



National Audit Office

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## **Report**

by the Comptroller  
and Auditor General

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## **Ministry of Defence**

# Improving value for money in non-competitive procurement of defence equipment

## Key facts

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**£8.8bn**

expenditure through non-competitive contracts in 2015-16

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**51%**

level of non-competitive procurement of defence equipment by number of contracts in 2016-17

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**£1.7bn**

savings expected from applying the Single Source Contract Regulations (the Regulations) over 10 years

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**1,891**

live non-competitive 'equipment' contracts that the Ministry of Defence (the Department) managed as at 21 August 2017 (66% of total non-competitive contracts by value)

**110**

contracts and sub-contracts operating under the Regulations as at 31 August 2017

**£23.9 billion**

the value of contracts operating under the Regulations as at 31 August 2017

**£313 million**

Department's estimate of savings and cost avoidance potentially achieved in the first two and a quarter years of the Regulations

**862**

contract data queries from the Single Source Regulations Office to suppliers and the Department outstanding, as at 31 August 2017

**386**

unfilled commercial posts in the centre of the Department, Commands, and the Department's agency, Defence Equipment and Support, as at 31 August 2017 (24% of total)

# Summary

**1** The Ministry of Defence (the Department) requires high-quality equipment to fulfil its operational objectives, and support arrangements to maintain this equipment. It can procure from UK suppliers or from abroad. Circumstances can arise where only one supplier can meet demand for certain types of expensive and sophisticated equipment, or where security considerations require the Department to contract with a trusted national supplier to maintain sovereign capability, for example, nuclear-powered submarines or complex warships. The Department has found it more difficult to secure value for money from procurement where there is no competition to assure it is paying the best possible price.

**2** In 2011, an independent review commissioned by the Department found that the system put in place in the 1960s to review acceptable levels of cost and profit on non-competitive contracts was outdated and ineffective. The review identified inadequate incentives for efficiency, insufficient challenge of costs, weak governance and a lack of transparency. In response, the government introduced the statutory Single Source Contract Regulations (the Regulations) via the Defence Reform Act 2014, and established the Single Source Regulations Office (SSRO).

**3** The SSRO is responsible for, among other things, recommending the profit rate to be applied to relevant contracts, producing guidance on allowable costs under the Regulations, and issuing opinions or determinations on issues raised with it by contracting parties. The Regulations include measures to increase transparency of supplier costs. In 2012, the Department stated that its policy was to pursue open competition wherever possible to fulfil the UK's defence and security requirements. The Department expects to generate £1.7 billion of savings over the 10-year Equipment Plan from the application of the Regulations. Achieving these savings is important to the Department's objective of maintaining the affordability of its Equipment Plan.

**4** Successful implementation of the Department's policy on competition would involve as many defence contracts as possible being let competitively, as well as non-competitive contracts normally limited to areas essential for national security costing no more than a fair return for suppliers. In some situations, however, the procurement approach that would deliver the best value for money might involve a long-term relationship with a single supplier.

**5** This report looks at how the Department has responded to the need to deliver better value for money for the taxpayer for non-competitive procurement and whether it is on the path to success. Part One provides background information. We then examine whether the Department:

- has a strategic view of non-competitive procurement (Part Two);
- has strengthened its oversight of non-competitive procurement (Part Three);
- is using the Regulations to secure savings through improved transparency and compliance (Part Four); and
- is developing skills and capacity to improve outcomes through negotiations (Part Five).

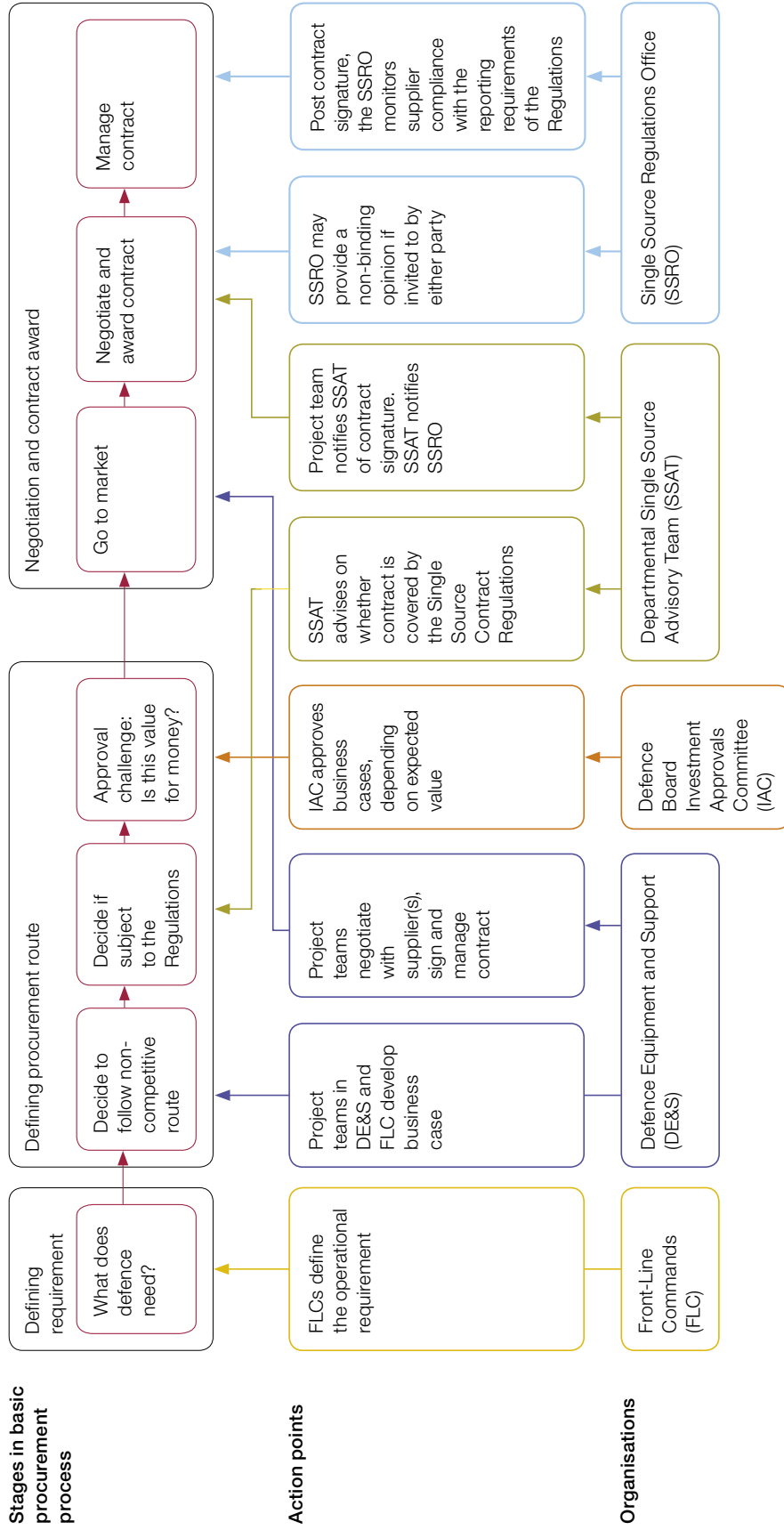
The success of the new regime will depend on the Department being able to tackle effectively a series of short- and long-term challenges. **Figure 1** summarises the system for procuring equipment non-competitively.

## **Key findings**

**6** **If they are implemented and applied effectively the Regulations offer considerable opportunities to improve contract management.** As at July 2017, 110 contracts (95 contracts and 15 sub-contracts) had been brought within the Regulations, with a combined value of £23.9 billion. Staff within the Department have welcomed the new regime because of the opportunities it offers to improve contract management. In particular:

- The ability to require full transparency of costs within suppliers' prices provides greater assurance on value for money.
- The regime provides statutory backing for efforts to negotiate down prices.
- Transparency of costs incurred during the contract allows identification of 'excess profits'.
- Building a knowledge base on costs informs future budgeting and contracting processes (paragraphs 3.2, 3.8, 4.3, 4.9 and Figure 7).

**Figure 1**  
Stages in the procurement process and organisations involved



## Immediate barriers to progress

### **7 The Department currently lacks good quality data on its portfolio of non-competitive contracts.**

In 2016-17, the Department introduced a new contracting, purchasing and finance system. As part of this process, thousands of inaccurate or obsolete records were corrected or removed from the system. As at 21 August 2017, the Department had 1,891 non-competitive 'equipment' contracts under management (66% of all non-competitive contracts). Within this database of 'live' contracts, 914 had contract end dates before 31 August, suggesting there was still work to do. Without accurate data, the Department may struggle to identify contracts that are due for renewal or amendment that may fall within the scope of the Regulations (paragraph 2.6).

### **8 The Department is committed to using competition wherever possible but it cannot show currently that it is doing so in a systematic way.**

Although the Department has made this commitment, between 2013-14 and 2016-17, the number of defence equipment contracts let non-competitively has remained stable at around 50%. However, the value of equipment contracts let non-competitively has been significantly affected by a small number of large contracts, varying from 24% to 75% each year over the same period. The Department does not set a target for the value of contracts it aims to let competitively as it believes contracts should be let using the most appropriate commercial approach, which in some cases may be non-competitive. However, where this is the case, the formal justifications presented by project teams of decisions to procure non-competitively are highly variable in quality, and there may be limited scope to challenge decisions within the timetables set for delivery of the requirement (paragraphs 1.2, 2.2–2.3, 2.8 and Figures 3 and 4).

## Short-term challenges

### **9 Most suppliers now accept the need to work within the Regulations, but some are resisting them and their interpretation by the Department and SSRO.**

Some suppliers are either resisting being subject to the Regulations or have failed to provide information about costs and prices required by the Regulations. The Regulations give the project teams and other commercial staff responsible for negotiating and managing contracts greater access to supplier information than ever before. This puts them in a stronger position to drive down costs. It is therefore not surprising that industry had initial problems or complaints about the single source regulatory regime. However, the Regulations will fail if contractors can evade them by not cooperating. The Department faces a particular challenge in gaining agreement from contractors to bring existing contracts brought within the regime 'on amendment', although these can be the highest-value ones (paragraphs 3.10, 4.5, 4.6, and Figure 9).

**10 The application of the Regulations has been hindered by a number of**

**performance problems.** Introducing a new regulatory regime where oversight has previously been weak is challenging, and the early years have been characterised by a number of difficulties. In particular:

- The SSRO's ability to assure itself that suppliers were complying with legislation by providing complete and accurate data has been hindered by the original IT system it used (which it has now replaced), and contractors' lack of experience of the new regime. At the end of August 2017, 862 queries raised by the SSRO about contract data (about 39% of the total) were outstanding, which could undermine the transparency around costs promised by the Regulations (paragraphs 4.10–4.11).
- Within the queries described above, a backlog of several hundred queries on contract data from the SSRO has built up in the Department's Single Source Advisory Team (SSAT). This backlog has been caused by higher than expected demands on its time, for example, in advising project teams. SSAT also held discussions with SSRO until December 2016 about the latter's review process, which has now been agreed. The Department and SSRO are now working to reduce the backlog. The SSRO is reliant on suppliers to submit data within the contract that is required by the regime. These may initially be inaccurate or absent, causing additional work, as SSRO is only able to gather this information from the suppliers, rather than from the relevant schedules of the contract (paragraphs 3.6, 4.11).

**11 The SSRO's interpretation of its remit has created additional friction, in part because it is seeking changes to its powers.**

The legislation does not confer on the SSRO many of the characteristics of an economic regulator and there are limitations on its ability to act independently of the Department when it is seeking accurate and complete contract cost information. It has consulted on proposed changes to its regulatory powers, which in its view would improve the working of the regime. This, and its sometimes confrontational public tone, has provoked differences of opinion with stakeholders, and limited the willingness of others to cooperate with it. All parties told us that fresh efforts are being made to reset relationships as the parties better understand their roles (paragraphs 3.9–3.10, 3.12, Figures 8 and 9).

## Longer-term challenges

**12 Realisation of potential savings identified from application of the Regulations will depend on good contract management.** The Department calculates that by July 2017 the Regulations had achieved reductions in contract prices of £313 million. This represents some 3.9% of total contract values. Part of this is cost avoidance, and part contributes towards the Department's 10-year target to save £1.7 billion from existing projects in the Equipment Plan through application of the Regulations, in order to release funds for new commitments in the 2015 Strategic Defence and Security Review. Whether these predicted savings are ultimately realised will depend on management of contracts within the Regulations, and further work to establish in which years benefits will be realised. Savings from applying the Regulations are needed to maintain the affordability of the Department's equipment programme and we commented in our report on the Equipment Plan 2016 to 2026 that not achieving these savings is a significant risk for the Department<sup>1</sup> (paragraph 4.16, Figure 10).

**13 SSRO has recommended changes to the baseline contract profit rate and is seeking to improve how it measures the impact of its decisions on suppliers.** SSRO makes annual recommendations to the Secretary of State on the baseline profit rate to be applied to contracts within the Regulations. So far, this has resulted in a significant drop in the rate – from 10.6% in 2014-15 to 7.46% in 2017-18 – although a reduction may not always be the decision. The Department has identified significant potential savings from these reductions in the baseline profit rate, but suppliers have criticised the way it is calculated. In its review of the rate, and in its consideration of allowable costs, the SSRO provides significant detail about its methodological approach. In a recent discussion document, the SSRO has investigated with industry ways to measure the impact of its decisions on the financial health of suppliers, in line with its statutory aim to balance value for the taxpayer with a fair return for suppliers. This is a complex area which will be developed and refined in the future (paragraphs 3.8, 3.11, 4.18, 4.19 and Figure 9).

**14 The effectiveness of the Regulations could be undermined by gaps among key commercial and cost assurance staff.** It is essential that the Department has sufficient appropriately skilled staff in key areas to achieve value for money given the large amounts of money at stake and the lack of competition. During commercial negotiations, staff have been able to improve their negotiating position through use of the new Regulations. However, the Department calculates that it is 386 (24%) commercial posts short of its ideal complement in the centre of the Department, Commands, and the Defence Equipment and Support organisation. We have identified shortages of commercial skills as a common problem across government. The Department has plans to partly address these shortages, as well as to improve the skills levels of existing staff. Its Cost Analysis and Assurance Service supplies crucial specialist costing and pricing support to project teams. This support is concentrated on the relatively small number of major contracts which, between them, account for a large proportion of contract values. Contracts below £50 million (worth some £6.5 billion in total) are unlikely to receive such support (paragraphs 5.5, 5.6, 5.7, 5.10 and 5.12).

<sup>1</sup> Comptroller and Auditor General, *The Equipment Plan 2016 to 2026*, Session 2016-17, HC 914, National Audit Office, January 2017.



## Conclusion on value for money

**15** The most effective route to securing value for money in defence procurement is normally through competition. However, because such competition is frequently absent on the largest defence contracts, the Department introduced the Single Source Contract Regulations to balance a fair return for industry with the need for better value for money for the taxpayer. The Department has identified significant potential cost reductions on contracts within the new regime, although the ability to actually deliver them will depend on controlling costs during the life of the contract.

**16** A series of short- and long-term challenges remain. In the short term, the Department needs to eliminate disagreements between key stakeholders and the continued opposition to aspects of the regime from some defence suppliers. Longer term, it needs to maintain credible pressure for competition whenever possible, and be able to measure and demonstrate the effectiveness of the regime in securing savings and maintaining a strong defence industry. Alongside these actions, the Department must increase its ability to negotiate contracts and scrutinise costs to secure better value for money.

## Recommendations

- a** **The Department should fully implement its plans to increase the capacity and capability of its commercial and cost analysis teams to ensure they are adequately resourced to handle the volume of contracts.** Given the key role of these teams in managing suppliers and identifying significant savings, the Department should implement in full its plans to upskill its commercial staff and ensure that its scrutiny and assurance teams are well-resourced. It should not scale back these plans in the face of pressures to reduce staff numbers. It should ensure roles are appropriately defined and made as attractive as possible to potential recruits.
- b** **The Department should be more consistent in requiring formal justification for non-competitive procurement, and be able to demonstrate it is applying credible pressure for competition.** Project teams should be able to demonstrate why a non-competitive procurement route offers better value for money. The Department is improving the visibility of future contracting requirements and identifying where competition can be increased.
- c** **SSRO and the Department should work together to monitor the impact of decisions on the defence industry.** The SSRO's statutory aims make clear it should balance value for money for the taxpayer with a fair return for industry. This is, however, a complex area, where the finances and behaviours of suppliers can be affected not just by the SSRO, but by the wider actions of the Department and a range of other stakeholders.

- d The Department and the SSRO should be clear on their respective roles, and how they will work together to ensure the Regulations are implemented effectively.** The two parties should formally clarify the areas of legitimate inquiry for the SSRO, reflecting the SSRO's functions. Once these areas are confirmed, the Department should ensure the SSRO has access to all contract-related information necessary for it to carry out its agreed role effectively.
- e The Department should develop standard analytics to allow it to absorb and challenge information quickly on non-competitive procurement.** These would cover, for example, contract status, details of contracts excluded and exempted from the Regulations, the extent of suppliers' compliance with the Regulations, action taken or planned in response to SSRO referrals, and the timelines of future contracts.
- f The Department should ensure that the Regulations are applied as intended by the legislation.** The Department should resist calls to dilute the Regulations. It should also set out clearly how it will achieve its target of 100% of eligible contracts being within the Regulations by 2019-20, referred to in the Committee of Public Accounts' hearing in March 2017.