subsidiary of an American owned company — changed as follows:

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(x) The withdrawal of Vickers (D&P) followed their merger with Brown and Root.

(y) The composition of the consortium changed on 20 January 1987 and then met the foreign control requirements defined in the Invitation to Tender. DML decided to use Lazard as their merchant banking adviser, and they brought Barclays De Zoete Wedd into the consortium to hold the employee trust shares and to provide access to Barclays Bank plc for working capital. Later on 20 January the Secretary of State announced that DML was the preferred contractor for the future management of Devonport Dockyard.

(z) Shortly before the Secretary of State’s announcement on 24 February 1987 that a seven year term contract for Devonport was being signed that day, DML further changed their consortium by bringing in BICC, the parent company of Balfour Beatty. The reduced Barclays De Zoete Wedd holding was to be used to establish a trust fund for senior employees and management of DML or the subsidiary Employing Company.

2.11 The effect of these changes was that, of the members of the original consortium who submitted the successful tender, only Brown and Root remained. A 60 per cent interest in DML is now held by companies who tendered unsuccessfully for Rosyth Dockyard.

**Term contracts**

2.12 The seven year term contracts held by BTL and DML require them to manage, operate and maintain
the Dockyards, to undertake all work placed by the MOD and to make the best use of Dockyard facilities; and they encourage them to seek commercial work in pursuit of this. The contracts specify the corporate framework (paragraph 1.6) within which the Dockyards will be managed; provide an illustration of the envisaged programme of defence work; and indicate the percentage improvements in efficiency expected as a basis for pricing individual jobs, although without making them contractually binding.
Part 3: Preparation for Commercial Management

Progress of the MOD's measures to improve efficiency

(i) The interim management measures

3.1 The interim management measures introduced by the MOD to improve efficiency under the existing MOD management aimed at a 15 per cent reduction in the Dockyards' costs through higher productivity and better use of resources, involving a reduction in the workforce of about 2,400 over the two years to 1 April 1967. The aim was to save £64 million in the two years up to March 1967 and £60 million per annum thereafter. But the loss of key staff and other changes prior to Vesting Day (paragraph 1.9) affected the Dockyards' ability to improve their performance. Following the MOD’s consideration of the report on the results of the interim management measures they informed the NAO in January 1966 that they assessed the savings rate as £30 million per annum at the end of the period. They concluded, however, that both Dockyards fell well short of achieving the target reductions. This was because the intention to introduce commercial management affected morale, and the MOD found it necessary to accord higher priority to the very significant amount of other preparatory work which had to be completed by Vesting Day. The NAO consider therefore that part of the shortfall in achievement represents an additional, if unforeseen, cost of preparing for commercial management; the MOD pointed out that this would have occurred with any change from MOD management.

(ii) The refits comparison exercise

3.2 In 1964 the MOD initiated a refits comparison exercise to compare the costs of refits of a frigate and a submarine at commercial yards with corresponding refits at Devonport Dockyard. The final results are not yet available but it is likely that meaningful comparisons will be difficult, because of the different work content and condition of the vessels concerned and the late introduction of additional work to some of them.

Planning for commercial management

3.3 In April 1966 the MOD set up a Dockyard Planning Team comprising senior MOD officials, Naval officers and a consultant to oversee the consultation phase and formulate a policy and plan for the transfer of the Dockyards' management. One of its first tasks was to establish the effect of commercial management on the Royal Navy, the MOD and other government departments. The Team established a Dockyard Planning Group, including representatives of other departments, to oversee individual Working Groups set up to make recommendations on the 19 areas affected. The Team also appointed representatives at each Dockyard to advise local management on the transition arrangements, and it played a major role in the tender exercise.

The customer organisation

3.4 The MOD recognised that the commercial management proposals would, if implemented, require a radical change in the way the Navy Department managed the refit and repair of ships and the support of fleet and civil shore establishments. They therefore commissioned a study which recommended a customer organisation to manage the refit programme, place contracts for ship refits and other work with the Dockyards and commercial shipyards, allocate work to the Fleet Maintenance and Repair Organisation (FMRO) at Portsmouth and manage the MOD's assets in the Dockyards.

3.5 The study report emphasised the importance of the new organisation's role in ensuring that the Fleet received the necessary level of support from the Naval Bases containing the Dockyards. It considered that this would best be achieved by an effective local organisation. In June 1965 the Navy Board envisaged that the organisation would divide more or less evenly between headquarters and the Dockyards. An MOD team which visited the United States in 1965 found that the corresponding US Navy customer organisation delegated a significant measure of autonomy to local staff controlled and co-ordinated by a slim headquarters staff of about 180, only 3.5 per cent of the organisation's strength. According to the MOD, the US headquarter's functions, unlike those of their own new organisation, do not include comprehensive planning, estimating or placing contracts.

3.6 The NAO noted that the new organisation under the Director General of Ship Refitting (DGSR)
employed 621 staff, 370 more than the predecessor Dockyards headquarters organisation and 70 more than envisaged by the study report (paragraph 3.4). Initially 71 per cent of the staff were at DGSR's headquarters in Bath, partly because this was the existing headquarters and other major associated MOD branches were there and partly because there were centrally co-ordinated implementation tasks to be completed. The NAO noted that MOD staff at the Dockyards felt that this concentration of staff in Bath had inhibited DGSR's ability in some cases to respond quickly to problems arising on MOD work in the Dockyards. In addition 139 staff of other MOD organisations, eg Technical Costs and Accountancy Services Divisions, are attached to DGSR. Commenting on its structure in June 1966, the Director of Naval Manpower Audit questioned whether there might be scope for reductions in staff numbers and grades. He plans a full management review and audit in 1988 after a year of commercial management. Meanwhile, DGSR have begun a study into the balance between headquarters and local staff.

3.7 The NAO found that shortly before and after Vesting Day, the local customer organisations at both Dockyards were below complement, by some 27 per cent at Devonport. At Rosyth consultants were brought in to assist. The staff shortages impaired the Ministry's ability to verify, and reach agreement with the commercial managers on, the work content outstanding on part completed projects (paragraph 3.14); they also reduced DGSR's ability to check the quality of work under the new management. It seemed to the NAO likely that this would cause problems in establishing responsibility for any faulty work on jobs which were in progress at Vesting Day. Also some of the initial written specifications for work given to the commercial managers were inadequate in certain respects. Further work by the MOD, largely in-house, has continued to define refit requirements more satisfactorily to allow economic implementation in February 1966. The MOD believed that the introduction of such systems for industrial organisations of the size and complexity of the Dockyards would normally require three or more years to plan and introduce, plus several years for further refinement and development. However, the MOD considered that by enhancing their existing computer bureaux, using packaged software to the maximum possible extent, and employing a large number of specialist consultants, it would be possible to satisfy the requirements of the Companies Acts and provide the incoming commercial managers with a basic, functional, accounting and information system by Vesting Day.

3.8 In January 1986 the MOD and consultants set out to develop a computerised system to meet DGSR's requirements for work specifications, contract management, Vote and management accounting, estimates and planning, and asset management. They recognised that the DGSR system should be compatible and capable of communicating with the information systems being developed for the commercial managers (paragraphs 3.11-3.13) and with the computerised store accounting system of the materials supply organisation (paragraphs 4.3-4.4). Because of the limited time available not all systems were fully operational by Vesting Day. By November 1987 the DGSR systems were largely operational, although the internal accounting system was not yet comprehensive and was capable of producing limited information only. Continuing work has been necessary to improve the reliability of the systems and to make available all the specified programs.

Handover arrangements

3.9 The arrangements for transfer to the commercial managers were affected by the difficulties and constraints described in paragraph 1.9. The effects have been felt mainly in the three areas described below.

(i) Parallel running

3.10 The MOD envisaged originally that the new managers would initially work alongside the existing Dockyard managers for at least three months prior to Vesting Day. Because of the Trade Unions' refusal to allow the potential managers access to Dockyard facilities and the time taken to place the management contracts (including the extension of tender time for Devonport), parallel management occurred for only one month at Devonport and two months at Rosyth.

(ii) New accounting and management systems

3.11 The MOD recognised from the outset that commercial management would require new commercial accounting systems for the two Yards. The Treasury approved development and implementation in February 1986. The MOD believed that the introduction of such systems for industrial organisations of the size and complexity of the Dockyards would normally require three or more years to plan and introduce, plus several years for further refinement and development. However, the MOD considered that by enhancing their existing computer bureaux, using packaged software to the maximum possible extent, and employing a large number of specialist consultants, it would be possible to satisfy the requirements of the Companies Acts and provide the incoming commercial managers with a basic, functional, accounting and information system by Vesting Day.

3.12 The MOD were also planning business management systems to provide the total integrated accounting, control and management which their consultants had advised was necessary to improve the operational performance of the Dockyards in a commercial environment. They recognised that it was necessary for these systems to link with the commercial accounting systems and desirable for them to be installed by Vesting Day. The MOD decided, however, to defer development until they had the full support of the incoming contractor. This
took account of the development time of several years, their own shortage of resources and the need to reflect the business practices and procedures of the commercial managers. The MOD informed the NAO that all the potential contractors except DDL endorsed their approach. They therefore gave priority to the commercial accounting system and, with the help of the consultants, had the foundation for such a system, although without some sub-systems, available by Vesting Day.

3.13 The development of the business management systems, which consultants had predicted would produce cost savings to the MOD of £9 million net over ten years at Devonport, was incorporated as a requirement of the term contracts. Former Dockyard management considered that the initial lack of these systems would affect the extent of efficiency gains, the degree of risk pricing possible, materials supply, and the length of the introductory period after Vesting Day required by the commercial managers to get themselves into a competitive position. All this will be reflected temporarily in the prices of Dockyard work but it should have been taken into account in the commercial managers’ business plans and financial projections.

### Work in progress

3.14 Work in progress at Vesting Day was valued at £305 million in the final Dockyard Operating Accounts. This was not charged to the commercial managers on handover, although they assumed responsibility for completing the work. It was therefore important to have satisfactory procedures for identifying and valuing the balance of work for which the commercial managers would be paid. The NAO noted that the former MOD Dockyards management regarded the procedures for assessing ship work in hand on Vesting Day issued by the MOD on 31 October 1986 as unsatisfactory. The problems foreseen, ie unreliable job records and staff shortages, made it impracticable for the MOD to assess accurately and agree with the commercial managers the outstanding work taken over (paragraph 3.7). Consequently this increased the difficulty of negotiating risk prices for the high value contracts for which this would have been attractive to the MOD (paragraph 6.3).

3.15 Problems also arose in identifying all those materials, previously issued and charged to jobs, which were due to be returned from the Dockyards to the Navy supplies organisation. The MOD expected the value of these returns to be in excess of £10 million. A report by the MOD Internal Auditors in August 1987 concluded that the apparent lack of urgency in the early stages of planning for commercial management had left large quantities of MOD-owned materials within the licensed area which had not been formally accounted for after Vesting Day; and the items returned would cause such a logistics problem that bulk disposals would be necessary. At Devonport the MOD have requested DML to take action to define the status of material held in production and other areas. The Ministry’s auditors responsible for MOD stores, tools and test or other equipment on loan to contractors (paragraph 5.6) also found that the existing records of such assets, provided before Vesting Day to the Dockyards, were unsatisfactory. They reported in August 1987 that there were still unquantified amounts in both Dockyards not on charge.

### Effects on the Dockyards’ work

3.16 As a result of the loss of key staff (paragraph 1.9), The Dockyards’ former managements warned the MOD in December 1986 and January 1987 that a serious situation was developing, with many projects running late. The MOD told the NAO, however, that they transferred no further staff out of the Dockyards after the commercial management contracts had been signed. Apart from the problems with work in progress and materials referred to in paragraphs 3.14 and 3.15, the staff shortages caused delay to Yard service work and some ship refits and to drawing office work in support of most ship projects.

3.17 The poor standard of refit work during that period on a submarine at Rosyth was the subject of a formal MOD Board of Inquiry. The Board were told that shortage of skilled staff and the Dockyard Management’s overriding concern with the transfer to commercial management contributed to a large extent to the serious deficiencies which occurred during the refit. The Board concluded that the management problems associated with the transition to commercial management dominated the scene in 1985-86. This did not, however, in the view of the Board, materially affect the standard of work on the submarine, the causes of which predated this period, but it may have contributed to the failure to identify the problem. The Board further concluded that, in any event, the overall position would have made effective corrective action very difficult. Nevertheless, the NAO understand that the standard of work performed during this period on other refits at the Dockyard was also adversely affected.

### Superannuation arrangements

3.18 From Vesting Day, the Dockyards’ workforce were no longer eligible to be members of the Principal Civil Service Pension Scheme (PCSPS). In preparing for the change without knowing which contractors would be chosen, and in the knowledge
that their tenure would be subject to review at the end of the Term contract, the MOD did not consider it appropriate for Dockyard staff to be transferred to the incoming contractors' own pension schemes. They therefore set up funded pension schemes, the Rosyth and Devonport Royal Dockyard Pension Schemes, the terms of which were negotiated with the contractors and Trade Unions before Vesting Day and included a number of measures to protect the Government's position. The Schemes were designed to provide superannuation benefits corresponding to those of the PCSPS (separate arrangements were made for redundancy terms and injury benefits). Employees who transferred to the Dockyard companies on Vesting Day automatically joined the appropriate Scheme but were given six months to exercise their option of preserving their accrued rights under the PCSPS, transferring them to the Dockyard Pension Schemes, or in some cases (for example, short service) taking a cash payment from the PCSPS.

3.19 The Government Actuary's Department advised the MOD and the Treasury on the principles and actuarial assumptions that should underlie the calculation of the values of the accrued pension liabilities to be transferred to the Royal Dockyard Pension Schemes. The principles and assumptions were agreed during the contract negotiations. The initial estimate of the total transfer values, which represented commitments brought forward, was £150–£200 million. By the end of the six months option period, just over 50 per cent of the workforce had opted to transfer their PCSPS benefits to the Dockyard Schemes. The final total transfer value to the two schemes is estimated at £125 million. The Treasury agreed with the contractors that interim instalments of the bulk transfer value would be paid until such time as the final payments due were calculated. They have also agreed that compensation for the loss of investment returns on the transfer values from Vesting Day to the dates of payment will be calculated at bank base rate plus 2 per cent.
Part 4: Effects of Commercial Management on Other Organisations

4.1 The introduction of commercial management affected other organisations within the MOD and the PSA which had dealings with the Dockyards.

The Procurement Executive

4.2 The MOD Procurement Executive Sea Systems Controllerate will continue to provide the Dockyards with the advanced technology and weapons systems required on warships, together with other items such as tools and test equipment (paragraph 4.3). The Controllerate estimated that they would need 80 extra staff as a result of commercial management.

The Naval supply organisation

4.3 In addition to the Sea Systems Controllerate, the Royal Naval Supply and Transport Service (RNSTS) was the major supplier of materials and transport to the Dockyards under MOD management. A Working Group set up to consider the methods by which materials and equipment should be provided to commercial operations recommended that the MOD should continue to support work in hand at Vesting Day until its completion. For new work, they proposed that the MOD should supply, on embodiment loan terms, a limited range of items with strategic or particular importance to MOD projects in the Dockyards or other ship repair yards. Such items should be known as Ministry Supplied Materials (MSM). Tools or Test Equipment should be supplied on loan. All other material requirements, known as Contractor Supplied Material (CSM), should be obtained on repayment from whatever source the managers chose. If the contractors were to choose to obtain all CSM direct from private suppliers rather than through the RNSTS, the latter would lose up to 20 per cent (£100 million) of Naval stores business (a much smaller proportion of total RNSTS business) and be confronted with a possible redundancy situation. The Working Group suggested that this would be a risk to the level of stores support provided to the Fleet and RNSTS's other customers unless the MOD incurred additional expenditure to maintain stocks for those customers.

4.4 The Treasury originally considered that the MOD should charge for MSM to make the commercial managers financially responsible for them and provide an incentive for effective use; and that, except for work in hand, the commercial managers should not be tied to using existing MOD stocks beyond a reasonable period after Vesting Day. However, after taking into account existing policies and agreements, and practice on embodiment loan items, the MOD, with Treasury agreement, accepted the Working Group's recommendations on free issues, in contrast to a decision to charge for use of MOD fixed assets (paragraph 5.2). For CSM, both commercial managers chose to use MOD sources and agreed contractual arrangements with the MOD for the supply of catalogued stores for seven years. These provide for supply by RNSTS, except where the commercial managers can show that they can obtain a range of materials on better terms elsewhere which RNSTS cannot match within 30 days, in which case the managers must co-operate in running down the RNSTS stocks in a manner satisfactory to the MOD. Either party may terminate the contracts by giving 24 months notice for all materials or 12 months notice for materials with a short lead time.

4.5 The MOD also have contracts for RNSTS to provide the commercial managers with material management and transport services, which the commercial managers chose to use. The transport services agreement covers the provision of all transport requirements for three years but may be terminated by either party giving 12 months notice. If the services are not satisfactory, the commercial managers may obtain them elsewhere. The material management services agreement covers the provision on repayment of 450 experienced RNSTS staff, together with the supporting computer systems and management procedures required for material procurement and stockholding for Dockyard refits. The commercial managers were given the option of using RNSTS material management services on repayment or of using an alternative material management system. They chose the former but were not given the option of having RNSTS staff transfer to them, as was done for some other Dockyard support departments.

4.6 The MOD informed the NAO that they did not consider this to be a realistic option because both staff and supporting systems were an integral part of the RNSTS organisation and information technology
infrastructure. The change would have affected the standard of service supplied by the RNSTS and prevented the MOD reabsorbing skilled staff without redundancy payments if they were no longer needed by the commercial managers for Dockyard work. The 12 months notice of termination provision of the materials management contract would give the MOD the opportunity to retain skilled staff and minimise redundancies. In the NAO's view transferring the experienced staff would have provided the contractors with the benefits of having them within the organisation for an important function from which significant savings were expected from a more commercial approach. It would also have relieved the MOD of the potential redundancy problem which would arise if the commercial managers reduced their purchases of CSM from RNSTS (paragraph 4.3), provided the managers still needed the staff to purchase the materials elsewhere.

**The Marine Services Organisation**

4.7 Under MOD management, the Dockyards obtained their marine services (harbour berthing, movements and transport, tank cleaning, etc) from the MOD's Directorate of Marine Services (Naval)(DMS(N)). These represented about four per cent of the DMS(N)'s total operating costs. An Internal Audit report on DMS(N) in 1985 concluded that there was a prima facie case for seeking commercial tenders for the bulk of its operations and it was doubtful whether it could compete on cost with the private sector. However, the users expressed satisfaction with DMS(N)'s standard of service and had reservations about the commercial sector for some of the tasks. Ministers agreed that the MOD should invite commercial tenders against comprehensive task specifications for evaluation against in-house costs, with particular emphasis on retaining the Fleet's confidence in the reliability of prime operational services. Meanwhile, DMS(N) would pursue in-house efficiency initiatives. The aim was to complete the evaluation, and any consequent placing of work to contract, within three years from July 1985. The MOD informed the NAO that so far they had found it was cost-effective to retain in-house those limited tasks offered to competitive tender.

4.8 The Working Group which considered the provision of marine services to the commercial managers concluded that until completion of the DMS(N) tendering exercise the managers should use DMS(N)'s services but with contractual provision for re-negotiation after a period of notice by either side. However, the MOD decided that, for operational reasons, the commercial managers would be constrained to use DMS(N) for harbour, berthing and movements tasks for the full seven year term of the contract. For other services, both DMS(N) and the commercial managers may withdraw from the term contract after the first year, subject to six months notice. In fixing the scale of charges annually, the MOD aim to cover the full cost to DMS(N) of providing marine services to the commercial managers.

**The Fleet Maintenance Bases**

4.9 Alongside the Rosyth and Devonport Dockyards are Fleet Maintenance Bases staffed by Naval personnel. They are equipped to carry out lower level maintenance and repair of Naval vessels but not refits. During the early stages of planning for commercial management the MOD envisaged enhancing the facilities of the bases so that they could relieve the Dockyards of unprogrammed work. The NAO noted that the MOD had decided not to proceed with this proposal.

4.10 In their 22nd Report 1983-84, paragraph 7, the PAC noted that urgent requests for unscheduled work represented about 10 per cent of the Dockyards' workload and had a major disruptive effect on the costs and timing of programmed work. Under the new arrangements, an allocation is made to Commander in Chief, Fleet, by DGSR out of Vote 6 which he may use to place contracts, through DGSR, with the Dockyards or other ship repairers. The MOD originally intended that the Dockyards should reflect the disruption caused by the injection of unscheduled work by charging extra costs to the customer causing the disruption through an unprogrammed work budget allocated to Commander in Chief, Fleet, from Vote 5. However, under the procedures now used the extra costs remain against the jobs disrupted, ie the refits on DGSK's budget, although they are funded from a separate delay and dislocation budget. The MOD informed the NAO that only very small charges for delay and dislocation had been made up to January 1988. However, it appeared to the NAO that this might reflect the lack of risk pricing in most current Dockyard contracts (paragraph 6.3); and also that the arrangements adopted would not ensure that Naval customers were aware of the full costs of their demands.

**Fleet and civil shore establishments**

4.11 Traditionally the Dockyards provided services to various fleet and civil shore establishments, the costs falling on the Dockyard Services Vote. The MOD recognised that any such work in future would be on a commercial basis but identification of the necessary Vote provision presented difficulties. In the case of functional machinery, for example, the MOD decided to authorise only essential maintenance and
to make other economies; they therefore provided £17 million in 1987-88 against initial bids of over £30 million. This decision resulted in a further reduction in the work to be allocated to the Dockyards in 1987-88. The MOD accepted that this would put pressure on the commercial managers in areas where they had expected more work, which would have been anticipated in the costings. The MOD told the NAO that, for reasons which were not entirely clear, the demand for support work from the establishments had fallen.

**The maintenance organisations**

4.12 Because the Dockyards under MOD management employed industrial resources capable of undertaking maintenance tasks, they used the services of the PSA much less than other parts of the MOD. The PSA managed the Dockyards' estate and buildings and provided civil engineering services, including gas, water and drainage; but the MOD were responsible for other maintenance, including mechanical and electrical work, telephones and shore services to operational ships. The PSA employed some 370 industrial staff at Devonport and Rosyth Naval Bases, of whom about 90 were primarily involved in the Dockyards. From Vesting Day the commercial managers became responsible for maintaining the Dockyard assets, subject to periodical examination of the condition of buildings by the PSA as technical advisers to the MOD. The PSA therefore lost some of their responsibilities, but retained their former maintenance responsibility for the non-Dockyard areas and assumed, in those areas, responsibility for some mechanical and electrical work transferred from the MOD.

4.13 The NAO noted that a problem arose with the transfer of maintenance responsibility to the commercial managers. The PSA arranged to transfer only industrial staff because of their shortage of non-industrial staff and their assumption that the managers would have their own estate management staff and procedures and would need only temporary assistance. The MOD considered that any contractor would need some support for the first six months and expected PSA to transfer or loan supervisory and non-industrial staff, and at Devonport to develop a suitable recording and accounting system for maintenance work.

4.14 When, in early 1987, the PSA met the chosen commercial managers they found them unable to take over building and civil engineering maintenance. The PSA informed the NAO that the only real problem arose from the scale of the request by DML, who had entered the competition at a late stage. DML had no suitable labour, supervisory staff or experience and expected to take over a going concern which they could control through their higher management structure. BTL requested the PSA to provide a senior civil engineer, plus the industrial staff and two supervisors already offered. Under agreements reached at or very soon after Vesting Day, the PSA agreed to provide BTL with supervisory staff for up to one year and DML with advisory services for six months on a repayment basis. The PSA informed the NAO that DML set up their own organisation and terminated the arrangements before the full six months had expired.

4.15 The NAO also noted that the MOD had set up their own maintenance organisations at Rosyth and Devonport for non-Dockyard areas, although most of their maintenance responsibility had been transferred to the PSA and the commercial managers. At Rosyth a Directorate of Services and Development, with 217 staff, is responsible with the PSA for the operation of plant and the maintenance of non-Dockyard areas of the Naval Base and a number of Fleet establishments in Scotland, and for monitoring the commercial managers’ maintenance of Dockyard assets (paragraph 5.10). At Devonport, similar responsibilities rest with a Naval Base Services Manager who uses the commercial managers or contractors because he has no industrial staff on the Naval Base.
Part 5: Arrangements for MOD Owned Assets

5.1 Under the term contracts (paragraph 2.12), the MOD retain ownership of all the land, buildings, plant and machinery in the Dockyards and finance the procurement of new assets. The commercial managers may also purchase assets. The MOD expect that these will usually be for commercial work and they will be offered first to the MOD on termination of the term contracts.

5.2 The Dockyard Operating Accounts, 1986–87, showed the net book value of Dockyard fixed assets at current cost at Vesting Day as £397 million. On the question of whether to charge for the use of MOD assets, the Treasury’s view was that charges should be levied, since this would give the managers the financial incentive to use the assets efficiently. Charging would also ensure that the commercial managers were not being subsidised to carry out non-MOD work. The MOD accepted the Treasury’s view although they realised that most of the licence fee, together with an element for profit, would be charged against MOD contracts.

5.3 The MOD also considered with the PSA the steps necessary to ensure that there was a proper record of the assets made available to the commercial managers and that the assets would be adequately maintained. In September 1985 the PSA commissioned consultants to produce a detailed inventory of the assets to be licensed to the commercial managers. It was originally intended that the consultants would produce individual capital valuations for all buildings and for machinery assets worth more than £3,000 each and an estimated total value for machinery items worth less than £3,000 each; a suggested commercial annual rental for their use; a valuation for insurance purposes; and information on the condition of plant and machinery. However, in the absence of Vote provision for the estimated cost of £1.25 million, the MOD and the PSA decided to limit the exercise and omit the condition survey of the buildings, the value of which they doubted.

5.4 The task was to be completed by the end of February 1986 but the Dockyard workforces refused to co-operate with the consultants or allow them access to the yards. The MOD decided that the consultants’ original terms of reference and timetable could not be achieved and arranged for them to carry out a limited valuation exercise, using basic information from the MOD and PSA records. However, the Dockyards’ computerised fixed asset registers did not include details of Dockyard equipments with an original cost of less than £3,000. These had been charged against revenue in accordance with the Dockyards’ accounting policies, although manual records were maintained of valuable and attractive items in this category. The NAO had previously drawn the MOD’s attention to deficiencies in the manual records and had suggested that the items concerned should be incorporated into the computerised records.

5.5 By March 1986, the consultants had produced an existing use valuation of Dockyard assets as at September 1985 (£294 million); a replacement value (£1,116 million); and an annual value, based on the existing use valuation, to be charged to the commercial managers as a licence fee (£31 million). The consultants were not able until after Vesting Day to make the required inventory of assets. This exercise was completed in late 1987. Thus at Vesting Day the MOD had no verified record of Dockyard assets worth more than £3,000 each and only incomplete records of those worth less than £3,000. In January 1988 the MOD informed the NAO that the deficiencies in asset records had been corrected.

5.6 In addition to the fixed assets there were many other items such as equipments and tools in the Dockyards (paragraph 3.15). Since Vesting Day such items have generally been supplied by the MOD as contract loan items under the arrangements described in paragraphs 4.3–4.4. There are well-established arrangements for MOD audit of items issued to contractors on such terms and the commercial managers will be subject to these.

5.7 The NAO noted that in December 1986 the Treasury protested about the failure by the MOD and the PSA to consult them earlier on the valuation and the licence fee for the Dockyards’ assets. The Treasury’s first opportunity for detailed discussions was at a meeting on 28 November 1986, when the contract negotiations for Rosyth Dockyard had almost been completed.
5.8 The Treasury and the MOD did not agree on the licence fee. The Treasury were concerned that adopting the consultants' proposals, based on the rental which could be negotiated in the market place, would not necessarily recover for the MOD the proper costs associated with the ownership of these important assets. The Treasury had previously indicated that interest on capital and depreciation should feature in the calculation of ownership costs and were surprised that the consultants had produced figures on an entirely different basis. They pointed out that, in the case of Rosyth, the annual fee recommended by the consultants was some £3 million below that which would recover the costs of ownership. They were concerned that this difference might encourage criticism that the MOD were in effect giving a considerable subsidy to the Rosyth contractor at a time when other ship repairers were struggling to stay in business. Despite the Treasury’s concern, the MOD applied the approach recommended by their consultants, who advised the MOD and the PSA that it was in accordance with accepted commercial practice. The Annual Operating Statements to be produced by DGSR (paragraph 6.27) will show the difference between the cost of Dockyard asset ownership, as prescribed by the Treasury, and the licence fees received. In 1987–88 this is expected to be about £10 million.

5.9 The MOD does not accept however that the commercial managers are being subsidised. The valuation was on the basis of the assets’ worth to the Dockyards as commercial businesses and the MOD believe that to have charged more than the recommended licence fees would have imposed an unfair penalty upon the commercial managers compared with other private sector firms. This inevitably would have been reflected in higher prices and had an adverse effect on the Dockyards’ ability to capture work competitively. The MOD also informed the NAO that the commercial managers regard the licence fees as excessive and prejudicial to their competitiveness (see paragraphs 6.20–6.22).

5.10 The commercial managers are responsible for maintaining all the assets covered by the licence fee. The MOD have made arrangements to monitor the existence and maintenance of assets (paragraph 4.15) but, because of staff shortages, these did not begin to operate until more than six months after Vesting Day. The NAO noted that the MOD had not accepted a PSA suggestion that a sinking fund, or insurance bond, be devised as a means of ensuring that the commercial managers had money available in later years for maintenance.
Part 6: Achievement of Objectives

The Government’s aims

6.1 The Government’s immediate objectives in introducing commercial management were to achieve

— improved efficiency in the Dockyards;
— maximum competition for Dockyard work; and
— full VFM for the Defence Budget and the Exchequer.

Improved efficiency in the Dockyards

6.2 The tenders by BTL for Rosyth and by DML for Devonport had forecast significant efficiency improvements. The MOD accepted that these forecasts were largely judgemental and could not be based on a fully informed analysis of what needed to be done or how or where savings might be achieved. The MOD were unable to commit the Companies contractually to the achievement of the forecasts but they are recorded in the term contracts and the MOD intend to take them into account in agreeing the manhour content of project contracts. In effect, new targets will be set for project performance each year.

6.3 BTL have agreed a programme with the MOD to give a reference point for the manhour content of contracts at Rosyth. At Devonport, the MOD will negotiate target performance improvements annually with DML for two years ahead. These will be expressed in relation to production rates for standard items and operations, and MOD contracts will benefit by two thirds of the negotiated improvement figure, regardless of whether more or less is achieved. The term contracts state that it is the agreed intent of the MOD and the commercial managers that risk pricing should be introduced as quickly as possible and the companies are under incentive and penalty commitments to set up systems to enable this to be done. However, the MOD told the NAO that they now realised that the 12 months allowed was too optimistic and that it might take up to four years to introduce full risk pricing at both Dockyards, although they hoped that some form of incentive could be built into many contracts in the meantime. Initially staff shortages (paragraph 3.7) and the commercial managers’ inability to produce estimates had been contributory factors to the delay. As at 31 December 1987, 697 contracts had been let. The following table shows the pricing arrangements for these contracts:

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<th>Risk Basis</th>
<th>Incentive Basis</th>
<th>Cost Plus</th>
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<td>146</td>
<td>552</td>
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* Placed subject to agreed pricing programme for final agreement of contract prices.

6.4 To encourage the new managers to secure commercial work, they will be required to meet staff redundancy costs arising from failure to meet agreed targets for commercial orders. The MOD have undertaken to bear the costs of redundancies, estimated at £25 million for 1987–88 and £60 million in total, arising from core programme reductions (paragraph 6.9) and increased productivity. The MOD have also agreed with the commercial managers that any costs under or over recovered by them due to major variations in the core programme will (above certain pre-determined levels) be paid by or repaid to the MOD. Such variations could include, for example, delays in the start of major projects or the withdrawal of any major project from the agreed programme.

Maximum competition for Dockyard work

6.5 In March 1986, the MOD told the PAC that initially the two Dockyards would have a “core” programme comprising some 70 per cent of the total Naval production load. This comprised ship repair work, some stock manufacture and repair, and other production work. The core work would be allocated on a non-competitive basis and be subject to the Government profit formula. A further 20 per cent of the Naval load would be open to competition among the Dockyards and private sector yards (compared with 22 per cent allocated to the private yards in 1986–87), and the other 10 per cent would remain with the MOD managed Fleet Maintenance and Repair Organisation (FMRO) at Portsmouth. The MOD expected the element open to competition to rise eventually to about 30 per cent.
6.6 In 1985, DGSR estimated that the introduction of less maintenance-intensive ships would reduce the total Naval production load by 18 per cent over the period of the term contracts. Before the term contracts were let pressure on the Defence Budget led to decisions to reduce the frequency of some refits and the work content of others. This reduced the estimated annual workload for the term contract period by an average of 10 per cent. Together these changes produced a 1993–94 total Naval production load some 22 per cent less than that originally projected for 1987–88. The term contracts were negotiated on the basis of this reduced programme.

6.7 Under this programme, only one warship refit during the term contracts is planned to be outside the core programme and thus open to competition. Devonport’s share of the total will fall from 43 per cent in 1987–88 to 31 per cent in 1993–94 and its planned 1993–94 “core” load is now some 45 per cent less than the original projection for 1987–88. By contrast, under the most recent plans the percentage of the workload allocated to the FMRO is increasing slightly, although that work is not subject to competitive tender or commercial management.

6.8 The MOD decided that, in order to maintain the core programme at a realistic level and to make economic use of available capacity, they would introduce to it a number of refits for Royal Fleet Auxiliary (RFA) and Royal Maritime Auxiliary Services (RMAS) craft. RFA refits were also introduced to the FMRO programme. The Department of Trade and Industry expressed concern about this new arrangement, since refits of most RFA and some RMAS ships had previously been contracted competitively to commercial yards in the UK, most of which are in areas of high unemployment. In response, the MOD re-affirmed their aim of building up the competitive element. Naval work accounts for 90 per cent of ship repair work carried out in private yards in the UK.

6.9 Under present plans the proportion of the reduced annual Naval ship repair load expected to be available for competitive tender during the period of the term contract will reach a peak of 29 per cent, but will fall to 23 per cent in the last year of the contract, compared with the 1986 target of 30 per cent for that year (paragraph 6.5). This will be mainly RFA and RMAS work. Additionally non-ship work, such as stock manufacture and repair, will continue to be carried out by private industry, although some will be included in the core programme and allocated to Devonport and Rosyth on a non-competitive basis. In August 1987 DML announced that, contrary to previous plans, Devonport would shed some 2,000 jobs before April 1988. They attributed this to changes in the core programme which they claimed had resulted in a 6.5 per cent reduction in the workload indicated to them when their contract was signed.

6.10 DGSR in 1986 considered that the amount of warship refit and repair work available for tender was dangerously low if a real competitive environment and potential improvements in efficiency were to be achieved; and, in 1987, that reducing the maintenance and refit work on certain warships might prove to be false economy if the vessels were to be kept running. It appeared to the NAO that the MOD were attempting to secure VFM in difficult circumstances by striking a balance between fostering successful commercial management of the Dockyards, through providing a balanced workload, and encouraging maximum competition. DGSR’s latest long term review suggests a need for the commercial managers to succeed in bringing in substantial non-Naval work to the two Dockyards in the not too distant future.

Value for Money

6.11 The MOD’s castings supplied to the PAC in June 1985 had predicted that commercial management would produce annual savings to the Ministry of £24 million to £26 million, rising to £29 million to £33 million after recovery of initial costs over ten years. These savings were measured from a baseline date of 1 April 1985 and included those expected from the interim management measures introduced under existing arrangements (paragraph 3.1). In June 1986, the MOD estimated the annual savings at £23 million (rising to £30 million after recovery of the initial costs).

6.12 The separate castings for the two Dockyards provided to the PAC when the successful tenderers were announced covered the seven years of the term contracts and took account of the reduced estimated workload on which they were based. They forecast aggregate savings of £123 million (net present value £89 million after discounting at 5 per cent) at Devonport and £39 million (net present value £26 million) at Rosyth, as compared with the cost of continued MOD management. About 70 per cent of these savings would occur in the last two years of the contracts. The MOD explained to the Committee why the format of these assessments, which compared the estimated costs of continued MOD management, a Government Owned (GO) plc operation and commercial management, differed from those previously provided: it was now more appropriate to compare the alternative options from Vesting Day rather than from the 1 April 1985 baseline in earlier castings; the substantial cut since the previous year

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in the Dockyards' programme also made comparisons with the earlier situation inappropriate; and contractors' assumptions about improvements in productivity replaced the earlier broad-brush assessments. The MOD also provided explanations of variations from the earlier castings in figures and assumptions. The NAO agreed with the MOD that, although the latest presentation could not be compared directly with earlier estimates, it was a more suitable and up to date basis for assessing the MOD's decision.

6.13 The former local Dockyard managements were not consulted in the preparation of the castings and they told the NAO that they did not agree with all the assumptions on which they were based. However, the MOD informed the NAO that they and the contractors had made extensive use of the wide range of costing information produced on a regular basis by the Dockyards. The NAO noted that the castings were still based on many assumptions which were subject to uncertainties: in particular the savings and improvements forecast by the successful tenderers (paragraph 6.2). The NAO have noted the following points which are relevant to how far the castings demonstrate that the new arrangements are likely to increase VFM to the taxpayer.

(i) Preparatory costs

6.14 Initial setting up costs of about £10 million deemed to be attributable to commercial management excluded £5 million for "refit specification writing" and included only £1 million of the estimated £15 million (actual £17 million) cost of the new commercial accounting system (paragraph 3.11), on the grounds that improved specification writing and a new accounting system would have been needed in any case. In the NAO's view it was unlikely that the MOD would have spent £20 million on these items under continued MOD management unless they were satisfied that such expenditure would be cost effective, for example by assisting improvements in such areas as materials controls.

(ii) Additional MOD staff costs

6.15 However, the NAO noted that the MOD credited no identifiable savings from these improvements in the castings for continued MOD management (paragraph 6.19). The MOD informed the NAO that they did not expect significant savings from replacement of an ageing and obsolete Dockyard accounting system. Some savings could be expected from the use of improved specifications under the continued MOD management baseline but these had been allowed for in the projected efficiency improvements. They also considered that increased materials control would only be feasible in the context of a full commercial customer/supplier relationship between the Dockyards and their material contractors.

6.16 Nothing was included for the costs of MOD staff time on preparation and implementation of commercial management: the NAO estimate these at some £7 million or more in DGSR, the Dockyards and Navy stores areas, and other areas were also involved. Since the staff were found from within existing resources and the Government was committed to change in any case, the MOD considered that no extra costs were involved compared with the other options for future management. However, in the NAO's view there must have been a loss of benefit to other MOD activities and some extra costs by comparison with continued MOD management.

6.17 The MOD have not produced an outturn of preparatory costs but the NAO estimated that they would have amounted to £38 million if the full costs of the new systems (£31 million) and staff time (£7 million) had been counted, compared with the £10 million included in the castings provided to the PAC to illustrate the extra cost of commercial management. This takes no account of the loss of potential Dockyard efficiency during the preparation period, which in the NAO's view might also be regarded as an initial cost of any change of management (paragraph 3.1).

(iii) Cost of continued MOD management

6.18 The number of DGSR staff is about the same as the MOD allowed for in their costing of the commercial management option. However, this costing did not include the costs of the additional staff required by the Sea Systems Controllerate (paragraph 4.2), which were not approved until after the castings had been carried out. The MOD have not assessed how far these costs, which the NAO estimated at some £1 million a year, represent an extra charge as compared with the cost of continued MOD management.

6.19 For comparative purposes the castings of continued MOD management assumed that over the seven year period the efficiency of the Dockyard industrial work force would increase by only 10 per cent. The possibility of a greater improvement in productivity over four years to April 1989 had previously been discussed in the context of the MOD's proposed Dockyard Plan for 1985–89 but the latter was overtaken by the adoption of the target of a 15 per cent reduction in costs in the two years to April 1987. It appeared to the NAO that although only half the target improvement had been achieved this was partly attributable to the impact of
6.20 There was a significant difference in the methods used to allocate the cost of use of MOD assets as between the commercial options and the cost of continued MOD management. The latter was charged £312 million (£258 million discounted) over seven years based on normal MOD cost accounting procedures, while the commercial management and GO plc options were charged £216 million (£179 million discounted) based on the annual licence fee payable to the MOD for use of the same assets. The licence fee reflected the consultants’ advice and the reasoning explained at paragraphs 5.8 and 5.9.

6.21 The MOD believe that had the Dockyards continued under their management, the total value of assets would have been maintained broadly at previous levels as the same criteria for determining the need for new and replacement assets and for investment appraisal would still have been applied. They also believe that commercial managers would not have proposed capital investment in excess of its business value in the past nor would they do so in the future. Thus the MOD consider that the different approaches to asset costs in the VFM castings are fully justified and reflect savings which they expect to accrue under commercial management (see paragraph 5.9).

6.22 However it appeared to the NAO to be incorrect to exclude the whole of the difference between these figures from the overall cost of the commercial management option. For existing assets, the need for which would have been established at the time of purchase, it represents that part of the cost of owning the assets which the MOD continues to bear directly under commercial management. While some savings might result from a more commercial approach to acquisition of assets in the future, it seemed to the NAO that purchases would continue to be based mainly on what was required for MOD work, most of which will be placed on a non-competitive basis. The amounts which the MOD have claimed will be saved over the seven year period, £96 million or £14 million per annum, are substantial in relation to average annual expenditure of £51 million on fixed assets in the period 1981–82 to 1986–87. The NAO calculated that using the same asset cost for both cases would reduce the savings as shown above.

6.23 The MOD are satisfied with the adequacy of their costings which they consider to be fully in accordance with Government Accounting guidelines for investment appraisal. But the NAO consider that adjustment of the costings in the light of the factors discussed above throws considerable doubt on whether, if the Dockyard workloads had remained as expected when the contracts were placed, commercial management would have produced the overall savings to the taxpayer within seven years on the scale which was forecast, unless improvements in efficiency substantially exceeded expectations. And delay in bringing into operation some of the features which were to assist efficiency — for example competitive pricing — is militating against this. However, the further reductions in Naval production have altered the picture again; and a current assessment of the value for money likely to be obtained from commercial management would require such a degree of speculation about what would have happened under alternative, including MOD, management as to make it not worthwhile.

## Monitoring performance

6.24 The MOD have assigned responsibility to the commercial managers for developing a mechanism for measuring and establishing performance levels so that they and the MOD can monitor performance improvements. The delays in introducing the new Dockyard computerised accounting systems (paragraphs 3.11–3.13) have affected progress on

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### Table: Net savings from commercial management predicted by MOD Costings, Extra asset costs borne by continued MOD management, Net savings if asset costs assessed on same basis for each case

<table>
<thead>
<tr>
<th></th>
<th>Net savings from commercial management predicted by MOD Costings</th>
<th>£m</th>
<th>Extra asset costs borne by continued MOD management</th>
<th>£m</th>
<th>Net savings if asset costs assessed on same basis for each case</th>
<th>£m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Devonport</td>
<td>123 (89)</td>
<td>72 (60)</td>
<td>51 (29)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rosyth</td>
<td>39 (26)</td>
<td>24 (20)</td>
<td>15 (6)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>162 (115)</td>
<td>96 (80)</td>
<td>66 (35)</td>
<td></td>
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</tbody>
</table>

(The figures in brackets are at net present value after discounting at 5 per cent.)
project costing and hence monitoring. As an interim measure, both Dockyards have used standard provisional hourly labour cost rates which they have applied to all work regardless of its technical complexity. The MOD have told the NAO that, by December 1987, differential rates had been agreed for Rosyth and adopted for Devonport, and that these were being applied retrospectively.

6.25 In their 21st Report of Session 1985–86 (HC 286, paragraph 20), the PAC stressed the importance of the MOD establishing satisfactory arrangements to monitor the efficiency and financial results of commercial management. They recommended that the annual report and accounts to be produced by DGSR should provide for Parliament a complete and genuine comparison with costs under MOD management.

6.26 In the subsequent Treasury Minute (Cmnd 9859) the MOD and the Treasury stated that the proposed published Operating Statements for DGSR would be broadly comparable in format and content with the accounts published in respect of the Royal Dockyards. They would show the total cost of refitting and other work, analysed by Dockyard and type of work, and taken with other monitoring measures would provide a basis for an overall comparison of costs.

6.27 In the event, the MOD and the Treasury have encountered difficulties in devising statements and monitoring measures which will allow worthwhile comparisons to be made between the performance of the Dockyards under the MOD and commercial management. After consulting the NAO, they have agreed the form of a DGSR Operating Statement which they intend to publish with the Appropriation Accounts. This will show the costs brought to account by DGSR for the repair and refitting of warships and other Naval craft, with an analysis of input costs over programme headings which, as far as appropriate in the new circumstances, follow the format of the previous Dockyard Operating Accounts. They have yet to agree the means for comparing performance. The NAO noted, however, that there were differences in format and content between the previous Accounts and the proposed new Statement; and that the latter, which is prepared using different accounting policies, will not provide the basis for a full comparison with costs under the previous management arrangements.

6.28 In particular, the NAO have pointed out to the MOD and the Treasury that there is an increasing percentage of ship refit and repair work expenditure at the Fleet Maintenance Bases and the FMRO at Portsmouth. This will not be recorded in the DGSR Operating Statement. It was also not included in the previous Dockyard Operating Accounts but decisions by the MOD to increase or reduce the ship repair and refit undertaken at these locations will have an effect on the Dockyards which will not be apparent from the new Statement.
Glossary of Abbreviations

BTL  Babcock Thorn Ltd
CSM  Contractor Supplied Materials
DDL  Devonport Dockyard Ltd
DGSR Director General of Ship Refitting
DML  Devonport Management Ltd
DMS (N)  Directorate of Marine Services (Naval)
DOL  Devonport Operations Ltd
DOGD  Defence Open Government Document
FMRO  Fleet Maintenance and Repair Organisation
GO plc  Government Owned public limited company
MOD  Ministry of Defence
MSM  Ministry Supplied Materials
NAO  National Audit Office
PAC  Committee of Public Accounts
PCSPS  Principal Civil Service Pension Scheme
PSA  Property Services Agency
RFA  Royal Fleet Auxiliary
RMAS  Royal Maritime Auxiliary Service
RNSTS  Royal Naval Supply and Transport Service
Secretary of State  Secretary of State for Defence
VFM  Value for Money