



National Audit Office

Report

by the Comptroller
and Auditor General

Ministry of Defence

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

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

Report by the Comptroller and Auditor General

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Sir Amyas Morse KCB
Comptroller and Auditor General
National Audit Office

20 October 2017

This report looks at how the Ministry of Defence 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.

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Key facts

£8.8bn

expenditure through non-competitive contracts in 2015-16

51%

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

£1.7bn

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

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).

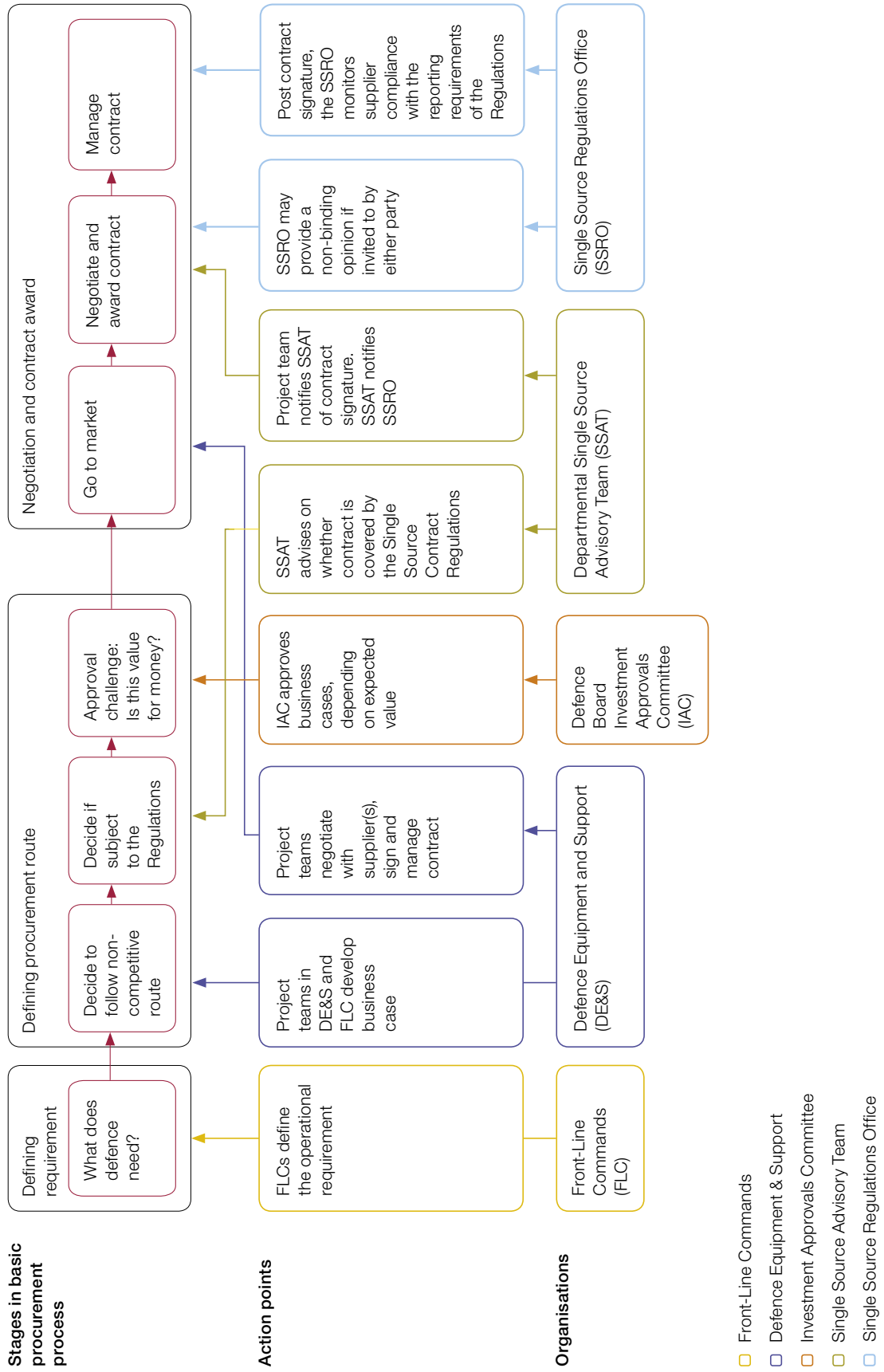
The success of the new regime will depend on the Department being able to tackle effectively a series of short- and long-term challenges. **Figure 1** summarises the system for procuring equipment non-competitively.

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 Department¹ (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).

¹ 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.

Part One

Non-competitive equipment procurement in defence

1.1 The Ministry of Defence (the Department) requires high-quality equipment to fulfil its operational objectives, and support arrangements to maintain and replace this equipment. It procures what it requires within the UK market or from abroad.² Ideally, it seeks to use competition to enable it to compare prices and solutions, and help to secure value for money. There will, however, be circumstances when only one supplier is able to meet demands for certain types of expensive and complex equipment, or where security considerations require a trusted national supplier. In such circumstances, competition may be impossible or inappropriate, and the Department takes a non-competitive route. This part explains what ‘non-competitive procurement’ is, and how and why the Department uses it. It also explains why the Department needed to improve its approach to non-competitive procurement.

1.2 In 2012, the Department stated in its White Paper *National security through technology* that its policy was to pursue open competition wherever possible to fulfil the UK’s defence and security requirements.³ However, it recognised that this might not always be possible. In 2015-16, the Department spent more than £8.8 billion non-competitively and £9.9 billion competitively on all goods and services, including equipment and support.⁴

1.3 The Department engages in non-competitive procurement for various reasons, some of which cannot be avoided. These include:

- maintaining a sovereign capability to manufacture and support equipment;
- meeting urgent requirements, such as replenishing stocks of weapons used on operations;
- securing long-term partnerships with industry, where the benefits of not opening contracts to competition outweigh the costs; and
- using the supplier that owns the intellectual property.

² The Department no longer procures equipment and support in-house with the exception of the Defence Science and Technology Laboratory (DSTL).

³ Ministry of Defence, *National security through technology*, Cm 8278, February 2012.

⁴ A further £5.1 billion was spent on: agreements for goods and services set up locally between the Department and supplier; international projects; payments to overseas governments; and direct payments to Ministry of Defence Trading Funds, DSTL and UK Hydrographic Office.

1.4 Non-competitive procurement also reflects continued consolidation within the defence sector, which means there are fewer suppliers able to manufacture major equipment. Non-competitive procurement may also occur for reasons of convenience, or because the Department has failed to monitor contract end dates.

1.5 Although a long-term relationship with a single contractor can in theory offer advantages through economies of scale, simplified supply chains and reduced procurement times, in practice it may lead to:

- lack of leverage to address poor performance because of dependence on one supplier;
- lack of transparency concerning the supplier's costs, making it difficult to establish a fair price;
- refusal by suppliers to share risk; and
- lack of incentive for suppliers to make their operations more efficient.

Using the non-competitive procurement route

1.6 Arrangements for non-competitive procurement are highly complex and involve a number of different participants (see Figure 1 on page 7), responsible for defining the requirement, selecting the best procurement route and negotiating a deal with suppliers. They include:

- **Front-Line Commands (the Commands):** the Royal Navy, Army, Royal Air Force or Joint Forces Command identify a requirement for equipment and develop the business case.
- **Delivery agent:** for contracts above £20 million, a delivery agent – normally Defence Equipment and Support (DE&S) within the Department – develops a commercial strategy, wins approval for the chosen approach, negotiates a deal with the supplier and manages the final contract.⁵ For lower-value contracts, commercial strategies can be combined with other submissions, reflecting the Department's policy of focusing resources on high-value contracts.
- **Suppliers:** private companies supply the required defence goods and services.
- **Ministry of Defence Head Office:** sets overall strategic policy, scrutinises business cases and provides expert advice to commercial teams, for example, via the Single Source Advisory Team (SSAT).

⁵ A separate organisation (Information Systems and Services) provides information systems and services.

Attempts to achieve value for money from non-competitive procurement

1.7 In 1968, in an attempt to exert control over excess profits and costs in non-competitive procurement, the government introduced the 'Yellow Book' regime. This was an agreement between HM Treasury and the Confederation of British Industry, overseen by a review board. It provided for 'equality of information' between Department and supplier at the point of contracting; 'post-costing' to identify whether actual costs conformed to estimates; and, through negotiation, the recovery of 'unconscionable profits'.

1.8 As a result of widespread recognition that the existing regime was ineffective and outdated, in 2011, the government commissioned Lord Currie of Marylebone to review arrangements for non-competitive procurement.⁶ His report concluded that the existing arrangements failed to prevent inappropriate behaviours and did not address the imperfections in the market arising from the lack of effective competition. Deficiencies included:

- limited access to contractors and inconsistent information from them, so that the Department could not assure itself it was achieving value for money;
- excessive focus on profit, rather than seeking reductions in the bulk of contract costs, and, in particular, insufficient challenge of overhead costs;
- restricted ability to adjust profits for contracts with above or below average risk;
- weak governance, with no assurance about the extent to which contracts were covered by the regime, and the need for industry agreement to make changes to arrangements; and
- a lack of standard reporting requirements, and guidance that was vague and open to interpretation.

1.9 Subsequently, the government introduced the Defence Reform Act 2014. This created a new statutory framework governing single source procurement called the Single Source Contract Regulations (the Regulations), and established the Single Source Regulations Office (SSRO) to be the independent regulatory body for non-competitive procurement of goods, works and services secured by the Department under qualifying contracts. Under the Regulations, most non-competitive contracts with a value greater than £5 million and certain categories of sub-contracts are subject to the new Regulations, unless exempted by the Secretary of State (paragraph 4.4). The regime is designed to increase transparency around supplier costs in order to enable the Department to identify non-allowable costs not appropriate to the contract, and apply a regulated and benchmarked profit rate.

1.10 Given the importance of non-competitive procurement for the Department, we examined current arrangements for securing value for money when using this approach (**Figure 2** overleaf).

⁶ Lord Currie of Marylebone, *Review of single source pricing regulations*, October 2011.

Figure 2 How the Department seeks to secure value for money from non-competitive procurement

Developing a strategic view (Part Two)	Strengthening oversight (Part Three)	Applying the Regulations to secure savings (Part Four)	Developing skills and capability (Part Five)
<p>Main bodies responsible</p> <p>The Department, Commands and the Investment Approval Committee.</p> <p>What would best practice look like?</p> <p>Contracts always let competitively, unless exclusions apply.</p> <p>Department has good visibility of its contract portfolio and how contracts are performing.</p> <p>All contracts receive appropriate scrutiny and oversight.</p>	<p>The Single Source Regulations Office (SSRO) and Single Source Advisory Team (SSAT).</p> <p>Regulations driving better VFM than previous arrangements.</p> <p>SSRO and SSAT carrying out their duties effectively.</p> <p>SSRO has appropriate powers and uses them effectively.</p> <p>When carrying out its duties the SSRO takes into account both VFM for taxpayer and fair prices for industry.</p>	<p>The Department, the SSRO and suppliers.</p> <p>All contracts that should be subject to the Regulations are brought into the regime.</p> <p>Exemptions are used appropriately.</p> <p>Suppliers are complying with regulatory requirements.</p> <p>All contract costs are allowable under Regulations and predicted savings are being made.</p>	<p>Defence Equipment & Support (DE&S) and Cost Assurance and Analysis Service (CAAS).</p> <p>All contracts receive appropriate levels of technical support, oversight and challenge.</p> <p>The Department has the right numbers of skilled individuals in post.</p>
<p>Information our report presents</p> <p>In Part Two we examine:</p> <ul style="list-style-type: none"> • The prevalence of non-competitive procurement. • The Department's visibility of contracts. • Attempts to increase competition through challenging decisions to procure non-competitively. 	<p>In Part Three we examine:</p> <ul style="list-style-type: none"> • How the Regulations have changed over time. • Oversight of the Regulations. • Powers and remit of the SSRO. • Relationships with stakeholders. 	<p>In Part Four we examine:</p> <ul style="list-style-type: none"> • How many contracts are covered by the regulations. • Supplier compliance with regulatory reporting requirements. • How determinations of allowable costs are made. • Cost savings expected from applying the Regulations. 	<p>In Part Five we examine:</p> <ul style="list-style-type: none"> • The contribution of specialist staff in approving projects. • The number and skills of commercial staff. • Specialist support to project teams.

Source: National Audit Office

Part Two

Developing a strategic view of non-competitive procurement

2.1 Given the stated policy of the Ministry of Defence (the Department) is to use competition as much as possible, we would expect to see it reducing the level of non-competitive procurement. This part examines whether the Department is managing non-competitive procurement strategically, through knowledge of the extent to which competition takes place, efforts to increase it, and the wider adoption of contracts which transfer risk to the supplier.

The prevalence of non-competitive procurement in defence

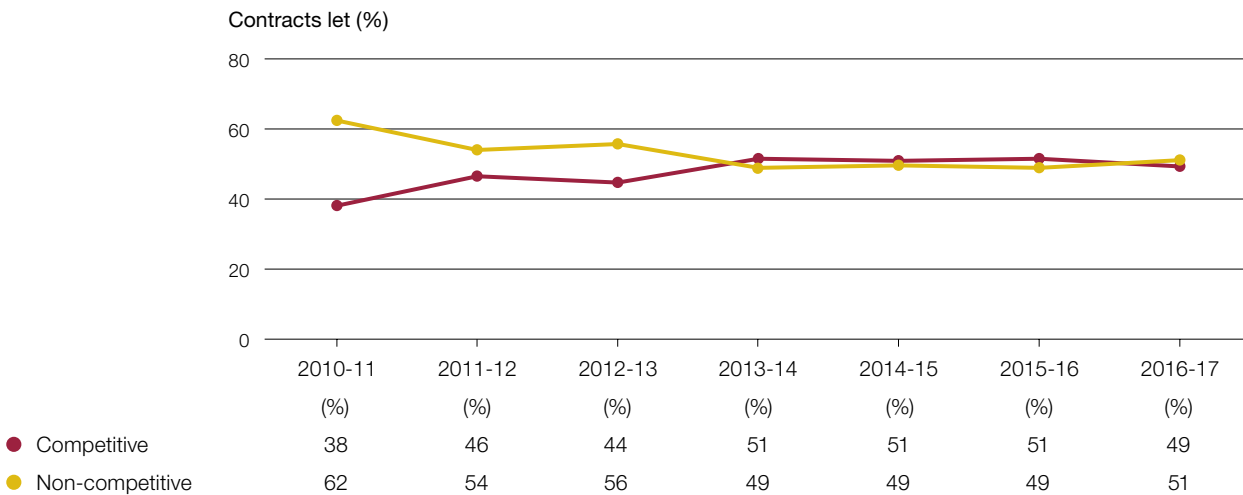
2.2 Although the Department's preference is to procure equipment and support through competition, it has not increased the level of competition since its 2012 statement (**Figure 3** overleaf). Between 2013-14 and 2016-17, the proportion of contracts let non-competitively has stabilised at around 50%.

2.3 The value of the Department's contract portfolio can change dramatically if it signs a single high-value contract (**Figure 4** on page 19). Between 2013-14 and 2016-17, the value of non-competitive contracts on the Department's books has varied between 24% and 75% of the contracts let. For example, one contract for logistics services represented 59% (£6.3 billion) of total competitive contract value in 2015-16. This volatility, which partly reflects the fact that the Department may consider a non-competitive approach to be the most appropriate, means that the Department has not set a target for increasing the value of contracts let competitively. Neither has it set a target for the number of contracts.

Figure 3

The number of new equipment contracts let by the Department

The proportion of live equipment contracts let each year is now broadly split 50:50 between competitive and non-competitive contracts



Notes

- 1 Contracts are shown by year let.
- 2 Excludes contracts with the Department’s Defence Science and Technology Laboratory, pan-government contracts, cross-departmental services and contracts let by the Defence Infrastructure Organisation.
- 3 Contracts stated as active on the Department’s database as at 31 March 2017.

Source: National Audit Office analysis of departmental data

Visibility of the full extent of contracts

2.4 In the past, the Department’s ability to manage strategically contract activity of all kinds, including non-competitive contracts, was reduced because its records were inaccurate and incomplete. As at 21 August 2017, the Department’s database had 5,828 live contracts, of which 2,856 (49%) were non-competitive. We estimate that 1,891 of these related to equipment.⁷

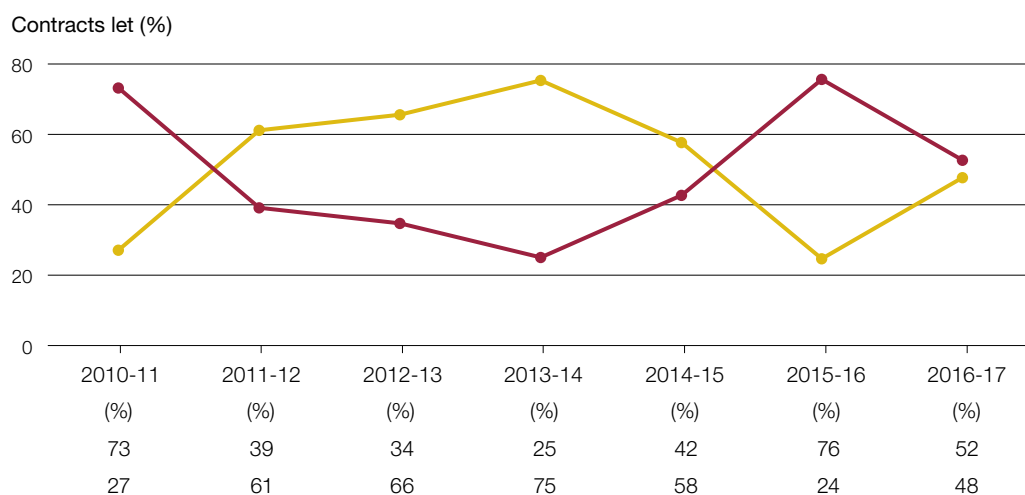
2.5 The Department divides contracts into four categories based on value (**Figure 5** on page 20). These categories attract differing levels of scrutiny by the Department, with oversight arrangements focused mainly on successfully delivering the largest and most important contracts (Category A). Given staff capacity constraints and the number of contracts, it is sensible to focus resources in this way, but this does mean the Department has only a partial view of its total portfolio. Just 22 of the 1,891 non-competitive contracts are Category A contracts, although these account for almost two-thirds of the total value (£23.4 billion).

⁷ This report focuses on equipment, to reflect the thrust of the Regulations. In order to do this we removed contracts let through the Cabinet Office and across government, intra-departmental agreements, contracts relating to infrastructure and contracts for cross-departmental services.

Figure 4

The value of new equipment contracts let by the Department

The share of non-competitive and competitive contracts by value can vary strongly from year to year



Notes

- 1 Contracts are shown by year let.
- 2 Excludes contracts with the Department's Defence Science and Technology Laboratory, pan-government contracts, cross-departmental services and contracts let by the Defence Infrastructure Organisation.
- 3 Contracts stated as active on the Department's database as at 31 March 2017.

Source: National Audit Office analysis of departmental data

2.6 The Department is now addressing long-standing problems with data accuracy. In 2016-17, it introduced a single system to provide an integrated, reliable source of information on finance and procurement. As part of this process, it has spent two years cleansing its contracts data and correcting thousands of records. Nevertheless, of the 1,891 non-competitive equipment contracts that were shown as 'live' on 21 August 2017, 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 due for renewal or amendment that may fall within the scope of the Regulations.

2.7 When the Regulations came into force, the Department had only partial information on upcoming contracts that could be subject to the Regulations. This lack of information creates challenges both in terms of predicting the workload of the Department's Single Source Advisory Team, and in identifying how to achieve the £1.7 billion savings target set for the regime. It has now compiled a list of future contracts from a variety of sources around the Department.

Figure 5

Value of contracts

Most of the Department's current non-competitive spending is through a few large contracts, but the Department also manages a large number of smaller non-competitive contracts

	Number of live non-competitive contracts	Average value (£)	Total contract value (£)	Proportion of total value of non-competitive contracts (%)	Example of contract
Category A (£400m plus)	22	£1,062,632,589	£23,377,916,968	57	Astute class submarine
Category B (£100m–£400m)	40	£207,188,423	£8,287,536,947	20	Replenishment of Paveway IV bombs
Category C (£20m–£100m)	127	£43,288,672	£5,497,661,364	14	Integration and support for naval combat system
Category D (up to £20m)	1,702	£2,058,546	£3,503,645,359	9	Test and evaluation services for Chinook helicopter

Notes

- 1 Data snapshot taken on 21 August 2017.
- 2 Excludes contracts with the Department's Defence Science and Technology Laboratory, pan-government contracts, cross-departmental services and contracts let by the Defence Infrastructure Organisation.

Source: National Audit Office analysis of departmental data

Attempts to increase the level of competition

2.8 The decision to procure non-competitively is made jointly by project teams and the Commands. Where this is the case, the formal justifications presented by project teams of decisions to procure non-competitively are highly variable in quality. These decisions are subject to varying levels of review. The highest-value Category A contracts, together with other contracts that are considered of strategic significance, are scrutinised by the Department's Investment Approvals Committee (IAC), where decisions to procure non-competitively can be challenged, although proper consideration of this should have taken place at an earlier stage. We reviewed 166 IAC decisions made since January 2015, identifying 14 occasions where the IAC had challenged the decision or indicated that a competitive solution would be expected. In most of these cases, given the stage reached in the procurement process, the IAC asked the project team to maximise opportunities for competition at a later stage or on similar projects.

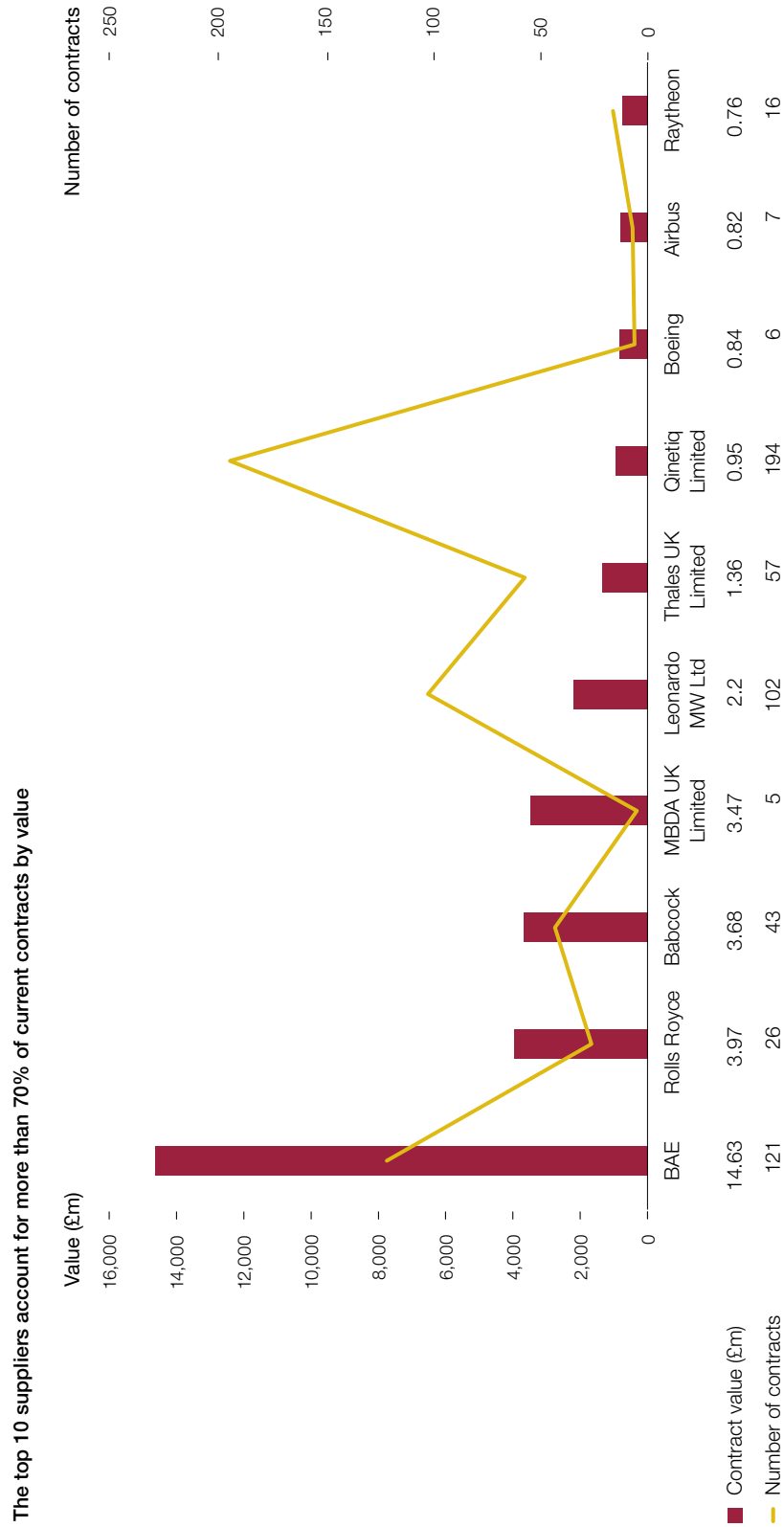
2.9 There are limits in the short-term and medium-term to what the Department can do to increase competition. A small group of suppliers dominate the non-competitive market, with the top 10 accounting for more than 70% of current contracts by value (**Figure 6** overleaf).

2.10 Introducing competition into areas of high-value equipment procurement that have previously been non-competitive can be a complex and lengthy process. For example, in 2009 the Department agreed that one contractor would have the right to be the lead contractor for complex warship procurement for a period of 15 years. The Department told the Committee of Public Accounts in March 2017 that it now wishes to open this role to competition for the upcoming general purpose frigate.⁸

2.11 It is also important to prevent a requirement originally procured competitively from becoming non-competitive because of intellectual property considerations. For example, the Department is seeking a replacement for its Bowman battlefield tactical communications system. With the cooperation of the existing supplier for this requirement, a design is being developed which can be competed openly through the transfer of intellectual property rights to the Department at pre-agreed points in the programme.

⁸ HC Committee of Public Accounts, *The Defence Equipment Plan*, Fifty-sixth Report of Session 2016-17, HC 957, April 2017.

Figure 6 Contractors receiving the largest revenues from current non-competitive equipment contracts as at 31 March 2017



Note
 1 Excludes contracts with the Department's Defence Science and Technology Laboratory, pan-government contracts, cross-departmental services and contracts let by the Defence Infrastructure Organisation.

Source: National Audit Office analysis of departmental data

Part Three

Strengthening oversight of non-competitive procurement

3.1 Parts One and Two explained that the Ministry of Defence (the Department) commonly uses non-competitive procurement, but that this is an area where it has lacked strong oversight. This part examines the introduction of the Single Source Contract Regulations (the Regulations), and whether new arrangements, including establishment of the Single Source Regulations Office (SSRO), have improved oversight of non-competitive equipment procurement.

Defence Reform Act 2014 and the Regulations

3.2 In introducing the Regulations in 2014, the Department decided to replace the previous voluntary approach (the 'Yellow Book') with a statutory regime. This was because of the difficulties in reaching agreement among stakeholders on the framework during consultation. The new framework establishes statutory rules on contract pricing and promotes greater transparency by requiring contractors to submit regular reports (see paragraph 4.10). Contractors must also demonstrate to the Department that costs are appropriate, attributable to the contract, and reasonable, rather than the onus being on the Department to identify where this is not the case (paragraph 4.13). The regime also allows the Department to impose civil penalties if contractors do not comply with the transparency requirements (**Figure 7** overleaf).

3.3 Not all non-competitive procurement falls under the new framework. The Regulations are not retrospective and some contracts are automatically excluded, for example, government-to-government agreements, contracts relating to the purchase of existing land and buildings, international collaborative contracts and contracts relating solely to intelligence. As at July 2017, the Single Source Advisory Team (SSAT) was aware that 19 contracts had been excluded, for example, for the operation of the government pipeline and storage system, together with intra-governmental agreements with the Defence Science and Technology Laboratory. This is likely to be an underestimate of the true number, as project teams are not required to inform the SSAT of contracts where exclusion from the Regulations appears clear-cut.

Figure 7 Comparison of the Yellow Book and the Regulations

Yellow Book

Intended to apply to all government non-competitive contracts.

Profit formula based on a comparable profit rate for industry reviewed annually against a reference group.

Profit rate overseen, together with rest of system, by a review board. Any changes agreed by industry.

No agreed definition of the key information and assumptions underpinning the contract price to be shared with Department.

The brief Government Accounting Conventions provided guidance on what costs were recoverable by industry in contract pricing developed on an ad hoc basis. Both parties needed to consent to changes.

Contractor expected to provide a full breakdown of costs, which were scrutinised and discussed by project team negotiators, although there was no mandated cost breakdown structure. Contractors were only required to share information when contracts were signed.¹

Departmental rights of access to labour and overhead rates governed by custom and practice. Information was often provided late or not at all.

Cost Assurance and Analysis Service carried out 'post-costing' of the contract to identify whether excess profit had accrued to contractor. There were considerable delays in provision of actual costs by suppliers.

The Regulations

Regulations will eventually cover 100% of eligible new non-competitive contracts with a value greater than £5 million, unless circumstances are exceptional.

Baseline profit rate based on a comparable profit rate for industry set annually, using a reference group set by the SSRO and a standard methodology. Statutory basis for calculation of other adjustments to profit rate.

Baseline profit rate and other adjustments recommended by the SSRO and approved by the Secretary of State.

Contract pricing statement requirements set out in the Regulations. Suppliers are subject to penalties for failure to report the full range of costs after the contract is signed.

The SSRO issues guidance on allowable costs. The Department determines the allowable, non-allowable and partially allowable cost categories for individual contracts, based on principles rather than specific rules.

Contractors have statutory obligations to provide a full breakdown of costs and demonstrate they are allowable, and these are scrutinised and discussed by project team negotiators.

Supplier reporting requirements require contractors provide information about actual overhead rates, to be reported within approved timescales.

Full reporting of contract costs from contract signature onwards, with penalties for non-compliance.

Note

¹ Comptroller and Auditor General, *Transforming government's contract management*, Session 2014-15, HC 269, National Audit Office, September 2014.

Source: National Audit Office

Oversight of the Regulations within the Department

3.4 Within the Department, the SSAT oversees the application of the Regulations and acts as liaison point and Departmental sponsor for the SSRO. These bodies now have a shared database of the relevant contracts under the Regulations, and the SSAT does now share with the SSRO its performance data on implementation of the Regulations, including the number of contracts let and their value. This is helping the teams to have a common understanding of upcoming contracts and the impact of their respective roles. The Department is not required to share with the SSRO the extent of contracts excluded and exempted from the Regulations, or the underlying reasoning.

3.5 Even though the initial flow of contracts has been lower than expected, the SSAT has experienced a heavy workload. This has included:

- **Providing complex policy advice to project teams**

Commercial teams in the Defence Equipment and Support (DE&S) organisation told us that the SSAT was involved throughout the procurement process.

- **Management of the relationship with the SSRO on behalf of the Department**

Soon after its creation, the SSRO directly raised queries with a small number of project teams. In order to assure a consistent and coherent response to SSRO queries, the Department decided that all communications between itself and the SSRO should be coordinated through the SSAT.

- **Difficulties in identifying contracts**

Although project teams are expected to notify the SSAT of relevant contracts, there were gaps in their awareness of the Regulations, and the SSAT has had to gather intelligence itself on future contracts through a range of ad hoc methods. The SSAT found that some project teams have tried to exclude contracts from the Regulations.

3.6 The amount of work required of SSAT has led to it having to prioritise some tasks over others. As the number of contracts has grown, the SSRO has also referred to the SSAT large numbers of unresolved queries about the quality of financial information received from suppliers under the Regulations. After assessment, these queries are relayed to project teams to be resolved. A considerable backlog of such queries built up during discussions between the SSAT and the SSRO about the latter's role in ensuring compliance with the Regulations, which have now been concluded to both parties' satisfaction. The SSAT then lacked the capacity to clear the backlog promptly. At the end of August 2017, 351 queries were waiting to be addressed by the SSAT. In six contracts queried by the SSRO, the Department identified deviations from the Regulations that had not been reported.

Powers and remit of the SSRO

3.7 The SSRO was created in July 2014 as a non-departmental public body, with board members appointed or approved by the Secretary of State for Defence. At the end of March 2017 it employed 33 staff, most of whom have a background in audit, accountancy, finance and regulation. The SSRO has experienced significant turnover at senior level, with three chairs since it was set up.

3.8 The SSRO has a number of key functions:

- **Developing a new profit-rate methodology**

The Defence Reform Act sets out six steps to determine the overall profit rate for contracts within the regime, starting with a baseline profit rate. The SSRO reviews the baseline profit rate, capital servicing rates and SSRO funding adjustment annually and submits a recommendation to the Secretary of State for Defence for approval.^{9,10}

- **Issuing guidance on allowable costs**

The SSRO issues statutory guidance on what costs are allowable for contracts within the regime. The Defence Reform Act states that allowable costs must be 'appropriate, attributable and reasonable in the circumstances', although there is considerable scope for interpretation.

- **Issuing opinions or determinations on issues arising**

Where a disagreement on costs cannot be settled through negotiation, the matter may be referred to the SSRO by either party. When such a referral takes place prior to contract signature, the SSRO can issue a non-binding opinion for clarity. When a matter is referred after contract signature, the SSRO has the power to make a legally binding determination.

- **Gathering data on relevant contracts and conducting value-for-money studies**

The SSRO plans to use its analysis of information on contracts to provide benchmarks for future contract negotiations. It also publishes statistics on its website based on the data received on contracts, and prepares in-depth studies.

- Additional functions of the SSRO are to keep the Regulations under review and to provide analysis on specific topics when requested by the Secretary of State.

While the SSRO is required to balance better value for money and fair prices, many of these functions can potentially or actually contribute to contract cost reductions, which should assist the Department in achieving its target of securing £1.7 billion of savings through application of the Regulations.

9 Capital servicing rates are adjustments for the cost of servicing debt.

10 Funding adjustments to contracts intended to allow the Department to recover half of the SSRO's costs.

3.9 Although described as a ‘regulator’ in the explanatory notes to the Defence Reform Bill, the SSRO has a tightly defined role as a ‘regulations office’. The legislation does not confer on the SSRO a number of the typical characteristics of effective economic regulators (that is, those that influence the price charged in a marketplace) (**Figure 8**).

Figure 8 Comparison with other regulatory organisations

The SSRO does not have the same characteristics as other regulatory organisations

Typical characteristics of an economic regulator	SSRO
Most are accountable to Parliament for their use of powers.	Accountable to Parliament through the Department. It has few direct powers, instead advising the Department on issues such as whether penalties should be levied for failing to supply information.
Determines which players can operate in the market by requiring operation under a licence.	Has no role in determining the suitability of suppliers.
Resources allocated according to risk.	Resources allocated in line with duties in legislation.
Usually able to require that industry provides them with the information they need.	Can ask the Department to penalise suppliers that do not provide information they are required to supply by the Regulations. The SSRO has the right to carry out studies in support of its statutory functions, but it has no statutory access rights to some information it believes is necessary to perform its role, such as copies of the relevant sections of contracts.
Seeks to ensure that senior executives endorse data submitted to them.	Data submitted online do not require sign-off from senior executives.
Seeks to bring investors on-side to deliver changes, emphasising the importance of building trust.	Bi-annual meetings of the SSRO Senior Stakeholder Forum and quarterly meetings of the Operational Working Group, and more informal contacts. Nevertheless industry told us that the SSRO had been resistant to their input, although we noted a generally low level of industry response to written consultations.
Staff often have a background in the relevant industry.	Staff have an accounting, regulatory, corporate finance or compliance background, but are not drawn from the defence sector.
Five-yearly price controls are typically used by regulators to promote sustainability.	Reviews the baseline profit rate annually, as required by the legislation. The rate adopted is a three-yearly moving average.
Focus on the industry’s performance against requirements as this is what should matter most to the customer, rather than profit rates.	The SSRO does not have a role in measuring wider contract performance.

Source: National Audit Office

Stakeholders' experience of the Regulations so far

3.10 Successful use of the Regulations requires all stakeholders to fulfil their statutory obligations. The views of the main stakeholders on the Regulations are summarised in **Figure 9**. In common with the experience in other sectors of industry subject to regulations for the first time, the early stages of the Regulations have been characterised by differences of opinion between industry and the regulatory body, in part, prompted by the SSRO's sometimes confrontational public tone. However, the SSRO and the Department have also disagreed about the former's interpretation of its remit. All parties emphasise that they are now seeking to make a fresh start in their relationships.

3.11 According to the Regulations, alongside its obligations to secure value for money for the taxpayer, the SSRO must aim to ensure that suppliers are paid a fair and reasonable price. In a recent consultation it has investigated with industry ways to determine whether its work impacts on the financial health of suppliers. As a result, the SSRO will develop the use of financial market indicators to measure defence industry health. Responses to the consultation emphasised that the wide range of factors that might impact on a company's health made selection of indicators a complex issue. Industry may also be influenced by a range of factors outside the remit of the SSRO, such as actions by the Department or foreign governments, or global economic conditions.¹¹

3.12 The Defence Reform Act 2014 requires the Secretary of State to review the regulatory framework every five years, starting in 2017. The SSRO made its recommendations for changes in June 2017, for consideration by the Secretary of State by the end of 2017. In January 2017, the SSRO launched a public consultation on its proposed recommendations. It aims to remove the factors that prevent contracts being brought within the regime, focusing on:

- **ensuring that single-source spending is appropriately covered by the regime**, for example, contract amendments, sub-contracts and those contracts currently excluded from the Regulations, such as international deals and intelligence activities;
- **increasing transparency**, by requiring contractors to report on sub-contracts and introducing more powers to support the SSRO's access to information; and
- **providing effective enforcement of the regime**, expanding the possible grounds for referral by contracting parties and transferring responsibility for issuing certain compliance and penalty notices to the SSRO.

Industry has also submitted its views to the SSRO and held a joint workshop with the SSRO and SSAT in 2017. The Department will decide what changes are to be adopted, in the context of its own views on how the regime should develop.

¹¹ Single Source Regulations Office, *Developing the SSRO's approach to calibrating profit rates in single source contracts*, June 2017.

Figure 9

Views of the Department, SSRO and industry on the Regulations

	Department's view	SSRO view	Industry view
Clarity of the Regulations	Principles-based approach means that interpretations will evolve over time, requiring pragmatism.	The SSRO provides clarity on the meaning of the Regulations either through its statutory guidance or by providing an opinion or determination when a matter is referred to it.	It has been a steep learning curve on all sides, and in some cases the Regulations have delayed contract negotiations.
Effectiveness of the Regulations	Clear evidence that the Regulations are proving effective in reining in costs. Valued by negotiating teams.	A positive start, as shown by the SSRO's reports on regime operation. Its review of the legislation aims to further improve the regime's effectiveness.	The Regulations do not promote change, innovation or cost reduction. Focus is on the profit rate methodology, but profits only represent a small proportion of total contract value.
Effectiveness of the SSRO	The SSRO has established itself as a key element in the framework but has had difficulty in accurately interpreting its role within the regime and has yet to develop the skills and expertise to allow it to fulfil its role effectively.	The SSRO believes it has had a demonstrably positive impact in a short time. The SSRO will continue to evolve its approach in response to its duties and stakeholder feedback.	The SSRO has sought to audit industry rather than regulate it. Does not consider whether industry is receiving a fair rate of return. Staff lack relevant experience, and its methodology has been flawed.
Effectiveness of the Department	Project staff are delivering cost reductions using the Regulations, with crucial central support from the SSAT, Ministry of Defence Commercial Policy team and CAAS.	There is scope for the Department to further embed application of the regime at the project team level and make more use of referrals.	Knowledge of the Regulations among project teams varies considerably. Constructive relationships with the centre of the Department.
Response of industry	Variable responses from industry. Most suppliers are reconciled to the Regulations and there have been some very constructive engagements, but some suppliers are still resisting implementation.	Industry compliance with reporting obligations is improving. But there is scope for some suppliers to improve both the timeliness and the quality of initial report submissions.	Some variation in views. Some found it much easier to comply with requirements than others. Some find requirements disproportionate to the level of business conducted in UK.

Source: National Audit Office interviews

Part Four

Applying the Single Source Contract Regulations effectively to secure savings

4.1 This part examines whether the Single Source Contract Regulations (the Regulations) are leading to complete transparency about contract costs, and whether this is resulting in the Ministry of Defence (the Department) paying a fairer price for equipment procured non-competitively. We look at whether the Department is: applying the Regulations to all appropriate contracts; gaining access to cost information; disallowing non-allowable supplier costs; and, as a result, achieving significant cost savings, within the context of its obligations to balance value for money and fair pricing.

Extent of coverage of non-competitive equipment contracts

4.2 In order for the Regulations to work effectively:

- the Department requires clear sight of which of its contracts should be subject to them; and
- the Regulations should provide exemptions only in exceptional circumstances.

Visibility of contracts subject to the Regulations

4.3 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. The new regime's credibility, and its ability to achieve savings, is dependent on the degree to which all contracts eligible to be brought within the Regulations are actually subject to them. As mentioned in paragraph 3.5, the Single Source Advisory Team (SSAT) has not found it easy to identify all contracts that should be included.

Exemptions

4.4 Contracts can be exempted from the Regulations only with the approval of the Secretary of State, a power which has not been delegated to officials. So far, this has happened on seven occasions (involving contracts with a total value of £217 million, or 1% of the value of contracts covered by the Regulations). These were:

- cases where the contracts were not for the delivery of goods or services and therefore not covered by the Regulations, such as the Department meeting pre-existing pension liabilities;
- a case where a sub-contract originally let competitively would have come under the Regulations retrospectively due to changes in time and scope, with the risk of operational consequences from any delay;
- a case which became subject to the Regulations at a late stage in the negotiations due to an international policy change. The Department undertook benchmarking to gain assurance on value for money; and
- cases where the purchase was of a standard 'off-the-shelf' product, where the supplier demonstrated to the Department's satisfaction that the price offered was competitive (for example, software licences).

Bringing all appropriate contracts within scope of the Regulations

4.5 The Department has a target that, by 2019-20, all non-competitive contracts with a value greater than £5 million and not covered by the exclusions set out in the Regulations, will be covered by the Regulations. There is currently disagreement between the Department and certain suppliers, who are either refusing to be subject to the Regulations or will not provide the required information about costs and prices. The Department is considering what action to take in these situations.

4.6 The Department faces a particular challenge with contracts pre-dating the Regulations that may be brought within them 'on amendment'.¹² Notification of amendments to the SSAT by teams has been variable, partly because they may not be aware that such contracts could qualify, and amendments are more difficult for the SSAT to identify than wholly new contracts. In addition, even if an amendment is identified as being eligible, the contractor must agree to the contract being brought within the regime. As a result of these factors, only eight contracts (worth some £7 billion) have been converted to Qualifying Defence Contracts (QDCs) on amendment.

4.7 It is not clear to what extent the Regulations are being applied to qualifying sub-contracts (QSCs) above £25 million. For sub-contracts over £25 million the prime contractors need to assess whether the sub-contracts are QSCs and notify the Department. Only 15 such contracts had been signed by August 2017. In some cases, suppliers are not clear whether a sub-contract qualifies for the Regulations and have disagreed with the Department about their status. A number of suppliers have told the SSRO that they support improvement and clarification regarding the definition of QSCs.

¹² The amendment in question could range from the contract entering a new pricing period with the terms unchanged, to a fundamental change such as moving from the design to manufacturing stage of a submarine or armoured vehicle.

4.8 In addition, some of the Department's largest contracts were set up before the Regulations in the form of framework contracts, with individual procurements or packages of support work then being contracted for as required. These arrangements were negotiated on the basis that they would deliver significant savings compared with more traditional contracts. Bringing such contracts within the Regulations presents considerable challenges if the benefits of the approach are to be retained, although the Department is confident that the largest of these contracts can be successfully brought into the regime.

Supplier compliance with contract reporting requirements

4.9 One of the chief benefits of the Regulations is the transparency of information on costs for all contracts. Project teams told us that the Regulations had allowed them greater access to supplier cost information than in the past. This allows the Department to monitor actual costs against the estimates included in contract prices. In time, this will lead to the build-up of a library of knowledge about contract costs, which will inform future negotiations. Collecting this information has been a challenge for the SSRO since the legislation made no provision for the collection of data from prior contracts. The SSRO is now attempting to gather such data as part of a study into industry's pricing of risk. They told us that they have had constructive engagements with the Department and industry as part of this work.

4.10 The legislation sets out prescriptive reporting requirements for all contracts, which, for example, after March 2017 will require contractors to submit seven reports in the first year of all contracts over £50 million. Suppliers experienced difficulties relying on the early reporting templates provided to the SSRO by the Department. Suppliers must submit information in a set format, which some told us requires them to devote additional resources to collating the data. All parties accept the original system put in place was not fit for purpose and the SSRO replaced it in March 2017 at a cost of £600,000. The new system is designed to be easier to use and early feedback to the SSRO from training sessions suggests this is the case.

4.11 The SSRO has raised a large number of queries regarding data submitted (or not submitted) by suppliers as part of its work to keep under review the extent to which suppliers are complying with their reporting obligations. As at 31 August 2017, the SSRO had raised 2,188 reporting and pricing queries on 98 contracts, of which 862 were unresolved (39%). Of these, 351 had been referred to the Department (see paragraph 3.6), 346 had been raised with contractors and 165 were pending submission to the Department by the SSRO. Many queries are minor in nature. Queries often concern inaccurate or incomplete submission of factual information within the contract, such as payment schedules, milestones and metrics. The SSRO told us that, in its view, these queries about data could be avoided, or resolved more promptly, if it had access to the relevant schedules of the contract. This is not currently the case. The SSRO is developing its compliance methodology, which will include a greater focus on specific recurring themes within the queries that it raises. As part of this, the SSRO will work with both the Department and suppliers to ensure that issues identified are raised and resolved in an effective and efficient manner.

4.12 The SSRO's work to review suppliers' compliance with reporting obligations has led to the identification of breaches of the Regulations that occurred during negotiations, but were not reported as deviations. Through its analysis of reports provided for individual contracts, and further investigation undertaken by the Department, it identified five contracts that had breached the Regulations because they had not observed the principle of 'not taking profit on profit'.¹³ The Department did not take action to correct the error in these cases.

Determining whether costs are allowable

4.13 The Regulations require the Department to determine which costs are allowable in suppliers' pricing proposals. Costs must be appropriate (expected to be incurred), attributable (necessary for the contract) and reasonable. Commercial teams told us that some suppliers had previously expected to impose their terms and conditions on the Department due to the strength of their position, but this was changing with the new Regulations.

4.14 The SSRO provides guidance the Department can refer to when discussing which costs are allowable in specific contracts. Disagreements between the Department and suppliers have centred on the 'reasonableness' of costs, the more subjective category. One such disagreement relates to 're-work'. Suppliers are expected to bear the cost of re-work caused by their poor workmanship, following an opinion by the SSRO on a contract referred to it in 2015.¹⁴ In one contract we examined, we were told that the supplier is now setting up a system to record the causes of re-work, but validating these claims will create extra work for the Department.

4.15 Some contractors have resisted complying with the UK's Regulations, partly because they already comply with the United States' Federal Acquisition Regulations. The UK's 'principles-based' approach contrasts with the 'rules-based' approach in the US, which is more specific about which categories of costs are not permitted. US regulations are also more permissive than the UK's in areas such as sales and marketing, and research and development. The SSRO issues guidance on what costs are allowable, which the Department considers, and the general policy is that such costs should only be allowed when they generate benefits directly attributable to the contract, while suppliers believe that this ignores the government's broader 'prosperity agenda' for UK industry.

¹³ Profit could be charged on profit if a sub-contractor is part of the same group as the prime contractor.

¹⁴ SSRO anonymised summary of first formal opinion on a Qualifying Defence Contract, November 2015.

Cost savings expected from the Regulations

4.16 The Department has set a 10-year target to save £1.7 billion by applying the Regulations, based on the original impact assessment. Achieving these savings is important for maintaining the affordability of its Equipment Plan. The Department has a more detailed objective of saving £637 million from the Regulations by 2020. This has been hampered by problems identifying forthcoming contracts (see paragraph 2.7). The Department told the Committee of Public Accounts (the Committee) in March 2017 that it was confident it would meet its target. The SSAT calculates that by the end of July 2017 the Regulations had achieved a reduction of £313 million in contract prices (3.9% of total contract values), based on returns for 79 contracts (**Figure 10**). Part of this is cost avoidance, and part contributes towards the Department's £1.7 billion target. As these savings are across the life of the contracts it is not clear how this maps onto the savings targets. The Department is undertaking additional work to ensure that reductions are properly identified, and to better understand whether the savings are likely to be realised within the timescale needed to meet the target. Actual achievement of these savings will depend on managing the contracts to time and cost. Some £3 million has been reported as achieved to date.

Figure 10

Potential savings arising from the application of the Single Source Contract Regulations

In the two and a quarter years to July 2017, the Department identified potential contract cost reductions attributable to the Regulations of £313 million

Category of saving	Amount (£m)
Baseline profit rate	58
Other profit adjustments	78
Disallowed costs	154
SSRO opinions and determinations	2
Other	22
Total	313

Notes

- 1 Savings from 79 contracts.
- 2 Total does not sum due to rounding.

Source: Ministry of Defence

4.17 As under the previous regime, the Department can carry out reviews of costs after the contract award and, if appropriate, recover excess profits. Between December 2014 and March 2016, the Defence Equipment and Support organisation reviewed 17 completed contracts which pre-dated the Regulations (known as ‘post-costing’), worth £447 million. This work resulted in the recovery of £5.2 million of excess profits. It will be conducting similar exercises in future on contracts within the Regulations.

Changes to profit rates

4.18 One of the elements of the regime contributing to the savings in Figure 10 came from the SSRO’s annual review of the baseline profit rates to be applied to contracts within the Regulations. This rate has fallen from 10.6% in 2014-15 (set using the former review board’s methodology) to 7.46% in 2017-18, although a reduction may not always be the decision. The SSRO’s approach to the review is based on similar principles to the approach used under the former ‘Yellow Book’ regime (see paragraph 3.2), but it has changed the range of companies used as comparators. Previously, the range of comparator companies was drawn from across British industry, but the SSRO now focuses on companies from the UK, Western Europe and North America (including defence companies) engaging in types of activity that are comparable with those across the range of defence contracts. In addition, it has used a three-year rolling average profit to smooth out fluctuations. The methodology that the SSRO has used has been criticised by industry, but is supported by the Department as being more robust. Debate has centred on the selection of comparator companies, and the use of the median rather than mean value of the comparator population. In March 2017, the SSRO published extensive information about how it had selected the comparator companies, their characteristics and identities.

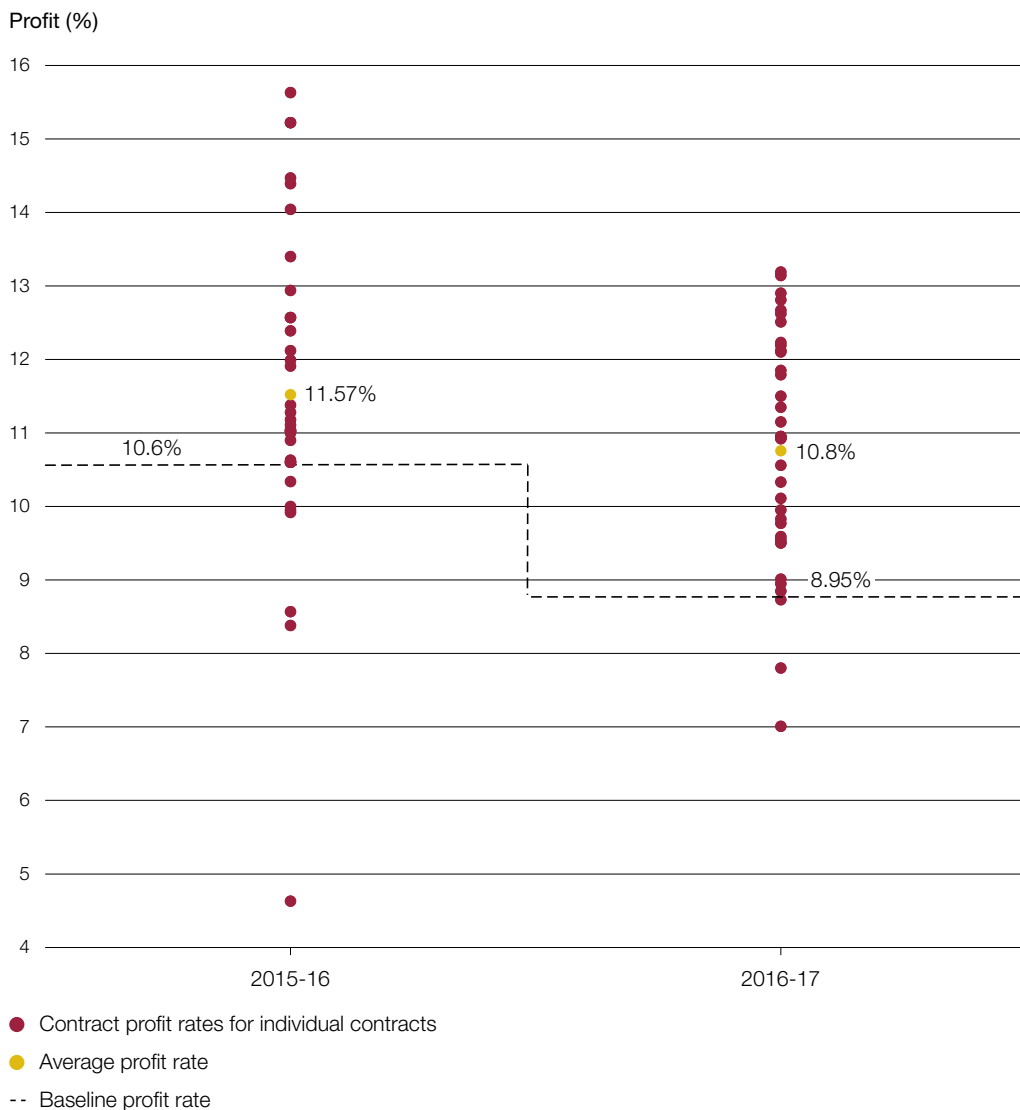
4.19 There are five other categories of adjustment that can be made to the baseline profit rate, for example, for levels of risk, which accounts for the variations in the corporate profit rate at individual contract level.¹⁵ While contract profit rates may be several percentage points higher or lower than the baseline rate due to these specific adjustments, they have followed a broadly downward trend since the Regulations started (**Figure 11** overleaf). In the SSRO’s opinion, it is too early to draw conclusions on any trends, especially because of the other factors that may influence contract profit rates. In June 2017, the SSRO published the results of a consultation that it had carried out with industry and the Department into ways of measuring profit rates of suppliers as a means of indicating that, among other things, suppliers were receiving a fair return (see paragraph 3.11).¹⁶

¹⁵ More detail on the application of these adjustments can be found at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/618406/Annual_stats_bulletin_June_2017_-_WEB.pdf

¹⁶ Single Source Regulations Office, *Developing the SSRO’s approach to calibrating profit rates in single source contracts*, June 2017.

Figure 11
Changes in contract profit rate for contracts within the Regulations

Since the introduction of the Regulations there has been, on average, a reduction in the profit rates of contracts



Notes
 1 Individual baseline and contract profit rates are shown for each contract by year. In some cases, single points represent several contracts with the same profit rate.
 2 Based on profit rates declared to the SSRO by suppliers. For some contracts the baseline profit rate declared to the SSRO varied from that set by the Secretary of State.

Part Five

Developing skills and capacity to improve outcomes through contract negotiations

5.1 The Single Source Contract Regulations (the Regulations) will have little value if the Ministry of Defence (the Department) does not have the skills to capitalise on them in negotiations. For the system to work well, shortfalls in the number and skills of staff in commercial and cost assurance teams need to be identified and addressed. Contract mechanisms must be put in place that avoid the Department being exposed to excessive risk.

Contribution of specialist staff

5.2 Following a fundamental independent review of its governance, the Department reorganised its operating model.¹⁷ From 2014, the Department delegated budgetary responsibility for equipment procurement and support to the four Front-Line Commands of Air, Army, Navy, and Joint Forces Command, and the Strategic Programmes Directorate within the Department's Head Office. Responsibility for programmes and project delivery remained principally with the Defence Equipment and Support organisation (DE&S).

5.3 The Department has taken a number of steps to upgrade its commercial function to reflect these changes. There is a cross-departmental board to provide leadership for commercial staff. A new 'Head of Commercial' post was created in each Front-Line Command (Command), and independent commercial review of large projects is embedded in the scrutiny process. Alongside this, the Department has also been improving its commercial capability, for example, through the Commercial Professionalism Programme that provides a range of standards, training and education. We discuss progress in more detail below.

5.4 The Department has identified gaps in the numbers of its specialist staff and is developing plans to address them. However, these plans are being enacted in the context of a commitment by the Department in the 2015 Strategic Defence and Security Review to reduce the civilian workforce by 30% by 2020.

¹⁷ Defence Reform Steering Group, *Defence Reform: An independent report into the structure and management of the Ministry of Defence*, June 2011.

Input of specialist staff to assist project approvals

5.5 As mentioned in paragraph 2.5, the Department's procurement processes are weighted so that the largest and most important contracts receive the most scrutiny and oversight. In particular:

- Category A contracts – larger than £400 million – have to be approved by the Department's Investment Approvals Committee (IAC). Some Category B and C cases of importance, in particular IT projects, are also approved centrally. Submissions to the IAC are supported by detailed reports from a scrutiny team at the centre of the Department. This team can challenge the proposed commercial strategy and costs, but we found this rarely leads to projects being delayed or rejected.
- The remaining Category B, C and higher-value Category D projects are approved by the Commands. Lower-value projects are approved in the delivery organisations. The Commands have their own teams to manage approvals with the support of Head Office. A departmental review noted, that, due to the volume of lower-value contracts, they were subject to less scrutiny, and that central teams could do more to gather together business cases and approvals carried out by individual Commands, and identify issues and best practice.

Commercial staff

5.6 The remit of DE&S is to deliver the equipment requirements set by the Commands. In 2014, the organisation embarked on a transformation programme, which has included the strengthening of its commercial capability by improving skills and bringing in individuals with private sector experience.

5.7 Commercial teams located in the Commands, Information Systems and Support, and DE&S, provide technical advice, support and challenge to project teams on the most cost-effective way to meet a requirement. In response to our 2014 report *Transforming government's contract management*, HM Treasury and the Cabinet Office carried out a commercial capability review of the Department. They made recommendations to strengthen commercial skills in senior ranks and in the Commands, and to identify broader resource and skill gaps.¹⁸ Such challenges are not unique to the Department. Our March 2017 review of civil service capability found that other departments have also struggled to develop their commercial functions.¹⁹

5.8 In response, the Department has developed a commercial 'blueprint' to address these issues. This includes plans for all commercial staff to undergo specialist training. Departmental staff received 9,859 person days of commercial training between May 2016 and June 2017.²⁰

¹⁸ Comptroller and Auditor General, *Transforming government's contract management*, Session 2014-15, HC 269, National Audit Office, September 2014.

¹⁹ Comptroller and Auditor General, *Capability in the civil service*, Session 2016-17, HC 919, National Audit Office, March 2017.

²⁰ Includes training delivered by the Chartered Institute for Purchasing and Supply.

5.9 One key area to be addressed is a shortfall of 386 commercial staff in the centre of the Department, Commands and DE&S (24% of complement). This is made up as follows:

- Within the Department centrally, and in Commands, the Department was seeking to fill 86 vacant posts at the end of August 2017 (out of a total of 547). The Department previously stated, in 2016, that it did not consider it could afford to fund its 'ideal' model level of recruitment given the pressures on the defence budget.
- Within DE&S, the shortfall was 300 posts out of 1,070. To fill these positions, DE&S is using its commercial freedoms as a 'bespoke trading entity' to recruit externally and move away from civil service pay-scales to make itself more attractive to those with relevant skills.

5.10 As well as enhancing staff skills, the Department is applying other means of improving its commercial capability. It is improving assurance about the commercial function by developing new tools (such as peer review of an individual commercial team) and making more use of existing tools (such as compliance questionnaires that test commercial officers' knowledge).

5.11 The Defence Academy offers courses on the Regulations to departmental staff. However, the Department's internal audit function found that there was no requirement for staff to attend training on the Regulations before implementing them, and only a minority of commercial officers within the Department had attended these courses by March 2017.

Specialist support to project teams on supplier pricing and cost compliance with the Regulations

5.12 Specialist staff, traditionally within the Cost Analysis and Assurance Service (CAAS), provide crucial expert technical advice on costs and prices submitted by the supplier to project teams within DE&S, and determine whether costs are allowable under the Regulations. Lord Currie's review in 2011 identified that CAAS staff numbers had nearly halved in the previous decade. Around 77 staff will carry out price investigations on non-competitive procurements in 2017-18. In addition a core group of five specialists provide expert advice on the Regulations.²¹ Project teams told us that they are very reliant on the support of these staff. Direct support from CAAS is only available as a matter of course on the relatively small proportion of contracts worth more than £50 million, since these account for a large proportion of total contract values. Support for other contracts (with a total value of £6.5 billion) is dependent on CAAS having available capacity when requested by project teams. One of the objectives of the additional training being delivered to commercial staff is for them to be able to carry out some costing analysis in their own right.

²¹ In addition to these numbers a further 114 cost engineering staff were transferred out of CAAS into DE&S Domains on 1 April 2017, as part of the transformation of DE&S. These cost engineering staff should be available to support future non-competitive pricing activities.

5.13 The DE&S is taking a more rigorous approach to evaluating suppliers' overheads, which represent circa £1.5 billion to £2 billion of spending annually. In the past, suppliers have not always provided these costs promptly, and indirect costs have not been agreed in a timely manner. For the 2017-18 indirect costs programme, DE&S has established a central team under senior commercial leadership to drive improvements in this area which will include enforcing reporting requirements by suppliers. DE&S will carry out a more systematic programme of investigations of overhead and labour rates with up to 130 suppliers, although prioritisation may be necessary. CAAS has around 80 staff available for this work. DE&S estimates that work will generate £79 million of savings over the next five years.

Appendix One

Our audit approach

1 Our study examines how the Ministry of Defence (the Department) is managing the challenge of securing value for money from non-competitive procurement. In particular, we examined:

- in what circumstances the Department uses non-competitive procurement;
- how the Department seeks to secure value for money from non-competitive procurement; and
- how independent regulation seeks to secure value for money from non-competitive procurement.

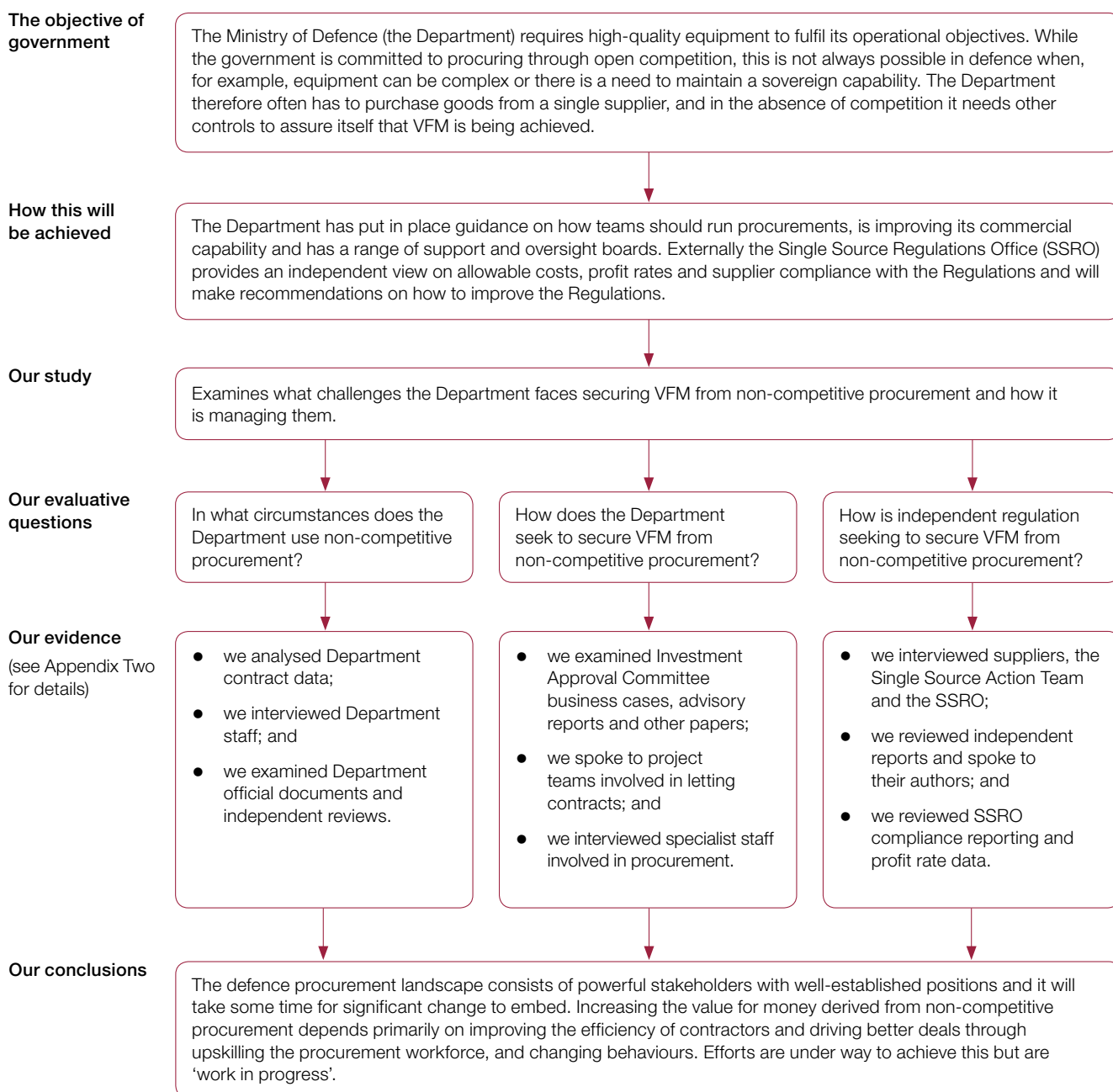
2 We applied an analytical framework with four main evaluative criteria to assess how the Department is securing value for money from non-competitive procurement. These criteria were whether:

- it has put in place effective tools and processes to protect value for money;
- it has sufficient numbers of skilled commercial staff to meet demands;
- its contracting approaches provide incentives for suppliers to deliver, and decision-makers to push back against, business cases that do not offer value for money; and
- it has sufficient data on its commercial activities to allow it to monitor whether it is achieving value for money.

- 3** We applied separate evaluative criteria when assessing how independent regulation was helping to secure value for money from non-competitive procurement, including:
- all appropriate contracts are brought within the Regulations and comply with them, and outcomes from non-competitive procurement are improving;
 - all parts of the system are operating effectively – the Department is working effectively with the Single Source Regulations Office (SSRO) (all appropriate referrals are made, and the SSRO is monitoring supplier compliance with the Regulations and making recommendations for the Department); and
 - profit rates are set that balance the interests of the tax payer with achieving a fair and reasonable return for industry that encourages contractors to continue operating in the defence sector.
- 4** Our audit approach is summarised in **Figure 12**. Our evidence base is described in Appendix Two.

Figure 12

Our audit approach



Appendix Two

Our evidence base

- 1** Our independent conclusions on how the Ministry of Defence (the Department) is securing value for money from non-competitive procurement were reached following analysis of evidence collected between January and September 2017.
- 2** The focus of our work was on contracting for defence equipment and support. We did not consider contracts for estates, which are not subject to the Single Source Contract Regulations (the Regulations), or the value for money of individual contracts.
- 3** Our approach and three main study questions are outlined in Appendix One. For each of these study questions we did the following work.

In what circumstances does the Department use non-competitive procurement?

- **We reviewed published information and documents.** This included external reviews of the Department's procurement practices, for example by Lord Currie. We examined information published by the Department and other bodies. We also examined published documents from other countries, for example, by the US Department of Defense and Government Accountability Office (GAO).
- **We reviewed the Department's internal commercial and acquisition guidance provided to its staff, and policy documents.** These included documents outlining when procurements should be competitive and when they should not, how to price them and when to involve other bodies like the Single Source Regulations Office (SSRO). This informed our analysis of the Department's policy regarding non-competitive procurement and the guidance staff have to follow when identifying when procurements should be non-competitive.

- **We analysed contract data provided by the Department's strategic supplier management cell, the SSRO and Single Source Advisory Team (SSAT).** This helped us identify the types of contract and commercial models used across the Department. This report focuses on equipment, so we removed contracts let through the Cabinet Office and across government, intra-departmental agreements, contracts relating to infrastructure, and contracts for cross-departmental services. We found issues with the completeness and accuracy of data and had difficulty reconciling different data sets to form a single source of information. We have drawn attention to this in the report. We interviewed staff involved in data collection and were given demonstrations on the IT systems used to collect data. We concluded that the data were robust enough for the purposes of highlighting the range of approaches used and the value of contracts.
- **We interviewed senior staff within the Department, including Defence Equipment and Support (DE&S) and the SSAT.** This helped us understand their strategic position on procurement.

How does the Department seek to secure value for money from non-competitive procurement?

- **We examined project and approvals documents.** These included business cases, commercial strategies, reviews prepared by the Cost Assurance and Analysis Service (CAAS) and Investment Approval Committee papers.
- **We interviewed staff across the Department involved in carrying out and supporting procurement activity.** These included staff in DE&S, CAAS, the Commercial Assurance Scrutiny and Due Diligence team and commercial staff in Front-Line Commands. This helped us understand the procurement process, when teams get involved and the support available throughout.
- **We collected data and information on nine randomly chosen contracts, within the Regulations and outside.** For each of these, we spoke to the commercial staff involved in sourcing and managing the contract, examined performance data and reviewed documents provided. This helped us understand how staff went about developing their commercial strategies, identifying suppliers and negotiating and managing contracts. We examined the support they received from within the Department and the guidance they followed. We did not audit the value for money of the contracts.
- **We assessed the Department's commercial capability.** This included examining staffing data, internal reviews, and speaking to front-line staff to assess needs, workload and training provided. We then reviewed the Department's commercial blueprint and plans for improvement.

How is independent regulation seeking to secure value for money from non-competitive procurement?

- **We carried out semi-structured interviews with representatives of the main stakeholder bodies.** In particular, we interviewed senior staff at the Department and the SSRO. We also spoke to representatives of eight major suppliers and their representative body to obtain their views on the Regulations and relationships with other bodies. We interviewed Sir John Parker, who prepared an independent report to inform the UK National Shipbuilding Strategy in November 2016. We also examined external and internal reviews and submissions for consultation on the Regulations.
- **We examined data on how the new regime is operating.** This included reviewing SSRO data on profit rates and suppliers' compliance with reporting requirements to assess trends. We also examined actual and predicted savings from implementing the Regulations and the assumptions underpinning them.
- **We spoke to other regulatory bodies, the Office of Rail Regulation, the Water Services Regulation Authority (Ofwat) and the UK Regulators Network.** This helped us understand how other regulatory regimes work.
- **We examined publicly available material,** such as GAO reports, to examine what processes are in place in other countries.
- **We held a workshop on regulatory practices.** We held an internal workshop with experts on regulation from across the NAO to seek their advice on the SSRO's role compared with that of regulators. We looked at how regulators are structured, and how they measure compliance, maintain independence and engage with the regulated market.

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