

Defence Committee

Oral evidence: [Defence Acquisition and Procurement](#), HC 698

Tuesday 6 December 2016

Ordered by the House of Commons to be published on 6 December 2016.

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Members present: Dr Julian Lewis (Chair); Douglas Chapman; Mr James Gray; Jack Lopresti; Ruth Smeeth.

Questions 169-241

Witnesses

I: Marcine Waterman, Chief Executive, and Matthew Rees, Director of Analysis and Reporting, Single Source Regulations Office (SSRO).

Written evidence from witnesses:

- [Single Source Regulations Office \(SSRO\) \(ACQ0008\)](#)

Examination of witnesses

Witnesses: Matthew Rees and Marcine Waterman.

Q169 Chair: This is the third oral evidence session of our inquiry into defence acquisition and procurement. The focus of this session is single source procurement and the role and remit of the Single Source Regulations Office—the SSRO. I ask our two witnesses to introduce themselves for the record and to open with a short statement about their organisation and how and why it was created.

Marcine Waterman: I am Marcine Waterman, the chief executive of the Single Source Regulations Office.

Matthew Rees: I am Matthew Rees, director of analysis and reporting.

Chair: Thank you for coming today.

Marcine Waterman: You might be aware that Lord Currie conducted a review of single source procurement in 2011, and key to that was shifting the emphasis from the MoD proving whether costs were allowable to the contractor justifying why costs were allowable. The review set in place the need for greater transparency on those costs, including standardising the reporting. Part 2 of the Defence Reform Act established an independent regulator that would have oversight of the framework and its operation.

Q170 Chair: What were the key recommendations of the Currie review? Was it simply to set up this body to ensure that, for those defence contracts that either have to be or, in any event, are placed without open competition, the substitute for open competition is a watchdog that ensures that the taxpayer gets value for money?

Marcine Waterman: I think that is correct. The key recommendation was to create a better transfer of information that would help the MoD to become a better buyer. His recommendation was for cost data that could be analysed by an independent body to give the MoD better benchmarking and information by which to price contracts and to ensure that it has efficiencies.

Q171 Chair: The other side of the coin is that you also have a role to ensure that the firms get fairly remunerated for their efforts, do you not?

Marcine Waterman: The Defence Reform Act established our two statutory aims. You are correct that the first one is to ensure value for money for the taxpayer in what the MoD buys, both in equipment and services, and equally, and just as importantly, that industry is paid a fair and reasonable return for those contracts.

We have two statutory aims, and then we have a series of roles and functions, which I will briefly set out. The first is to assess the appropriate



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rates for how one constructs the profit. Another is to establish statutory guidance on determining what costs are allowable. Our third is to assess compliance with that pricing regime and with the whole functioning of the Defence Reform Act. Fourthly, it is to analyse the data that we collect from contractors so that we can provide analysis to the MoD on the efficiency of these contracts. Lastly, if you come to a case where you want an expert third-party view or opinion, we can offer an opinion on how the contract should be priced before it is signed. Or, after the contract is signed, we can determine, through a legally binding determination, what the appropriate price should be for that contract. So we have six fundamental roles that oversee the entire operation of the Defence Reform Act.

Q172 Chair: So there is a great deal of work involved in all that, and this, as I understand it, has replaced the previous system which was known as the yellow book regime. Can you explain to us a little bit about how that system used to work and whether any aspects of it have not been carried forward that perhaps should have been into the SSRO structure?

Matthew Rees: Certainly, the yellow book is the predecessor to the rules and regime that we look after now. One of the things that has continued is the setting of a profit rate, although we have fundamentally changed the methodology to make it more fit for purpose. There are aspects of the Government accounting conventions that we have then adopted in our allowable costs guidance. There has been a series of fundamental reviews with the objective of making sure that that balance between taxpayer and shareholder value is preserved and maintained and to create more confidence in the system going forward.

Q173 Chair: So you do not think there was anything that the old system used to do that you do not do and which you could do better.

Marcine Waterman: I would not say so. I think it is exactly as Matthew described. Rather than having a voluntary organisation, it was set up as a partnership between the industry and the MoD. It is basically putting in an independent regulator to make the regime more effective.

Q174 Chair: Have you got a system for self-assessment, monitoring the way in which you are managing to achieve the objectives that you have outlined?

Marcine Waterman: Yes. We obviously have a corporate plan signed off by our board and published on our website. It has a series of corporate objectives, as you can imagine, and most of which is delivering our statutory aims, which is about the profit rate and compliance and allowable costs and of course being financially responsible as an organisation. Included in that corporate plan are performance indicators and our objectives, and the board monitors that on a regulator basis.

Q175 Chair: How do you think you are doing?

Marcine Waterman: I think we are a well-managed organisation. I think we are delivering our corporate objectives. I think we have made a positive contribution to start, but, as we put in our submission, we believe that there are still limitations to the functioning of the regime.

Chair: I think we will probably come on to those later, but, if we do not in our questioning, do feel free to signal to me that you would like to make any additional contributions.

Marcine Waterman: Thank you.

Q176 **Jack Lopresti:** Your role demands that you regulate a complex mix of public and private providers of defence equipment. How do you think you could better understand the needs and challenges of industry?

Marcine Waterman: We have an extensive stakeholder management strategy. Indeed, I report to the board how we are delivering against that objective. Last month alone we met with the industry—we had three site visits. We have regulator meetings, we have senior stakeholders, we have operational working groups, and every time a new contractor signs a contract we have both physical and telephone meetings to on-board them. We spend an awful amount of resource on our stakeholder engagement. It is essential that they understand the regime and how it operates.

This is not just about a stick with which to beat up industry; this is about us getting the best both for the taxpayer and for industry. There are benefits to single-sourcing, but they have to act responsibly.

Q177 **Jack Lopresti:** How could industry help your organisation function better and understand the challenges?

Marcine Waterman: It is quite interesting that in any regulatory model—I always think of a pyramid and a tree—the bottom is self-regulation. In that way, industry is responsible for understanding the Act and the regulations and it is responsible for justifying its costs as allowable. In that, self-compliance is quite an important aspect. They need to take ownership for that.

Matthew Rees: I would add that, as a relatively new organisation, we spend a lot of time learning from industry. We obviously see a lot of information at a contract level. We have seen a lot of sites in practice out in the country. It is a combination of what we see on a desktop basis and what we see as we go out around the country, and we are obviously keen to ensure that we are fully informed of the trends, challenges and opportunities that British industry faces.

Q178 **Mr Gray:** Before we leave your involvement with industry, my understanding is that you have prepared a paper on wage inflation in the defence industries. Are you planning to publish that at some stage?

Marcine Waterman: Matthew is the author of it; I will ask him to answer.

Matthew Rees: Correct. We were asked by the Secretary of State to produce a report on wage inflation. That was the first piece of work that I undertook with my team when I started earlier this year. That report was presented to the Secretary of State in July this year, and we are waiting for the Secretary of State's permission for the publication.

Q179 **Mr Gray:** It would be a useful reference for this Committee to have that



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paper. Perhaps we should write to the Secretary of State to ask for it.

Can I just press you a little on the general principle? It has been a very long-standing belief, certainly of the Conservative party, that competitive tendering—competitive purchasing—is by far the best way to do anything. We introduced it, for example, in local government purchasing. CCT—that was our great Thatcherite invention, if you like. Surely that would reap greater benefits than single-source procurement of the kind that you are asked to regulate on.

Matthew Rees: May I just answer from the perspective of my own work experience; having spent a number of years at the Competition Commission and generally observed the way in which Government policy is set, I think we all subscribe to the belief that competition leads to a more prosperous economy. However, in the defence sector there are a series of reasons why competitive contracting is not possible. We exist to respond to that challenge. What we are really doing is trying to move the outcome closer to what a competitive outcome might be—aware that competition isn't always a feasible outcome. The factors why somebody has not used a competitive tender are not factors that we are in control of. These are decisions made by the contracting teams within the MoD on a contract-by-contract basis.

Q180 **Mr Gray:** So you are using the single-source regulation as a means to encourage competition—to achieve the same ends as competition.

Marcine Waterman: No—

Matthew Rees: To achieve the same end, particularly, for example with—there are two examples. One is the profit rate: that is a recommendation that we make to the Secretary of State that resembles the kind of economic regulation that is applied across water in the energy sectors and the other parts of the economy where there isn't a competitive choice; and the second aspect is the allowable costs guidance, which is really setting a series of principles that any intelligent customer would be asking when looking at what is being offered in response to a tender.

Q181 **Mr Gray:** I will tell you about one particular aspect of the advantages of single-source regulation over competitive tendering; that is sovereign capability. Are there areas of sovereign capability where you would argue that the SSRO regime is better than competition?

Marcine Waterman: I think it is not for the SSRO to make a statement about the policy under which the MoD purchases its equipment or its services. I think that is one for the MoD; but of course if there is only one provider for something that you need to protect national security then single source is the mode in which it is purchased.

Mr Gray: But that is a matter for them; you merely observe the contracts they—

Marcine Waterman: The point is if the MoD decides to single source, what we would like to see is that all of that spend is actually covered by the regime, so you get the best price, the best quality and on time.



Q182 Mr Gray: Fifty-five per cent. of all new contracts by the MoD last year were single source, which sounds an awful lot to me—it was 23% by value of all new contracts. Haven't we gone too far down the single-source procurement channel, and wouldn't it be better to bring that percentage down a bit, because of all this concern about value for money?

Marcine Waterman: Let me just go over the numbers. Last year, the MoD, in their annual statistical bulletin, stated that they spent £8.9 billion on single source and £9.9 billion competitively. If you look at the number of contracts they placed; yes, it was 55% that were non-competitively placed. That is historically high. The MoD, over the history, has been between 40% and 50%. Interestingly that is a similar statistic to the United States. However, it is significantly higher than Australia and Canada. Canada is 18%. Lord Levene, in our paper recently, said that when he was in charge, he had it down to 12%. I think what is important—and one of the interesting aspects we learned from our work internationally—is the reason that Canada has it at 18% is that they have stated criteria of when you can use single source and that is independently assessed. The decision making has a secondary purpose to ensure that that is the right approach and that, therefore, the balance is correct.

Q183 Mr Gray: Is it part of your remit to comment on that percentage? Suppose it went to 70%, would it feel it part of your remit to speak to the Secretary of State and say, "Actually, we think this is too high?"

Marcine Waterman: We don't have the role in which to make that comment. What we can do, which we will do annually, is to state the facts. It is for the policy makers and yourselves to say whether that is the right amount. What we would like to see is a better justification when we do get a contract as to why.

I don't know if you are aware of the range of things that are purchased. It is the obvious—the nuclear submarines, weapons and aircraft—but it is also things such as parachutes, systems and software. We believe there needs to be a better justification for why everything needs to be single sourced. I am happy to be put out of business if that is the right approach, but if it isn't, and what you can see long term on the spend and the equipment plan, then you need to have an effective regime in which to ensure that you are getting the best price.

Q184 Ruth Smeeth: Good morning. I would like to ask some specific questions differentiating between those contracts that are reported to you and those that are referred to you. Can you tell us how many qualifying defence contracts and subcontracts have been reported to you each year since 2014, and what proportion that has been of the total equipment plan?

Marcine Waterman: Okay. It is correct that those terms are often misused. Let's just confirm that "reported" is the statutory requirement from the Act for a contractor who signs a single-source contract to report it to the SSRO. Whereas "referred" is when you are asking for that expert opinion or a determination on price.

If we go back to reported, since the SSRO was established in December 2014, we have had 61 contracts reported to us; up until last week, when we got our 61st. The total value of those 61 contracts is £15 billion. In that figure, it is worth saying, there are seven subcontracts.

Q185 **Ruth Smeeth:** Can you give us a breakdown of 2015 versus this year, to see if we can see a pattern as it increases?

Marcine Waterman: Yes. In 2014-15 we had 34 reported to us and this year so far we have had 27. You asked how that relates. We don't get information from the MoD on how many contracts they sign. Indeed, that was one of Lord Currie's recommendations that was not implemented. However, we can compare their total spend to the spend that we are overseeing. Last year, for 2015-16, it was between 15% and 20% of the total MoD non-competitive spend. It feels as if we have a very small proportion of what they are doing.

Q186 **Ruth Smeeth:** Can you talk us through the process for SSRO in relation to contracts that are reported to you? What do you do with them?

Marcine Waterman: The first thing is that a contractor contacts us to say that they have signed a report. The statute requires them to issue three reports to us within 30 days of signing. That gives us information on how the contract has been priced, under what formula the contract has been priced—whether it is fixed firm, cost plus—the duration of the contract, the total allowability of costs, the profit and how the profit was made up.

From that piece, we do a compliance check against the regulations. First, have they supplied us with the right information? How accurate is the information? You might be surprised, but we don't get the contracts, so we don't know if what we are being told is the truth. We would like to think that the MoD would tell us if the information was correct. We might come on to that.

From there, we may have queries sent back out to industry asking questions. It is worth noting that I have 860 queries on the first 50 contracts out with industry and the MoD at this time. From that, Matthew's team will put the data in a database. When we get enough information we hope we can start the benchmarking and, indeed, conduct analysis. I am sure Matthew will talk about our statistical bulletins.

Finally, we produce an annual report for the public—we believe in transparency—on how the regime is working and operating in compliance with the actual pricing regulations.

Matthew Rees: To add a little bit of colour to that, in the early stage of the report, there are a lot of two-way discussions between the contractor and the team to make sure that we have received the information and it has uploaded correctly. The compliance process is, again, a two-way conversation: we ask questions, and there is a liaison with the Ministry of Defence. Separately from that, we do a set of analyses. We have published seven statistical bulletins which draw on information reported to us in the contracts.



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We do not mention the identity of particular contractors, to avoid the risk of providing commercially sensitive information to the public, but we have published a range of indicators on things such as the profit rate, engineering rates, the trends in subcontracting, the use of international companies and the contract duration, so we have started to produce a series of indicators to provide more information about the breadth, quantity, scale and variety of different activities going on within the contracts.

Q187 Ruth Smeeth: Fascinating. To step back to something that was just stated, can you repeat how many pieces of information you are currently requesting from industry and have yet to receive, regarding contracts.

Marcine Waterman: We have 860 queries out with either industry or the MoD.

Q188 Ruth Smeeth: And how long has it typically taken to respond to those queries? Are you getting responses?

Marcine Waterman: To some. We are getting responses to some, and I think the team has told me that over the last two years we have cleared about 200 of the queries, but we still have quite a lot outstanding.

Q189 Ruth Smeeth: What authority have you got to demand the information?

Marcine Waterman: We don't have any. One of the other recommendations that Lord Currie suggested and that we did not get was the ability to require information. We only have the information provided to us. To clarify the way the regulations were set out, in the pricing statement, when they give you the profit and the total cost, they are supposed to provide you also with the justification, the assumptions and the calculations. That is left for interpretation, so you can imagine that that is where a lot of the queries come in. One needs to understand that risk profile. If you don't have the contract, of course there are even more queries. One could say it might be burdensome to industry. If we had the contracts and the pricing schedules, perhaps we would not need to have those queries; we could do our job quite quickly.

Q190 Ruth Smeeth: We will come to that shortly when we start talking about contracts that have been referred to you. Do you believe that more contracts should be referred to you? It would be very difficult to determine within the current framework how many you should actually be seeing or not.

Marcine Waterman: Let's go back to the difference between reported—

Q191 Ruth Smeeth: Yes. Should more reported to you?

Marcine Waterman: It is not a surprise—we have been public about saying it—that the regime has been slow to embed in getting the contracts, but it is right that there are a number of contracts that the MoD amends. They have a long-term relationship with a supplier, and now they want something new, so they amend the contract. At that stage, under the current Act, there has to be agreement between industry and MoD to put



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it within the regime. We would like to see that put away, because that is obviously a limitation, which is why we believe we have low coverage. There are also contracts that are excluded—the Secretary of State has the right to exempt contracts—and all foreign military sales and other elements are excluded by the Act, so we are not actually seeing the whole range of contracts, but I simply do not know how many should come to us.

Q192 Ruth Smeeth: Why do you think the Government are reluctant to report more contracts?

Marcine Waterman: I am not sure the Government are reluctant to; as I said, it is the issue of having to get industry's agreement for all contracts if they have already entered into a relationship. Just last week, a very large contract was announced that is an extension to a contract made in previous years. It is a single source, but you have to ask the industry player, "Will you stick it within the regime and have it regulated?" If they say no, there is no power that anybody can have.

Q193 Ruth Smeeth: Okay. Moving on, how many contracts have been referred to you since 2014 because of a dispute?

Marcine Waterman: It is not just disputes, although that is one reason why you would send it to us. It is disputes, clarifications of how the Act should be interpreted and where they just want a third-party expert view. Those are the three reasons for a referral. We have had three. We have had two at opinion stage, which is prior to signing the contract, and we have had one determination. This is an area where we believe the MoD should be using that tool more regularly to ensure the best price for the piece of equipment. Indeed, something we might be recommending in our review of the legislation is that perhaps that enforcement power should move to us, as a more independent person, to make sure we are getting the right price. So it is two opinions and one determination so far.

Q194 Ruth Smeeth: That seems extraordinarily low. On that basis, when a contract, or a subcontract for that matter, is referred to you do you see the whole contract or just those parts that are under dispute?

Marcine Waterman: Only those parts. As a matter of fact, what is interesting—I mentioned this, I think, in our submission—is that we have so far challenged £45 million of non-allowable costs. Of that figure, 78% comes from one of the opinions where we are actually given the pricing schedule. So one could see that we could be so much more effective if we had access to all the data.

Q195 Ruth Smeeth: Can I just get you to confirm that your inability to see the full contract is affecting your ability to do your job effectively?

Marcine Waterman: Efficiently—we believe so.

Q196 Mr Gray: The process you describe must be lengthy. How long does it take from the moment of referral to the moment of decision?



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Marcine Waterman: For an opinion we have put in our corporate plan we need to act fast. We do not want to be seen as delaying the decision making, so we do it within 40 working days, which I believe is quick. We use an independent panel so we have independent experts who sit and help to decide on the opinion. A determination takes longer because it is, of course, legally binding and I need a few more processes, but I believe that we do them within five months.

Q197 **Mr Gray:** So how do you react to the allegations I have heard from the military that your interference in the contract is delaying the equipment going through the front line? People are saying, "This is a new bureaucratic organisation that is preventing us from getting what we need effectively to conduct warfare".

Marcine Waterman: I would like to clarify that—it is very important. The SSRO has no role in the negotiation of contracts. There should be no reason for any delay because of what we are, who we are or what we do. We have no role until the contract is signed, and 30 days hence, when they submit their first report, is when we come into the position.

Q198 **Chair:** Are you saying then that although you might take issue with the terms of a contract retrospectively the supply of the equipment is not held up in any way while your inquiries are carried on?

Marcine Waterman: Absolutely, that is correct. There is no delay.

Q199 **Chair:** Right. So there is no way in which what you are doing can delay anything; it may just change the sums, as it were, to do with the exchange of revenues and the costs.

Marcine Waterman: That is absolutely correct.

Q200 **Chair:** I want to go back a bit to clarify something I am still not quite clear on. I understand about the foreign military sales and we are going to be coming on to that in a moment, and I understand that there is a minimum of £5 million on any of these qualifying defence contracts for them to come into your purview, as it were. What I am still not quite clear on is the amount of discretion the MoD has in asking you to look at a qualifying defence contract. Are we saying that there are lots of qualifying defence contracts, each worth a minimum of £5 million, but that you get to see only some of them and it is entirely at the discretion of the MoD which you get to see?

Marcine Waterman: Just to reiterate the process, yes, the first hurdle is the total value of the contract, and it must be £5 million.

Chair: We've got that.

Marcine Waterman: Secondly, it must not be a category that is excluded, which is foreign military sales, our intelligence or land or buildings. Then the third hurdle is that if it is an ongoing contract that has been amended there must be agreement.

Q201 **Chair:** I understand that, but are there any QDCs other than in those



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categories that you do not get to see because it is at the discretion of the MoD whether you get to see them?

Marcine Waterman: If the Secretary of State exempts a contract from the regime we do not get to see it. That is up to him solely and under his own power.

Q202 **Chair:** That is rather unusual, isn't it, for a watchdog? Effectively, you are supposed to be keeping an eye on all this stuff, yet the Secretary of State for Defence can simply decide, in any given case, apart from the three special categories you have mentioned, that he does not want the case to go to the SSRO.

Marcine Waterman: That's correct. It is often pressure put on from industry. This is a very strong industry, and we have seen instances where a foreign company simply refuses to be regulated, and therefore the Secretary of State exempted.

Q203 **Chair:** No, sorry, that's different because it's a foreign one.

Marcine Waterman: No, that's not a foreign military sale. There are qualifying contracts. It is not just UK companies that are regulated. Currently, about 90% coming into the regime are UK companies—we can talk about that—but there are foreign companies that are a single source to the UK Government that are part of the regime.

Q204 **Chair:** But is there any reason why you should not have the ability to ask to see any of these contracts that at the moment the Secretary of State might exempt?

Marcine Waterman: One of Lord Currie's key recommendations was that the SSRO should see all single source spend, whether it qualifies or not, so that we can keep the totality of the regime as effective as possible. That was not granted to the SSRO, and I have no power to ask for that information. Indeed, I am not given any information.

Q205 **Chair:** Finally on this, for the avoidance of doubt, are you saying that a significant number of QDCs other than the three categories we have discussed might have been referred to you but are not? How great a proportion is that?

Marcine Waterman: I simply don't know the answer. I am not given the information. All I can tell you is that from the analysis we have done, and from the MoD's published figure of spend, we have seen 15% to 20% of that spend only. I don't know how many contracts or what make up that 80%. I just know we are not seeing it.

Q206 **Chair:** I know it was the view of at least one of your two former chairmen that you were not being given nearly enough QDCs to examine. Is that a general feeling within the organisation, to this day?

Marcine Waterman: We are pleased to see that we have 61. That is a vast improvement. We are getting contracts in. Indeed, we have some very large contracts, and that is excellent. It is nice to see that the regime is taking hold, but it is still low coverage and slow to embed.



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Q207 Douglas Chapman: Good morning. Following on from that, in your view should Government-to-Government contracts be excluded from your scrutiny?

Marcine Waterman: We don't believe that Government contracts should necessarily be excluded. We understand that during the debate about the Defence Reform Act, the Ministry explained that there are concerns about whether foreign Governments would agree to sell if they had to comply with some of the sensitive reporting measures. One of the reports contractors have to provide includes their strategy about defence sites and capacity to deliver and build. There was a view that foreign Governments would not allow that information to come to the SSRO or, indeed, to the MoD. But there was no argument that there should not be transparency on the costs of those contracts.

While we do not have the evidence, we do know that just this year, the Government have let £5 billion in the P8 and the Apache helicopter contracts, so these are very large contracts. What transparency is there about the profit and the cost that is put on all the rest of the contracts that are non-competitively purchased by the MoD? We believe that to make it happen, one needs to just give the Secretary of State the authority to exempt that sensitive report, if indeed that is the key issue that is blocking the need for transparency.

Q208 Douglas Chapman: So if some sort of guarantee could be given about the security of that information, would it be possible for you to develop the appropriate models or tools to scrutinise properly some of these Government-to-Government contracts?

Marcine Waterman: I think we will be consulting on a proposed recommendation that Government-to-Government contracts should come within the scope of the regime.

Matthew Rees: Certainly, from an analytical point of view, the legislation and the regulations that followed it set out a very prescriptive set of reports. Technically, there is no reason why you could not look at those reports individually. As Marcine was saying, a particular one may be about industry capacity and locations, but that information does not have any impact on the profit rate, for example, so we would be very flexible in our approach to the analysis and review needed.

Q209 Douglas Chapman: What is the value of the savings that you have made for the MoD since 2014? Could you give us a breakdown of how those savings are made?

Marcine Waterman: Yes. What one doesn't know is how many savings the MoD has made to the point when they are contracting. We are told that the regime is quite effective and the whole idea is that they have a new pricing schedule in terms of allowable cost, but from what we have seen and done—

Q210 Douglas Chapman: Do you see all those schedules?



Marcine Waterman: No, we don't see what the MoD has access to. From the information we have—the limited scope of data reported to us—we believe we have identified £110 million in the first 50 qualifying contracts. That is partly based on the first opinion, where we identified nearly £35 million of savings through wage inflation, faulty workmanship or inflation indices. We have also identified a further £45 million that we say is non-allowable cost under our guidance—either egregious, such as entertaining or charitable donations, or relating to some of the bigger issues around how one prices risk.

A feature of our new approach to assessing profit has brought the cost down by £63 million, so the MoD has an additional £63 million to spend on good front-line capacity capability by a new profit methodology that we believe is more robust. Indeed, what we put in our submission is that if you look at the whole equipment plan over the next 10 years, the MoD could save £3 billion just based on our methodology. It is a substantial amount of money. Even if we have low coverage of QDCs, establishing some of these principles has had a really positive contribution.

Matthew Rees: Just to comment on that figure, the profit rate that we are setting is designed to replicate what a competitive outcome should be. To come back to our two duties—value for money for the taxpayer and value for the shareholders of the companies—when we are talking about reductions in the profit rate, we are talking about reducing it to what we think is a competitive level. Certainly, as the rate has come down over the first two years of the SSRO's responsibility, that has created an enormous opportunity for savings for the taxpayer, but we do not feel that that is a disadvantage to industry, because we are trying to replicate the harsh realities of competition.

The £3 billion is a figure that we have estimated looking forward over the entire life of the equipment plan. It is yielded by reducing the profit rate to a competitive level; clearly that money can either be saved and spent elsewhere by the Government or retained within the MoD's budget and spent on additional equipment, personnel or services.

Q211 **Douglas Chapman:** So these are significant savings. What about your own costs—salaries, pension costs and how much it takes to run the actual service?

Marcine Waterman: We are very small—very lean and mean. We are at £5.7 million; if you just look at the savings figures, you are talking about saving the taxpayers £20 for every £1 we spend. We are very small—we are 33 people—so it is quite challenging.

Q212 **Douglas Chapman:** So by comparison with the personnel resource that the MoD or the industry has, you are a bit like piggy in the middle. In terms of the savings you could potentially generate, you are doing that with one arm behind your back. You are not getting the full picture and you are not getting the resources that are required for you to do your job.



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Matthew Rees: There is a combination of costs, though. What we are doing is investing in data systems. To come back to the regulations, we receive a vast number of different reports. Clearly if we just inspected them all manually, that would take a very large number of people and a lot of time. At the moment, as we have had a relatively slow rate of adoption of the regime, we are doing a lot of it manually but we are also investing in the database systems that we will need. I think there are scalability benefits as well; clearly we are a small office—much smaller than the MoD or the defence industry—but we need to balance our resources carefully within the budget. People and systems, as a whole, is the way we would look at this.

Q213 **Douglas Chapman:** But at the same time, you're giving the taxpayer a better rate of return on their investment, and you're doing that with a fairly small team to deliver what is a quite substantial saving.

Marcine Waterman: We do. The advantage is, if you had more on the regime, and we had more financial autonomy, who knows what we could achieve.

Matthew Rees: I think our benefit-to-cost ratio compares extremely favourably to the NAO, where I have previously worked. We look carefully at the cost of our own equipment and people versus the taxpayer benefit that would flow. We just need to be careful, for as long as we do that, that we balance our duty towards industry. This is not simply about spending our resource to reduce shareholder returns. It is about balancing shareholder returns and taxpayer value.

Q214 **Jack Lopresti:** How has industry responded to the reductions in the baseline profit rate, and how do the margins we operate in this country compare with, say, our competitors in the US or France, in particular?

Matthew Rees: Certainly, looking at the profit rate through the eyes of a shareholder in a company, you would expect the company to want a high rate of profit. As we have said several times, the reality is that we are trying to benchmark a competitive outcome. We have had a series of discussions with industry over the summer, and we have reviewed the methodology on the request of the Secretary of State. We have continued that dialogue, and we feel very comfortable that the methodology that we have is robust and defensible.

One of the things that we are doing in response to industry questions is to increase the transparency around that methodology. We hope, as we publish our recommendations in the new year, that we will be able to answer all of the questions a legitimate shareholder, investor or company would want to know about the rate. As I said, it is designed to replicate what a competitive market would achieve.

Price controls across the regulated sectors are often controversial, and people often look to those for their own commercial interests. We just need to get that balance right. I certainly feel, from having taken responsibility for the rate and from the series of engagements that we've had with industry and the MoD over the summer, that we are in a much

more comfortable position of at least explaining what we're doing and why we're doing it. I cannot predict at the moment whether industry will like the answer they get at the end of the day, but we are clearly trying to be fair and reasonable in our approach to it all.

Q215 Jack Lopresti: I did ask how does industry compare here, so far as the margins they are operating under, with our competitors in the US and France.

Matthew Rees: Certainly, we use an international benchmark to run our methodology. It has moved away from the yellow book method, which was UK-focused, to an international focus. There are North American and western European companies within that basket. When the SSRO did some analysis on the profit rates in different countries for the defence sector last year, it showed that there are a range of profits. Actually, some of the US companies can make higher profits in some parts of the economy, including defence. Indeed, the range of profits varies across western Europe. The UK has broadly similar levels to the US overall and is slightly lower than France. As the sample size was reduced, I am uncomfortable giving hard numbers for those ranges, but there is certainly a press release from last year that we can refer you to that had those data, if it would be helpful.

Q216 Jack Lopresti: And you are confident that, in the future, you can continue to reassure industry that they will get a reasonable return on their investment, compared with the risk and the commitment that they are making.

Matthew Rees: Certainly, one level of detail below what we are doing is worth noting. All we are recommending here is a profit rate called the baseline profit rate. There are a series of steps that the legislation set out. On top of the baseline profit, there are potentially adjustments for risks, incentives and capital. The actual profit rates at the contract level are higher than our baseline rate.

In addition to that, those profit rates are set on what are known as estimated costs, which are generally at the start of the contract. The outturn, as it is described in the regulations, could be higher or lower. The risk-reward ratio actually comes down to the type of contract that has been agreed between the MoD and the contractor. Just thinking about the profits that a company can earn, provided they are prepared to take risks, they could make significantly higher profits than the baseline that has been set. By contrast, if they did not manage that risk properly, they may make lower profits.

Jack Lopresti: Thank you.

Q217 Chair: We know from testimony from ADS that it is not terribly happy with the methodology for the baseline profit rate. Paul Everitt said, "We don't believe the methodology they"—meaning "you"—"developed is robust enough and we have some strategic concerns about it. We think that gets even worse when you try to develop numerous rates." Will you explain why you feel it is important to have more than one baseline rate?



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Matthew Rees: Certainly. The range of contracts that are coming into the regime is diverse. Some contracts have a much more significant manufacturing element, some have a more significant service element and some may be of a support nature. The proposal we consulted on over the summer was to develop a series of additional rates so that we can more closely reflect our profit rate to match the type of contract. In that consultation, which took place initially in 2015 and was then refined in 2016, we proposed to separate out the develop and make, which was the manufacturing type of activity, from the provide and maintain, which has more elements of in-service provision, and we started to think about ancillary services and construction as additional ranges. We feel that range of rates will provide a greater degree of flexibility to apply the right rate of profit to the right kind of contract.

Q218 **Chair:** As an example, if one particular enterprise project was riskier than another, would you feel there should be a higher profit margin built into that to incentivise them to take the risk?

Matthew Rees: The underlying methodology that I was describing talks about baseline profit. There is already an element of risk built into the profit methodology at the second of the six steps. That is plus or minus 25% of the baseline profit. That scope already exists within the contract.

The third element that is also described in a lot of detail in the regulations is style of contract. The pricing method can allow risk to be taken by the taxpayer, effectively, or by the contractor. I feel there are elements of risk built into the existing regulations. The actual introduction of the multiple rates is more about trying to find business activities that are more closely related to the kind of contracts we are observing.

Q219 **Chair:** Okay. We are talking about the amount of profit that is made, but of course far more money is spent on costs. Marcine, you mentioned that egregious costs have sometimes been claimed by companies, which you have rejected—for example, charitable giving costs and entertainment costs. Can you give us some nice horror story-like examples of the sort of inappropriate inclusion among business costs of items that the Government and the taxpayer ought not to be funding, which you have identified and disallowed? Are you happy that you have a sufficient vantage point to enable you discover these and to save the taxpayer a great deal more money?

Marcine Waterman: Of course, Chairman. The whole point of the regime was to set out the principles of allowability, because the Currie review and the Minister recognised that some of the egregious costs should simply not be in contracts.

Q220 **Chair:** Such as?

Marcine Waterman: We thought that by setting that out they would be done with. Unfortunately, even in our first few contracts and continuing we are still seeing them. You have Christmas parties and charity donations. You have tickets and fines for cars. You have sales and marketing, when there is no direct benefit to the MoD or a direct link to the contract.

America has similar rules on the pens, the shows, the air shows and the entertaining. All of that is important in having a sustainable defence sector, but we do not believe the taxpayer should pay for it cold. There needs to be a reasonable, demonstrable link as to why we should pay for that and what the benefit is that you get. Those are the egregious costs that we are still seeing.

Q221 Chair: In a nutshell, big defence companies are smuggling in activities on to the bill that they render to the MoD, which really ought to be part of their normal expenditure as a business and that are not specifically linked to the contract concerned. That is pretty bad, isn't it?

Marcine Waterman: It is, and one of the concerns we have is that we only see it if somebody happens to release it in the information. There is no standardised reporting to the SSRO of what I would call indirect costs that are either buried in their overhead rates or in the functioning of the business. We only see it if it is reported. We wish to change that and be very specific. We would like to see how the indirect costs and overhead rates are made up so that we can start to address the reasons and how they do their business. We need to make them more efficient. The benefit in the long term, as we used to say to the industry, is that if you do not incur those costs, you make your business more efficient and perhaps will improve your exporting.

Q222 Chair: Would you be willing to send us a little table showing a number of the specific examples where you have disallowed costs?

Marcine Waterman: I am happy to write to the Committee with the identification of these costs. I obviously could not attribute them to a contract, so as long as that is understood. When you say that we have disallowed—

Chair: We will do the shaming without the naming.

Marcine Waterman: I have no power to disallow. All I can do is bring to the MoD's attention that it should not have allowed this cost and it should do something about it. Hopefully we will come on to talk about how we can make that more effective.

Q223 Chair: Do you have any follow-up on that? Let us say you have found certain examples of a certain contract and you have written to the MoD and said, "You should not have allowed these." Is that the end of it as far as you are concerned, or do you get a report back eventually to know whether the MoD did anything about it?

Marcine Waterman: That is the idea of our compliance report. The MoD needs to indicate to us what it has done. Hopefully we will see that come through in reports. I cannot say yet that we have actually seen action taken. The idea then is for us to make a public report on an annual basis about what the MoD and indeed industry have done in terms of compliance with the law.

Q224 Chair: So at the moment, the MoD is already obliged to come back to you with what action it takes as a result of your identification of these



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misspends, for want of a better term.

Marcine Waterman: It is not obliged by the Act, no.

Q225 **Chair:** It is not obliged to, but has it undertaken that it will do that?

Marcine Waterman: Yes, it has.

Q226 **Chair:** But it has not yet done it.

Marcine Waterman: I don't believe so.

Q227 **Chair:** Any other suggestions as to how compliance levels can be improved?

Marcine Waterman: I think compliance would be improved if we could increase the transparency of the cost schedules and the information that we get. One of the likely consultation recommendations we will make to change the legislation is to get back to the Currie recommendations to enable us to see the contracts and to get the reports, so that we can break down the direct costs, the labour hours, the labour rates, the inflation and the overheads, so we can start to make a difference in making sure that the MoD gets the best price. That is a key recommendation that we want to make.

One of the regulatory tools was given to the MoD as the enforcer. The SSRO has no enforcement powers, so the MoD can clearly just ignore us, but what we would like to see is the ability for the SSRO as the independent regulator to issue a compliance notice. This is not because we want to have all this power; it is really saying that once we have tried engagement and once we have tried to use self-regulation, we must be able to ultimately have that red card that says, "This simply cannot be." With serial offences, we would like the power to issue a determination where we have got a significant cost issue, or a compliance notice that you are required to give us the reports. We have one very large contract for which we have been supplied two numbers—how can we do anything with that? We would like the ability to get the contract and the contract schedule—the schedule of prices—and so be able to be a more effective regulator.

Q228 **Chair:** So at the moment you can request information, but you would like the ability to require it.

Marcine Waterman: That is correct.

Q229 **Mr Gray:** You have significantly fewer powers than most other regulators we know of. The CAA, the CMA, Ofcom and Ofwat all have substantial enforcement powers, and some of those you have described are in the Currie report. Is there any likelihood at all that you will move more towards having their sort of enforcement and regulatory powers? For example, is there any move by the MoD to reconsider the legislation?

Marcine Waterman: We are required under the Act to review the operation of the legislation and, indeed, to make recommendations to the Secretary of State this year, after three years of operating the regime. It



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is very key to our recommendations that we are launching in the next week or so a consultation, to which you may all reply, to suggest that to be effective we ought to have enforcement powers. It seems to us that the MoD is conflicted, what with being the specifier, the buyer and the user of the services that we regulate, but they hold the only tool by which to enforce compliance with the Act. We think it would actually help them if that power was transferred to us. We will be recommending that by June, this summer, and it is then up to the Secretary of State whether he wishes to amend the legislation and bring that to Parliament's attention.

Q230 Mr Gray: Philosophically, it does seem slightly like, as you say, you are simply too close to the whole thing. You are part of the MoD machine, and the Secretary of State refers cases to you only when he wants to; for some other cases, when he doesn't, he doesn't even say why he doesn't want to. Surely, if you are going to be an independent regulator, you really do need significantly more muscle; otherwise, you will be having the wool pulled over your eyes all the time.

Marcine Waterman: I would agree.

Q231 Mr Gray: From that point of view, what about your physical location? At the moment, you look like an MoD office: you are sitting in the MoD, you look like part of the MoD, and you are just a sort of MoD wing. Wouldn't it be better to be elsewhere in a separate office, or perhaps in a different Government Department, such as the Cabinet Office?

Marcine Waterman: What is important is that, in essence, it is enshrined in the Act that we are the independent regulator. We do not physically sit with the MoD. Indeed, we are quite a long way away in Chancery Lane, for the purpose of having that physical location split. But it is correct that they make the senior appointments to our board and they provide our funding. It is not for us to say who we should be sponsored by, but it is important that it is very clear what our financial autonomy is and whether, for example, there is parliamentary scrutiny of my third chair. It is about getting that sense of what is the appropriate relationship if we are to be truly independent. Surely the MoD wants that too. For us to be effective, we need to be able to work without fear or favour.

Q232 Mr Gray: Parliamentary scrutiny is a good point, isn't it? You are not directly answerable to the House of Commons Defence Committee, although on this occasion you have been asked to give evidence to us, and there is no regular review of your work by any parliamentary organisation, is there?

Marcine Waterman: No, there is not.

Q233 Chair: You have been going for two years, and you are obviously developing as you go along. I am glad to hear that you feel that the number of contracts being referred to you is now improving. My first encounter with you was somewhere around about the second half of your first year of existence, when your then chairman came to see me—I think you were with him—and expressed very great concern that you were not being utilised as intended in terms of the number of contracts being



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referred to you. In these two years, it appears to be a success story, because when you compare the money you seem to have saved with the money that you cost to the taxpayer, there is a very substantial profit, as you said—I think you said it was around £20 saved for every £1 spent on your existence. Nevertheless, you have had some problems: you have lost your chairman and your acting chairman, who succeeded him. Is there anything you feel you can appropriately tell us in public about why that is? Has it been something to do with frustration or dissatisfaction with how the system is working? What is the reason for it?

Marcine Waterman: I am sad and regret that we have lost two excellent chairmen. I worked very well and closely with them both, and we did a lot—as you said, we have achieved a lot together—and had great working relationships. It is a personal decision when one resigns. I wasn't in the meeting with the Ministers when either resigned, but I do know that they both felt strongly about the importance of clarity—whether a chairman reports to the MoD or to his board and what the explicit arrangement is around our independence. I do believe it causes confusion to our stakeholders. That is one of the key lessons that I have personally learned from losing chairmen. We need to be clear about our role as an independent regulator and how that works with the MoD and what that relationship is.

Q234 **Chair:** This really goes back to the points that James has just been making that there is something anomalous about you being under the umbrella of the very organisation—the Ministry of Defence—that you are involved in rigorously scrutinising. Would you not feel more comfortable if you were outside the MoD power structure?

Marcine Waterman: I just feel that that is not something that I have an opinion about. I think what is important as the chief executive is that we have the characteristics of an independent body—we can speak impartially; our board is empowered to set our direction, to hold me to account and to deliver our statutory aims—and that we do have financial autonomy. I do believe that there is a role for parliamentary scrutiny of our chair. I am less bothered about who oversees that, in terms of Government accountability.

Q235 **Chair:** But was this question of inadequate apparent independence a factor in the decision of the two chairmen to step down?

Marcine Waterman: I think you'd have to ask them.

Q236 **Chair:** All right. What is the timetable for the appointment of a replacement? Can you tell me in a little more detail what the role of the chairman actually is? You are the chief executive. You actually manage the operation, don't you?

Marcine Waterman: I do. I have day-to-day control and management of the organisation. It is quite interesting—the job description of the chairman has changed significantly from our founding chairman to the recruitment of our third chairman, or our second permanent chairman.

Q237 **Chair:** And what is that description?



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Marcine Waterman: Industry was asked to comment. We had no role or any input into the job description, but it appears to be focused more on collaboration with industry and the MoD, which we welcome—that is part of our strategy. There is a much more internal focus than an external focus, and I am concerned about establishing and determining our own destiny as an independent organisation seems to be lacking in the new job description.

As for the timetable, as you know, our interim chairman resigned on 19 October. We do not currently have a chairman. I do have board members here today supporting me, which is excellent. We can operate with our three non-executive board members—we are quorate—and we have a board meeting later this week. The MoD tells me that they have an appointable candidate; that is with the Minister. I know nothing further about the process or the appointment.

Q238 **Chair:** We did have an occasion previously with the appointment of the Service Complaints Commissioner where she appeared in a sort of pre-appointment hearing with members of the Defence Committee. Do you think that is something that would be of assistance in the case of putting forward a replacement chairman—that the person concerned ought to come before the Committee and explain his or her vision for the organisation and take some questions?

Marcine Waterman: I think that is an excellent suggestion. In my past, and with other regulators, chairmen all went through pre-scrutiny. It is important, particularly if your oversight body is the Ministry that you are regulating. It would enable you to hear his or her priorities and to set what their objective is in becoming the chair and settling this organisation. This is a new organisation, but losing two chairman has been unsettling, challenging and quite distracting.

Q239 **Douglas Chapman:** I would like to follow on from a point that James raised and that the Chair has also alluded to, on our oversight role in this Committee. We have just completed reports on Type 26 and Type 45 frigates and so on. If in the future, we were looking at something and asking whether that was good value for the taxpayer and so on, what sort of relationship with the Committee would you envisage, apart from sending the chairman along if we invited them? Is there any other supportive action that you could take that would help us deliberate whether a certain piece of kit—whatever it was—was good value for the taxpayer and whether savings could be made if it was procured in a different way? It is that kind of thing. I appreciate the relationships you have, where you are between the industry, the MoD and so on, and how where you sit could be precarious, but in terms of our overall scrutiny role, is there anything that would stop you from giving us help with the way that we look at different procurement contracts?

Marcine Waterman: I'd like to roll that back before I answer to say that that was what envisaged by Lord Currie. Indeed, some of the recommendations were that the SSRO should give the MoD an assessment of the realism of the budgets they use for large purchases of equipment



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and services. Indeed, he recommended that the SSRO should be able to assess the efficiency of procurement practices and have the right to open an audit. We got none of those powers. All we can do is produce reports that can give an indication of whether something has achieved value for money, but we can only do that in an anonymised fashion, because the contracts are seen as commercially sensitive. We could not unpick a particular contract and its costs, but we can and intend to give the trends in how the MoD is procuring things. That is particularly the issues around how they price risk and what they do with overheads and their control on wage inflation, which is a very big feature of most of these contracts.

Matthew Rees: Certainly, our forward programme studies would be generally more at the industry level. We would look across the range of contracts, particularly across categories such as wages, as we discussed, overhead costs and the risk profile within the contract. We envisage using the data reported to us to provide a good degree of granularity analytically. That would be useful for you, the MoD, contractors generally and the public at large in understanding trends in cost over time. That information will take time to emerge. Some of it will inevitably be a little dry because by its nature it is quite analytical. Hopefully, as we build up on that programme, we will start to address the demand that is out there for analysis.

Marcine Waterman: In time, when you have procured so many different ships or aircraft, we can start to give you benchmarks on average cost per flying hour or the average engine cost. We can start to give you those pictures of comparability.

Q240 **Chair:** Finally, you mentioned that you are a lean organisation, with 33 people altogether. Of course, the MoD is a gigantic organisation. Do you feel that if you were to get some of the extra powers that you feel you need to require information rather than to request it in particular, you would be able to do that and remain a lean, tightly budgeted and well controlled outfit, or would you then begin to expand as bureaucracies have an unfortunate tendency to do?

Marcine Waterman: I am not looking to build an empire, but it is quite interesting that the authors of the Lord Currie report and, indeed, Lord Currie envisage an organisation of about 50 people. There has been no conversation—I have been here from the beginning—about what is an appropriate size. I have 33 fantastic people, but they are stretched. We have no contingency. We have very little money. So I still see us as growing—we should be growing—but that is a very difficult conversation to have in a time of austerity. That goes back to what is our value, and we believe we are contributing appropriately.

Matthew Rees: Coming back to the point about data, we are all using very sophisticated data systems and we are investing in our own systems, so I think that there is a scalability issue that will naturally come from having the right information flow, and then we will be able to use that additional resource to look very selectively where we need to. I would not say that we see the organisation growing inexorably. This is actually about



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having the right data and systems and the access rights, so that we can focus our attention where the risks are.

Q241 **Chair:** It is important that you set a good example in those terms, isn't it?

Marcine Waterman: Yes, I must be value for money if I'm going to analyse others.

Chair: Exactly. On that positive note, I thank you both, Marcine and Matthew, for your very interesting and very clear testimony. We are most grateful to you.

Marcine Waterman: Thank you very much for having us today.