

executive summary

- 1 It is a long-standing principle of public procurement that effective competition between suppliers is likely to be the best means of achieving value for money. Experience shows, however, that it may not always be practicable or sensible to use competitive procurement. In such cases, alternative means are needed to secure value for money. The policy of the Ministry of Defence (the Department) is to use non-competitive procurement to acquire its military equipment only where there are compelling reasons. Over the last five years one quarter of the Department's annual expenditure of £9 billion on contracts for equipment and related services has been spent on non-competitive projects.



- 2 In the context of non-competitive procurement, the Department has processes in place which aim to replicate the pressures that apply in competition. These processes comprise a long-standing agreement between the Government and the Confederation of British Industry (the 1968 Agreement), and the No Acceptable Price No Contract (NAPNOC) policy. All non-competitive contracts valued at over £1 million are negotiated in accordance with this policy. Since 1998, the Department has also been applying a new approach known as Smart Acquisition (formerly Smart Procurement) to improve value for money in all its procurement.
- 3 The 1968 Agreement between the Government and the Confederation of British Industry provides that Government non-competitive procurement should be based on three key elements:
 - The Profit Formula, which determines the rate of profit contractors should earn on non-competitive contracts placed by Government departments;
 - The principle of Equality of Information between contractual parties, whereby each reveals data that is relevant to the agreement of a fair and reasonable price; and
 - Post-Costing which allows the Department to determine whether there was Equality of Information at the time of pricing and helps to inform future pricing through lessons learned. It also allows either party to refer a contract to an independent Review Board if it believes there has been inequality of information that may have led to an excess profit or substantial loss.

- 4 The Profit Formula element of the 1968 Agreement is currently under review. Moreover, the changes being made as a result of Smart Acquisition may have the potential to affect the other main elements of the 1968 Agreement. We shall keep under review these developments in the Department's framework for non-competitive procurement and report further if necessary.
- 5 NAPNOC is mandatory for all non-competitive contracts and amendments to contracts worth £1 million or more. Since its introduction in 1992, NAPNOC has been applied to some 1,850 contracts with a total value of £25 billion. It was introduced with the aim of replicating some of the pressures which exist in competitive tendering where prices are agreed before contracts are placed in non-competitive situations. The fundamental objectives of NAPNOC are:
 - To price the contract before work commences. This objective is known as "pricing at the outset".
 - To ensure that the price closely reflects the price which would prevail under market conditions. This objective is known as "Should Cost" pricing.
 - To enable a company to maximise the opportunity to innovate, to be efficient and deliver timely performance of the contract, all of which, if achieved will improve profitability on the contract and the competitiveness of the company in future business with the Department.

Pricing at the outset also confers an additional advantage for the Department, in that it knows its financial liability at the time contracts are placed and is therefore able to be more informed about its budgetary assumptions.

- 6 This report examines the procedures followed by the Department once it decides to procure goods or services non-competitively. It considers how well the Department puts into practice the existing framework - the 1968 Agreement and its policy of NAPNOC - and whether the outcomes of non-competitive contracts are in line with agreed prices and ensure the timely delivery of equipment and services. In so doing, we examine:
 - The framework and guidance for non-competitive procurements
 - How the Department conducts non-competitive procurements.
 - The outcomes which the Department achieves from its non-competitive procurement.



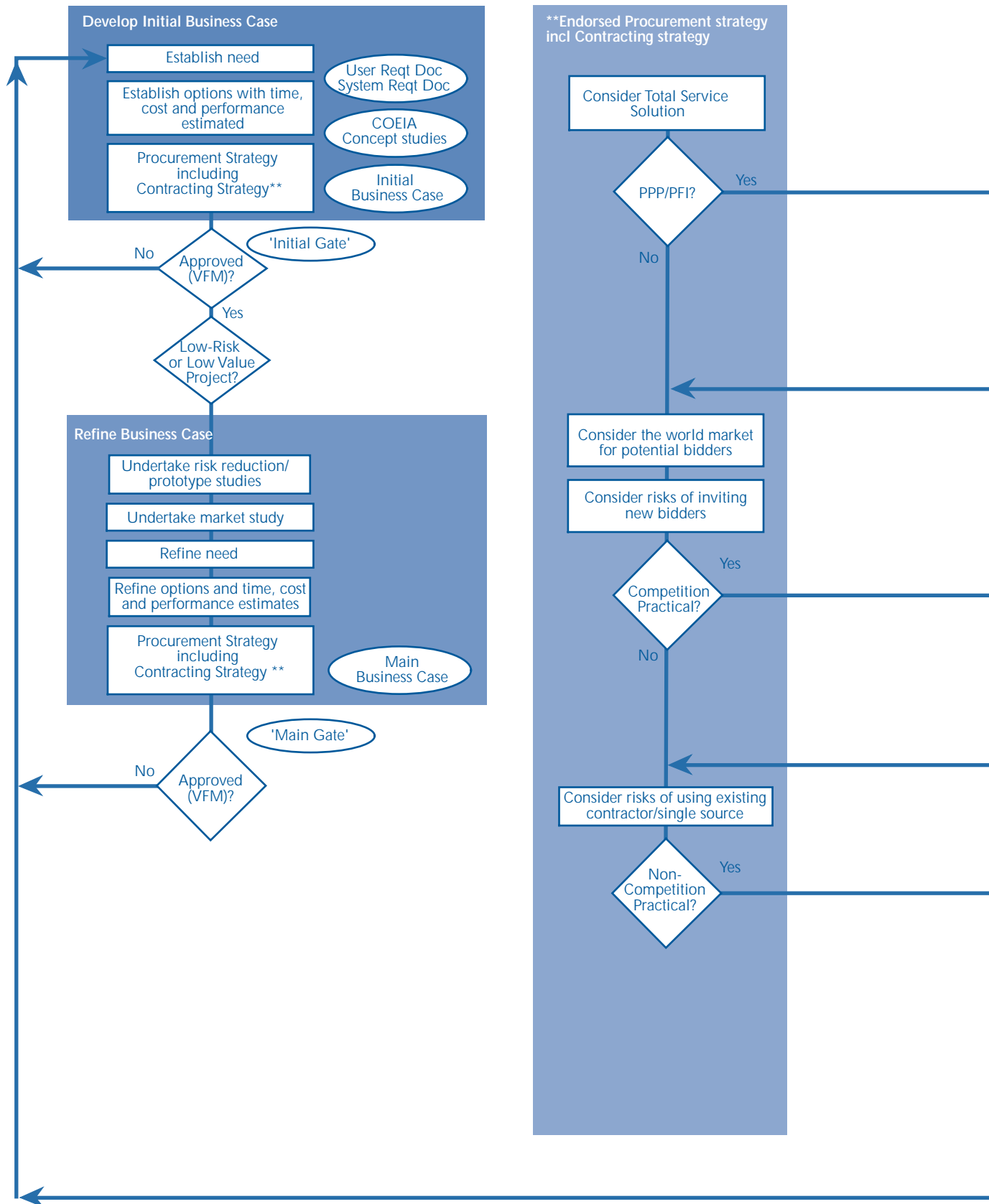
- 7 Our methodology, which included a comparative examination of the processes used for non-competitive procurement in a sample of public and private sector organisations, is described in Appendix 1. **Figure 1** shows a model of the non-competitive procurement processes followed by the Department while **Figure 1A** shows the composite model of the processes followed by the comparator organisations. The respective models show that there are many similarities in the approaches followed. We explore a number of these similarities throughout this Report.
- 8 We found that:
- While the existing non-competitive processes are well defined and understood there is scope for the Department to further develop the framework within which non-competitive contracts are let.
 - When conducting non-competitive procurements the process which the Department follows generally works well but needs improvement in some key areas.
 - The outcomes of the non-competitive process are mixed and the Department should make more use of the data gathered and past experience to inform future practice.

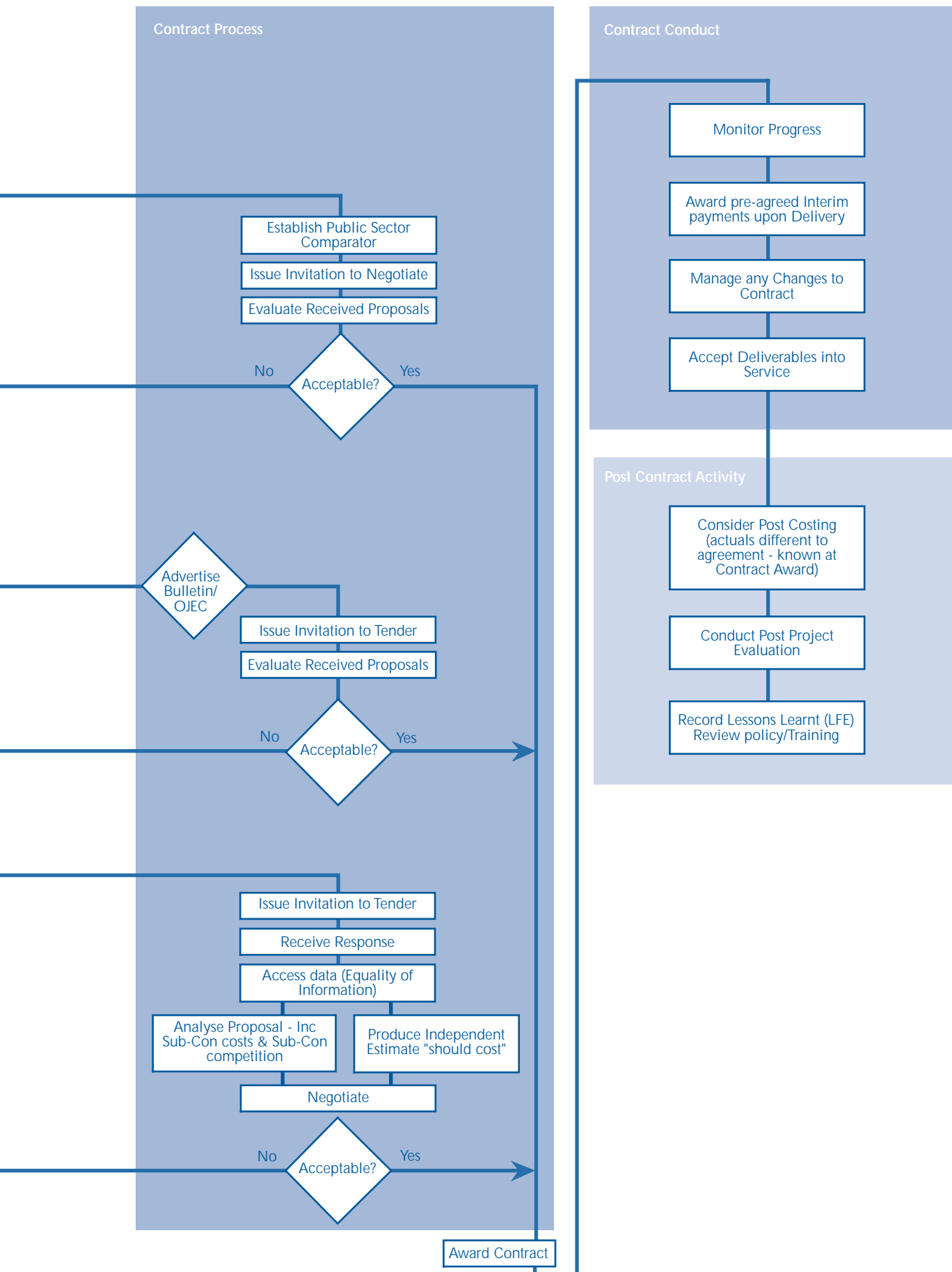
There is scope for the Department to improve the framework within which non-competitive contracts are let

- 9 While the Department's general procurement policy is one of competition, it recognises that there are circumstances where competition is inappropriate or impracticable. Since 1993, the Department has had a performance measure to compete 75 per cent by value of its contracts to ensure that competition remains the predominant procurement route. The Department has broadly achieved this performance measure in each of the past five years. (Paragraphs 1.3 to 1.7.)

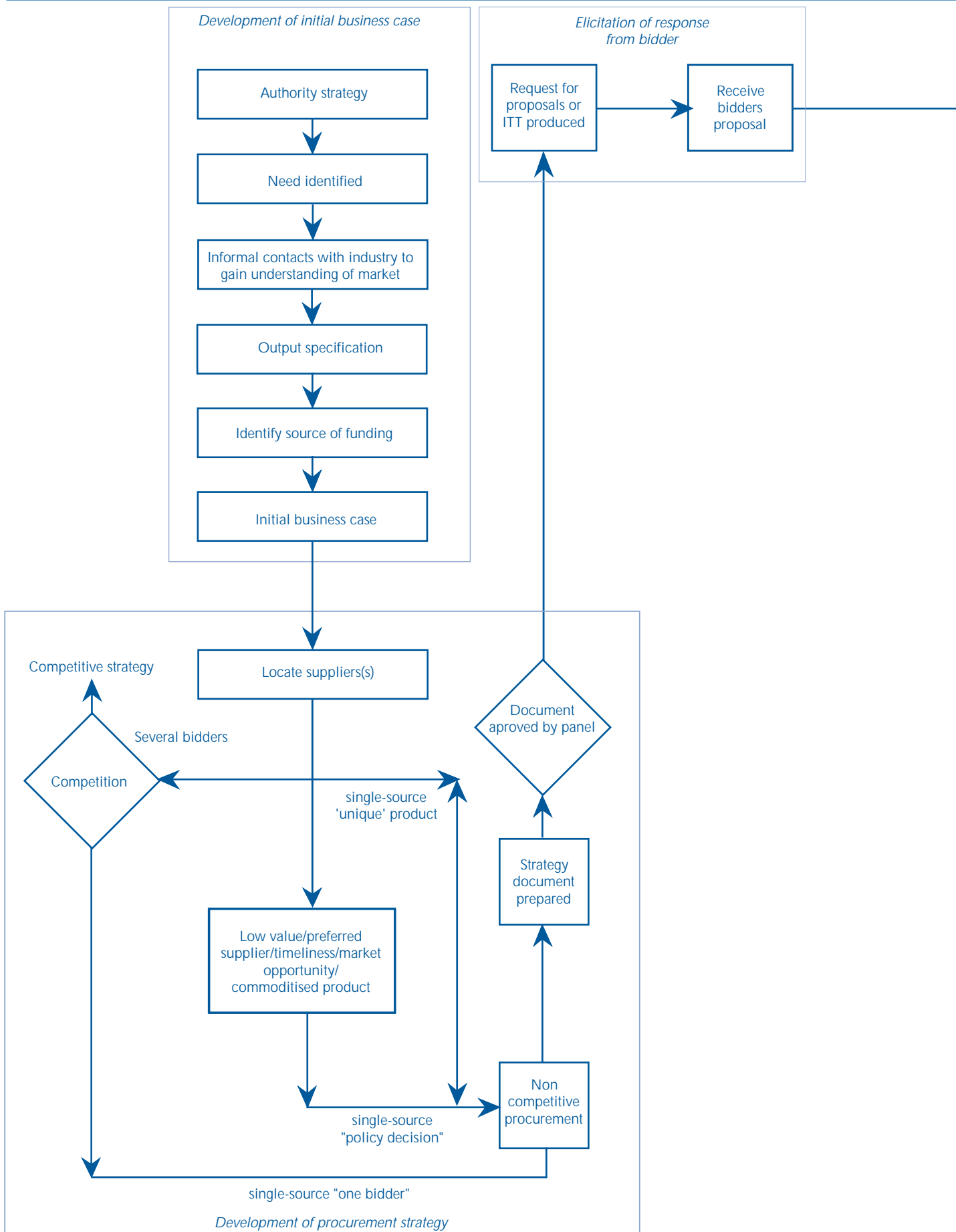


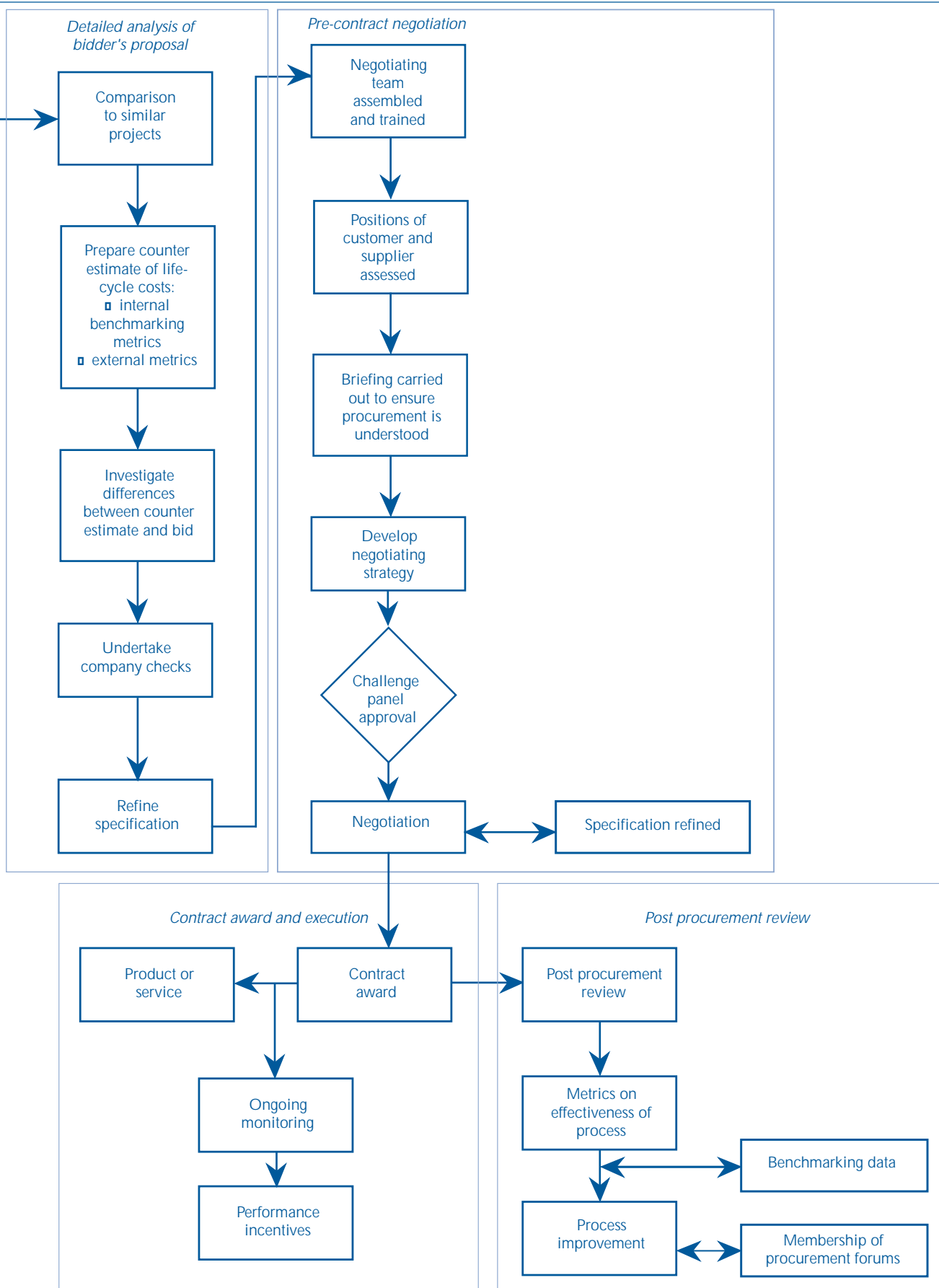
1 The Department's single source procurement process





1A The National Audit Office model of comparative practice





- 10 Once a decision has been made to procure non-competitively, the Department applies its framework consisting, as explained above, primarily of the 1968 Agreement and its NAPNOC policy, both of which are clearly defined in its working level guidance. The Department's approach is intended to ensure that it achieves value for money while suppliers obtain a fair profit. At present, the profit formula is currently under review by the Department, the Treasury, the Department of Trade and Industry and the Confederation of British Industry. It is anticipated that this review will not be finalised before April 2002. (Paragraphs 1.8 to 1.11.)
- 11 We found that there are also some concerns over the application of the principles of Equality of Information and Post-Costing. Thirty one per cent of the contracts we surveyed revealed that the Department's Equality of Information Statement was not being completed though alternative methods were used to provide assurance of Equality of Information. In addition, the Department has had concerns over the timeliness of Post-Costing given that its benefits can decrease considerably over time. The Department is now reviewing the timeliness of Post-Costing. These concerns about Equality of Information and Post-Costing may be addressed by Smart Acquisition practices, such as the Department's aim of working more closely with contractors in longer term relationships known as partnering. Partnering is a favoured approach amongst some commercial comparators and offers several benefits including the incentivisation of performance, the encouragement of innovation, and a reduction in costs. (Paragraphs 1.12 to 1.19.)
- 12 The guidance for non-competitive procurement used by commercial comparators is relatively concise and aims to identify principles and not focus on processes. However, the Department's working level guidance, though less inclined to brevity, is generally perceived by staff to be effective. We found that the Department's guidance for non-competitive procurement is dispersed among various publications and is not always up to date. (Paragraphs 1.20 to 1.22.)

When conducting non-competitive procurements, the processes that the Department follows need to be better applied in some areas

- 13 We found that the work of the Directorate of Pricing within the Specialist Procurement Services in pricing proposed non-competitive contracts has led to some significant reductions in prices prior to contract placement but that currently the Department's arrangements for such work on contracts placed overseas do not always provide the same level of information. Some steps have been taken for pricing bodies such as the Specialist Procurement Services to be able to price other nations' contractors under the terms of Memoranda of Understanding between those nations. We found the vast majority of contracts staff are currently satisfied with the work of the Specialist Procurement Services. (Paragraphs 2.2 to 2.11.)
- 14 The use of Should Cost data to determine a price that closely reflects market conditions is common to both the commercial comparators and the Department. We found that the Department has encountered problems in deriving a Should Cost model because of a lack of historical data on some projects and, in one case, where the Should Cost analysis did not address all of the elements of the contract. These difficulties are often intrinsic to projects depending on new technology or a high software content. In the inevitable cases where no formal Should Cost model exists, the Department has been ready to be innovative in using other means to achieve a credible estimate of what an item should cost. (Paragraphs 2.12 to 2.15.)

- 15 We found that risk registers were compiled on 40 per cent of the contracts surveyed, including nine of the ten largest. Very few contracts used joint risk registers although the Department's guidance encouraging their use was only introduced in late 1998 after many of the contracts in our survey had already been let. Only a small number of risk registers addressed the potential risk arising from the non-competitive nature of the contract. Although the Department's guidance stresses that as many sub-contracts as possible should be competed, only 24 per cent of the contracts surveyed had sub-contracts which were competed. Among the reasons for this low number are unrealistic assumptions about the scope for competition and problems caused by trying to compete for proprietary items. Furthermore, we found that the Department does not always have visibility of the work undertaken by sub-contractors though in some cases the prime contractor is effective in this role. Where prime contractors establish longer-term and more open relationships with key suppliers, the Department is likely to also benefit by having improved visibility of work done by sub-contractors. (Paragraphs 2.16 to 2.26.)

The outcomes of the Department's non-competitive procurement processes are mixed and the Department should make more use of past experience to inform future practice

- 16 Since 1993, the Department has had in place a target whereby 90 per cent of all non-competitive contracts, on a rolling three-year average, should be priced at the outset. In the last four years it has met or exceeded this target. We also found that a key objective for the Department in negotiating non-competitive contracts is to achieve an affordable price. While the Department has used NAPNOC to negotiate some significant reductions in price this has sometimes meant that contracts have been placed later than planned. (Paragraphs 3.2 to 3.5.)
- 17 Performance in meeting timescales for the completion of non-competitive contracts is good with two-thirds of contracts surveyed achieving these. The results of Post-Costing returns for the years 1997 to 2000 show that, on average, costs to the contractor have been 3.5 per cent below the original estimate. The returns also revealed that there are wide fluctuations in the variations on agreed costs. (Paragraphs 3.6 to 3.8.)
- 18 The Department holds a range of data on non-competitive procurement but this does not focus systematically on the outcomes of the process and, as such, it cannot fully assess trends or the potential impacts on value for money. The Department's 75 per cent performance measure for the value of contracts to be placed competitively was introduced in 1993 when the emphasis was on encouraging a step change in the level of competition. This performance measure is of limited utility now given recent changes in the procurement environment. The commercial comparators tend to focus on achieving value for money when they analyse the data gathered from their non-competitive procurements. (Paragraphs 3.9 to 3.12.)
- 19 The Department has a Lessons Learned database but this does not have a specific section on non-competitive procurement. Nevertheless, a number of the contracts we surveyed did yield lessons that could inform future non-competitive procurements. The commercial comparators carry out post-project evaluation to assess any potential value for money improvements; the capture of any benchmarking information; and the identification of any lessons learnt. (Paragraphs 3.13 to 3.16.)

Recommendations

- 20 To improve the way it places and manages its non-competitive contracts, the Department should implement the recommendations in the following table.

Evidence from the Report	Action recommended
"On 31 per cent of the contracts we surveyed, no Equality of Information Statement was signed despite the Department's policy that such statements should be completed in all instances." (Paragraph 1.14.)	The Department should ensure that all NAPNOC contracts have an Equality of Information Pricing Statement in place before a contract is placed.
"Post-costing...enables the Department to draw any lessons that can be learnt..... It can also be used to provide evidence for a reference to the Review Board."	The Department should conclude its review of Post-Costing activity to ensure that Post-Costing takes place within a timeframe that maximises the benefits.
"The Department is reviewing how to improve the timeliness of Post-Costing given that delays can impair its effectiveness....." (Paragraphs 1.15 - 1.16.)	
"Partnering or collaborative working covers a range of practices designed to promote more co-operation between contracting parties." (Paragraph 1.17.)	The Department should review whether there is scope to extend the application of partnering across more non-competitive contracts.
"We reviewed the [Department's] guidance and found that it is dispersed among various publications and is sometimes out of date." (Paragraph 1.21.)	The Department should conduct a review of its existing guidance on non-competitive procurement to ensure that it is both accessible and up-to-date.
"We are concerned that the arrangements in place for pricing contracts with overseas contractors should always offer complete assurance that value for money is being achieved." (Paragraph 2.9.)	The Department should regularly review the arrangements it has in place for pricing contracts with overseas contractors to ensure that these arrangements provide the best possible assurance that value for money is being achieved.
"The extent to which the picture of the Directorate of Pricing as a properly resourced outfit can be maintained may be questionable given that the demands on their expertise are likely to increase. This is due to the increased likelihood of non-competitive procurement as a result of industrial consolidation..... [and the] need for [it] to contribute to the pricing of non-competitive contracts which may be let with the newly privatised QinetiQ..." (Paragraph 2.11.)	Any further consideration of the resources allocated to the Pricing Directorate should be assessed in light of the potential for improving the efficiency of the process as well as a quantified assessment of the benefits the Directorate produces, in relation to other priorities for resources.
"Problemscan occur when deriving Should Cost estimates." (Paragraph 2.14.)	The Department should ensure that it always utilises existing techniques to generate the best possible Should Cost data to ensure a robust pricing process.
"The Department's guidance, issued in late 1998, refers to the developing use of joint risk registers as an aid to pricing. This is reflected in our survey finding where 26 per cent of the contracts that featured in the survey had a joint risk register, most of which were let prior to the guidance being issued." (Paragraph 2.16)	All NAPNOC contracts should have a joint risk register.

Evidence from the Report

Action recommended

"Only three of the contracts we surveyed considered the possibility of risks emerging because of the non-competitive nature of the contract." (Paragraph 2.17.)

Risk registers for non-competitive contracts should include an assessment of the additional risks due to their non-competitive nature.

"The Department's guidance states that wherever appropriate, it should have visibility of how prime contractors organise and place their sub-contracts. ...Of the NAP-NOC contracts we surveyed, 37 per cent of those with sub-contracts did not have conditions in place which gave visibility of sub-contracting activity although the largest contracts such as that for Astute covered the point fully." (Paragraph 2.22.)

The Department should ensure that it has visibility of how the contractor manages its sub-contracts.

"Seven of the contracts we examined in our survey failed to meet their original timetable for placement." (Paragraph 3.5.)

There needs to be greater realism regarding the timescales set for negotiating non-competitive prices.

"A performance measure of achieving 75 per cent of procurement through competition had a greater logic when the measure was first introduced in 1993 and the emphasis was on encouraging a step change in the level of competition. In our view, it is of less utility now....." (Paragraph 3.11)

The Department should manage and understand its business by always focusing on value for money and should again review the need to have a set performance measure for the amount of procurement it competes.