HOUSE OF COMMONS

Public Accounts Committee

Oral evidence: Non-competitive procurement of defence equipment, HC 723

Wednesday 10 January 2018

Ordered by the House of Commons to be published on 10 January 2018.

Watch the meeting

Members present: Meg Hillier (Chair); Sir Geoffrey Clifton-Brown; Chris Evans; Caroline Flint; Shabana Mahmood; Nigel Mills; Stephen Morgan; Bridget Phillipson; Gareth Snell.

Sir Amyas Morse, Comptroller and Auditor General, Adrian Jenner, Director of Parliamentary Relations, National Audit Office, Jeremy Lonsdale, Director, NAO, and Richard Brown, Treasury Officer of Accounts, HM Treasury, were in attendance.

Questions 1-117

Witnesses

I: Stephen Lovegrove, Permanent Secretary, Ministry of Defence, Cat Little, Director General, Finance, Ministry of Defence, and Michael Bradley, Director General, Resources, Defence Equipment and Support.

II: Stephen Lovegrove, Permanent Secretary, Ministry of Defence, Cat Little, Director General, Finance, Ministry of Defence, Nick Elliott, Director General, Commercial, Defence Equipment and Support, and Neil Swift, Interim Chief Executive, Single Source Regulation Office.

Reports by the Comptroller and Auditor General

The Equipment Plan 2016 to 2026 (HC 914)

Reforming Defence Acquisition (HC 946)

Examination of witnesses

Witnesses: Stephen Lovegrove, Cat Little and Michael Bradley.

Q1 **Chair:** Good afternoon and welcome to the Public Accounts Committee. We have a busy afternoon looking at defence issues. We have two main panels. The first is to look at single-source defence procurement, and particularly the role of the Single Source Regulations Office. We are then going to look at equipment cannibalisation in the Royal Navy.

We are expecting a possible vote at four o'clock, though we can't be sure of these things, and we have quite a lot of ground to cover. We also have some issues that we want to raise with Mr Lovegrove at the beginning of the session. We are going to try to be quite brisk in our questions and answers. The brisker you are, the quicker you get home to tea. Take that as an invitation and encouragement.

Before we get to the main sessions, which I will introduce properly, I will introduce the witnesses in front of us, because we have to cover some issues that have arisen in the Committee before and that are in the news at the moment.

We welcome Michael Bradley, who is director general (resources) at Defence Equipment and Support at the Ministry of Defence; Stephen Lovegrove, the permanent secretary at the Ministry of Defence; and Cat Little, who is the director general of finance at the Ministry of Defence. Welcome to you. I think this is your first time in front of us, Ms Little.

Cat Little: It is.

Chair: Welcome.

Cat Little: Thank you.

Q2 **Chair:** Do you have a financial qualification?

Cat Little: I certainly do. I am CIPFA qualified.

Q3 **Chair:** Good. We like to ask, because it has not always been the case in Whitehall.

I want first to ask for an update on the outstanding 12 contingent liabilities. Without boring anyone watching, I have raised this a number of times with you, Mr Lovegrove. You have obviously gone through a period of discovery about contingent liabilities that were not reported to Parliament or, perhaps even more alarmingly, to the Treasury. Do you think that you have got a grip on it now and that the contingent liabilities you have told us about are the 12 you did not report to the Treasury and the 10 you did not report to us? Are those the outstanding ones that you have discovered?

Stephen Lovegrove: Yes, I do. I should take the opportunity of apologising to the Committee that this situation has arisen and seems to have arisen repeatedly. The three cases—Phalanx, Astute 6 and the Type 26 contract—really did prompt us to take a good, hard look at ourselves because that is clearly an unacceptable position for the Department or indeed Parliament to find itself in. So we have asked DE&S, which is where the majority of these contracts have arisen, to do an absolutely thoroughgoing piece of work, which is now complete, and it has had a look at 3,200 contracts.

Q4 **Chair:** That's the wider departmental review.

Stephen Lovegrove: It is not, actually. It is the DE&S contracts. There are obviously a number of contracts across defence. We have contracts in the Defence Infrastructure Organisation; we have contracts in the IT organisation—ISS—and we are now in the process of looking through those. There are not as many, and they are unlikely to give rise to as many potential contingent liabilities as the ones in DE&S, just by the nature of those contracts. However, we are taking this process further than DE&S. In so far as DE&S is concerned, we are content that we are at the end of that process. It has given rise to the identification of 12 other contracts, 10 of which should have been notified, but we are confident that that is it. I will ask Mr Bradley to take us through the detail, if I may.

Michael Bradley: Can I start by apologising on behalf of DE&S? We should not be having this conversation, and I can assure you that we have taken this matter very seriously. It has involved us reviewing 3,200 contracts, and we have now surfaced 12 issues that we recorded in the letter that we sent you. I can assure you that we have taken a number of steps to make sure that this situation is not repeated.

We have produced a response plan, and there are broadly four things that we have done to try to address this issue. First, we put in place mandated training across our organisation to make sure that the relevant people actually understood the rules, and knew of the existence of the rules, which has been a key issue within certain parts of our organisation. Secondly, we have improved the quality and clarity of our policy and procedures internally to make sure that everybody has a clear understanding of what the rules are. Thirdly, we have given a number of staff briefings to the senior management group within DE&S. About 100 people were briefed at a very senior level to make sure that they understood all the rules around this subject. Finally, we have put in place a number of extra controls on the approval process internally to make sure that we cannot forget to check whether there is indeed a contingent liability.

Q5 **Chair:** It is interesting that you talk about those further controls. Does it not show that there was a complete lack of grip on financial management when these contracts were let that you did not identify the contingent liability and get it agreed?

Michael Bradley: Well, not a total lack of control on financial management. On this particular aspect, which is quite technical, there was a gap on 12 occasions in our knowledge and understanding. To put that in context, we place 900 contracts a year. The issues we have had on the 12 go back six or seven years, so we are talking about a failure rate that is a very minute percentage of what we do. Nevertheless, our job is to make sure that we do not fall foul of any of the regulations at any point in time. We will make sure that we are much better at this particular area in the future.

Q6 **Chair:** I will bring in Mr Mills in a moment, but I just wanted to highlight the one that stood out as the largest: the Submarine Delivery Agency's future submarines. The contract value was £1.63 billion. The risk of negligent performance in submarine design work is assessed as very low, but that is a very big contract to have missed this out on. That was the largest, wasn't it?

Michael Bradley: It is, and I am not going to sit here and defend it. It is unacceptable, from your perspective and from mine.

Q7 **Chair:** And it was four of the 12 submarines. Is there an issue with the Submarine Delivery Agency?

Michael Bradley: At the time that those contracts were placed, the Submarine Delivery Agency did not exist, so it is before that agency was created. We found in the review that the problems—the 12 that we are talking about—were only present in three of our 12 operating centres. Submarines was one of them, helicopters was another, and finally there was land equipment. It was not a problem that was right across our organisation. Our job is to make sure that all our project teams understand and apply the rules, and that we do not repeat this, but it was not right across the piece.

Q8 **Nigel Mills:** What is the sanction going forward, Mr Bradley, if you sign off a contract that you are not legally authorised to sign?

Michael Bradley: It would be a very serious matter if that happened, because in the past we have failed organisationally to educate people to the right level. Now we have educated all our staff we will have to take any such issue very seriously. That may involve disciplinary action if appropriate.

Q9 **Nigel Mills:** But you knew these rules, didn't you?

Michael Bradley: Yes, I knew the rules.

Q10 **Nigel Mills:** And the board that authorises these big contracts knew these rules. Didn't anyone think to check at any point?

Michael Bradley: Well, we did think to check, but we didn't check thoroughly enough. It's clear, isn't it? Clearly, from an organisational point of view, from a board point of view, from my point of view, it is a failure. I am not going to sit here and say anything other than we should have picked it up—absolutely, we should have.

Q11 **Nigel Mills:** Knowing what your signing authority is is a fundamental part of any procurement process, isn't it? This isn't a minor technicality—"Oh, how unfortunate."

Michael Bradley: Absolutely, but the problem we have had is the project teams themselves not identifying the fact that there was a contingent liability there. Some of our project teams—I explained that it wasn't all of them—just didn't realise it was there. Clearly, from our perspective, we should have had controls that picked up the fact that there was something there. It's a failure.

Q12 **Nigel Mills:** That's worse, isn't it? When you negotiate a contract and you go through the terms, agreeing to cover someone's liability or cap it is presumably quite a fundamental part of a negotiation. It is not something where you sort of accidentally go, "Yeah, okay, you can pay the first 10 and we'll pay the next 200." That is not a minor part, is it?

Michael Bradley: When we fully disclose all of the data around these 12, I think you will find that all of the clauses and all of the indemnities that have been put in place are legitimate and are in the best interests of the taxpayer, and everybody will look at them and say they were sensible things to do from a commercial point of view.

Q13 **Chair:** But the Treasury hadn't seen them.

Michael Bradley: At the moment, we haven't had Treasury agreement, but for all 12, we have now submitted all of the data around them. We submitted them all before Christmas, and we are waiting for Treasury to review all of that submission. You can imagine that it is quite a large amount of paper that we have now had to put in front of them.

Q14 **Chair:** What if the Treasury doesn't agree with the contingent liability level?

Michael Bradley: We need to have a conversation with them because we have, wrongly, signed contracts with those clauses in.

Q15 **Nigel Mills:** Are those contracts binding, then? They are not ultra vires?

Michael Bradley: I would need to take advice on that from a lawyer, but I would imagine that they are binding. But, as I say, I am confident that when Treasury looks at those clauses, they will see that they are in the best interests of the taxpayer and that they were put in place for all the right reasons and that, while we are guilty of not following the correct process, when you look at the detail of the contingent liabilities and the indemnities that have been given, they will be things that you are comfortable with. I certainly am.

Q16 **Nigel Mills:** You discovered a whole collection of contracts, Mr Bradley, that you signed without the due authorisation from the Treasury or Parliament, and you have not thought to check whether those contracts don't have a legal problem. That seems like an unfortunate oversight. If I was the other party, I would be quite keen to know whether the contract I had signed was actually valid or not.

Michael Bradley: The contract is indeed valid—sorry.

Q17 **Nigel Mills:** Ultra vires contracts aren't enforceable, are they? That is the point of having ultra vires.

Michael Bradley: I am sorry, but I am not a lawyer so I am out of my depth on that particular subject. I would need to take some advice, but I would imagine—

Q18 **Nigel Mills:** Mr Lovegrove, have you got a view?

Stephen Lovegrove: I have certainly got a view that the types of contingent liability arrangements that were entered into are sensible ones, and I can see why the project teams went in the direction that they did. The issue here is the control environment, in DE&S in particular, which over a period of time had been unrefreshed and allowed to decay, to be honest, in a way that meant that this comparatively small number of contracts went through. Dealing with that control environment is a very, very important issue. It is not something that we are complacent about, thinking that it is just in DE&S, which is why we have extended the review to the other parts of the organisation.

Q19 **Nigel Mills:** But you haven't looked to see whether this collection of contracts that didn't get properly approved are actually legal.

Stephen Lovegrove: If you are asking a specific question as to whether or not these contracts are enforceable as a result of DE&S signing them, I would have to take legal advice. I would imagine that they are enforceable. I would guess—without being an expert—that a failure in our control environment would probably not void those contracts, but I would need to take legal advice on that.

Chair: We would welcome a clarification on that, and I think some of the people in those contracts would too.

Q20 **Caroline Flint:** Can you clarify for me the process for confirming that a procedure has been followed correctly? Is there some sort of written submission—a checklist, if you like—that ticks off everything people are meant to do, or is it just assumed?

Michael Bradley: Now there is a checklist.

Q21 **Caroline Flint:** Was there not a checklist before so that whoever was the leading person—

Michael Bradley: Not a comprehensive one, no.

Q22 **Caroline Flint:** Okay, it was not comprehensive. What did you—or whoever should receive these things—receive to be informed that the proper regulations had been applied?

Michael Bradley: The issue we have had is that some of our project teams were not aware of the rules around contingent liabilities and what needed to happen to get them approved. What we have done in the checklist is make sure that we have other people checking to make sure that we—

Q23 **Caroline Flint:** If this is a smaller problem—it is not all the project teams—what was the problem with those project teams that meant that they did not know the rules but everybody else did? Was it a personnel problem that meant their management support did not know, or did not train and inform their staff? I would have thought that all the project teams should have the same guidance, which they should all read.

Michael Bradley: They did all have the same guidance, but as we are dealing with people, some people were aware of the rules and some people were not.

Q24 **Caroline Flint:** That is what you have managers for—to make sure that the people they are managing and supervising know the rules. Is it a management problem?

Michael Bradley: It has been, and management has now reacted to put in place new controls to make sure that that cannot happen again.

Q25 **Gareth Snell:** I wonder what discussions and conversations you have had with the other parties to those contracts? You both said that you would be confident that the contracts are enforceable. What information have you provided to them? Obviously, they could be entering into a contract that means they are much more open to liability than they expected in the first place.

Michael Bradley: We have not had any conversations with industry about the 12.

Q26 **Gareth Snell:** I mean the specific counter-signatories—the commercial entities—on those 12, not necessarily industry as a whole.

Michael Bradley: No, we have not spoken to them, because, as I say, we believe that the contracts will be enforceable. As Stephen described, it is a weakness in our control environment internally that has been the problem. As I say, I am confident that when everybody looks at these clauses, they will not be concerned about what we have done in terms of the clauses themselves, but I have to apologise, as I said, for the fact that we have not followed the correct approvals process.

Q27 **Gareth Snell:** Just to be very clear, the commercial entities that are the counter-signatories to the 12 contracts that have been identified are not aware that they may be exposed to much greater liability than they currently are while you seek advice on whether those contracts are enforceable?

Michael Bradley: They are not aware of it, because we have not gone to them and said that, no.

Q28 **Gareth Snell:** Why?

Michael Bradley: Because, as I said, we strongly believe—and I do not have a lawyer sat alongside me to confirm it—that the contracts will be enforceable. It is an internal approval process that has fallen down; therefore the contracts will be enforceable.

Chair: We are going to get some advice from the Department on that.

Q29 **Sir Geoffrey Clifton-Brown:** Mr Lovegrove, you are the accounting officer at the Ministry of Defence.

Stephen Lovegrove: I am.

Sir Geoffrey Clifton-Brown: Given the relatively small number of contracts where contingent liabilities exist, would you not expect to be informed in future of every single contract that contained a contingent liability?

Stephen Lovegrove: I have not asked for that information as yet. I have delegated that responsibility to my subordinate accounting officer, in the form of the chief executive of DE&S.

Q30 **Sir Geoffrey Clifton-Brown:** It is not just DE&S, is it? It is other agencies as well.

Stephen Lovegrove: No, that is true, but there are subordinated accounting officers in each of those quite large organisations. I do not actually know whether the fact that there are 12 contracts in which contingent liabilities have arisen that have not been notified means that there are only 12 contracts with contingent liabilities associated with them. Almost certainly, that will not be the case. I would have to realistically take a view as to how many contracts of the 3,200 that are in existence at the moment contain a contingent liability. Do you know the answer to that off the top of your head, Mr Bradley?

Michael Bradley: No, I don’t. We have obviously focused on looking for ones that had not been previously flagged, so I can’t tell you off the top of my head how many contain a contingent liability. But all of those will be disclosed in the accounts, so we can quickly find out.

Stephen Lovegrove: They will clearly, however, come through the finance function, which does work formally, so in that formal sense they are disclosed.

Cat Little: On behalf of Stephen, I undertake to circularise all accounting officers and all parts of the Department to get a senior sponsor to assure us that they have identified all contingent liabilities in line with reporting requirements. As Michael said, we do include all of them within the annual reporting accounts of the Department.

Q31 **Sir Geoffrey Clifton-Brown:** In your reporting process, does each contingent liability have a maximum amount of liability that is involved? Do you quantify what that maximum liability could be?

Cat Little: There isn’t a maximum liability.

Q32 **Sir Geoffrey Clifton-Brown:** Or a likely liability?

Cat Little: We always try to assess and quantify the liability, where we can. Some of the contingent liabilities we deal with are by nature contingent on other actions happening, such as fines, penalties—things that we can't possibly know—but wherever possible, we would seek to try to disclose this. The accounting standard in question sets out the parameters under which you would seek reasonably to assess the quantity.

Stephen Lovegrove: There are some areas where contingent liabilities arise, particularly in the nuclear area, where they have arisen because it is impossible for industry to adopt that level of liability, should a catastrophic risk occur. By the very nature of the realisation of a catastrophic risk, it is extremely difficult to work out how much the liability will be. Therefore, they are kind of state risks. Nuclear in a sense is a kind of state business, as indeed we discussed when we talked about Hinkley Point. Similar types of situation arise there. There are some where it is not possible, by nature of the risk.

Q33 **Sir Geoffrey Clifton-Brown:** A final, important question: are you confident, Mr Lovegrove, that you have now identified all of the contracts that had not previously been disclosed as having contingent liabilities?

Stephen Lovegrove: I am confident in DE&S. I cannot give you that confidence in the other main contracting areas of the Ministry of Defence at the moment, which are principally DIO, the infrastructure organisation, and ISS, our information technology division. We are doing the reviews at the moment and will undertake to report to you in March. We certainly want to get those reports done for the reporting accounts.

Q34 **Chair:** So, by March at the latest. Thank you very much. We will keep an eye on it. I want to pick up quickly on the defence review. There is obviously the defence strand of the national security capability review. Recent reports in the media—I think on Saturday—suggested that the defence strand will be delayed. Is that true?

Stephen Lovegrove: The national security capability review has not been finalised in toto yet. There are 12 strands to it. The Secretary of State has been clear in the House that he wants to take the opportunity to look through his own lens at the kinds of threat that we are facing at the moment and the kind of capabilities we are ranging against them. That has inevitably delayed a little part of the defence part of the national security capability review. We are still in discussion with Cabinet officers as to exactly what the consequences of that may or may not be.

Q35 **Chair:** Is there likely to be a full-blown strategic defence review, if this can't get agreed?

Stephen Lovegrove: I am not at liberty to answer that question, partly because I don't know.

Q36 **Chair:** Okay, let's put it this way. Would it be helpful to you as permanent secretary that, if instead of trying to shoehorn the challenges of defence into the wider national security capability review, you instead had a full strategic defence review, given the £20 billion hole in your budget over the next decade?

Stephen Lovegrove: I will be guided by Ministers as to how they wish to proceed on that.

Q37 **Chair:** I would not want you to reveal advice to Ministers, but you do have a very new Secretary of State who has only been in post for a matter of weeks. Without wanting to give him advice, what is your view about whether it would be a good idea to have a full strategic defence review given the £20 billion hole in your budget?

Stephen Lovegrove: I don't recognise the £20 billion hole in the budget.

Q38 **Chair:** We know it is a very tight budget. Can we at the very least agree on that? There is a lot of over-commitment.

Stephen Lovegrove: It is a tight budget with many pressures on it; there is absolutely no question about that. We have a range of answers to how you may wish to arrange the budgets and the capabilities over the next 10 years depending on ultimately political advice and decision making. I really do not think that it is my place to try to pre-empt that political decision making.

Chair: We will be talking to our sister Committee, which I know is very much interested in this as well, and I am sure that the Secretary of State will not get an easy ride from us in the House, but thank you.

Q39 **Sir Geoffrey Clifton-Brown:** Mr Lovegrove, you are about to let a contract for replacing the Boxer mechanised infantry vehicles for the Army. Have you decided to whom that will be let?

Stephen Lovegrove: I will defer to my colleagues, who I think may be better informed on where that process is up to.

Cat Little: We passed the initial gate at the end of last year, and we are currently in the assessment phase. There has been no final decision yet on who to let that contract to, or the final specification, so we are still in the assessment phase process.

Q40 **Sir Geoffrey Clifton-Brown:** The reason for my question is that you will be aware that British industry, principally in the form of General Dynamics, are concerned that they will not be given the chance to bid for this contract—that it will be let to a single supplier. Can you give us an assurance that British industry will be given a chance to bid for this contract?

Cat Little: No decision has been made yet to whittle it down to one supplier, so at this stage there is every opportunity for that supplier to compete.

Q41 **Sir Geoffrey Clifton-Brown:** That doesn't sound like a very convincing argument. British firms have expressed an interest in this contract. Why wouldn't you allow them to bid for it?

Cat Little: Well, absolutely. We are about to come on to single source. Competition is obviously healthy; it is the best way of us testing the market. We would want British defence supply as an industry to have an opportunity to compete for that contract. At the moment, that is absolutely the case.

Q42 **Sir Geoffrey Clifton-Brown:** Mr Lovegrove, there have been reports in the press that our aircraft carrier, the Queen Elizabeth, has developed a leak, and that you will not be bearing the cost of those repairs. Can you give us any update on that?

Stephen Lovegrove: Again, I will ask Ms Little to answer that question.

Cat Little: I believe the stern seal is the technical term for where water has been coming into the stern. We will not be liable for the financial costs. That is part of the contractual arrangements in place, and it will not be an additional cost to Defence.

Q43 **Sir Geoffrey Clifton-Brown:** How long are those repairs likely to take? Is she likely to be out of commission for any appreciable length of time?

Cat Little: I believe the work has started. I do not know the end date. Perhaps when colleagues from the Royal Navy are in front of you, you might want to get a fuller answer to that question.

Chair: Thank you very much. I know that Mr Bradley is leaving us at this point, because we are going to bring on other panellists for our session on non-competitive procurement, which Sir Geoffrey briefly referred to. I think we have Nick Elliott and Neil Swift joining us.

Examination of witnesses

Witnesses: Stephen Lovegrove, Cat Little, Nick Elliott and Neil Swift.

Q44 **Chair:** Welcome to the first of our main sessions on defence. As Sir Geoffrey mentioned, there are opportunities for the Department to choose to have a single-source contract. The regulations to do that were introduced after a review in 2014, with an aim to reduce contract crises. The aim was that the new organisation would be able to have a transparent view about the profits for industry and the benefits to the taxpayer. We want to talk about how that is going on the back of the NAO's Report, and to learn where there are issues and problems, and in the light of Brexit what the impact may be on British industry, where some procurement is done through single-source regulations.

I will introduce the witnesses, because they have changed. Nick Elliot is the director general for commercial, defence equipment and support at the Ministry of Defence; Mr Lovegrove has been introduced before and is the permanent secretary; Cat Little is the director general of finance; and Neil Swift is the interim chief executive of the Single Source Regulations Office. When is the permanent chief executive going to be in post?

Neil Swift: The advert is due to go out later this month.

Chair: Did the last chief executive leave in October?

Neil Swift: In October, yes.

Chair: So you are here until the incumbent is in place.

Neil Swift: Yes.

Chair: Fantastic, thanks very much.

Q45 **Gareth Snell:** Let me start with Mr Lovegrove. The Ministry of Defence has acknowledged that the best way to get value for money is through competitive process, yet since 2013, the number of contracts that have been let in an uncompetitive process has roughly stabilised at around 50%. Can you tell the Committee what you have been doing since 2012 to try to stimulate additional levels of competitive tendering and procurement in the Department?

Stephen Lovegrove: Maybe it is worth very briefly fleshing out why we find ourselves in a position where 50% of our contracts go to single source. That is not a situation that we would like in a perfect world; we would like 100% of contracts to be competed. There are good reasons why that cannot happen in the defence industry and they are all outlined in the NAO Report, which is a very complete summation of where we are. The two that I would highlight are the retention of sovereign capability, which is very important in certain areas, and that we have a very heavily consolidated defence industry. It has been subject to successive waves of mergers and business combinations that have left us with a comparatively small defence industrial base. If we believe that there have to be usually UK suppliers, that could drive us into a place that leaves us effectively with monopoly suppliers.

The most important element in seeking to fix that, over and above the SSRO and the Single Source Regulations, is likely to be the national shipbuilding strategy. That is a situation, with the Type 31s that are coming up, where we have very specifically decided to alter the way in which we will contract for those types of ships, in a way that a couple of years ago we would certainly would not have done.

Q46 **Gareth Snell:** That’s lovely, but I am not talking about what will come later—that is something that my colleagues will look at. I am specifically interested in the 2012 acknowledgement that 50% was probably not ideal, and that there should be greater levels of competitive procurement. That has not happened in the past five years, so as far as I can see, either the Department did not try to see a greater number of competitively procured contracts, or it tried things and they failed. Which one is it?

Stephen Lovegrove: To be honest, it will be a mixture of those two issues. We will always have a significant proportion of our contracts that are single source. We cannot really get away from that. We have made significant attempts to develop the competitive landscape in the UK. We have certainly invested money in making sure that we are bringing suppliers to the table. We have tried to simplify our processes—

Q47 **Gareth Snell:** If that is the case, why has there not been an appreciable decrease in the number of contracts that have been let non-competitively?

Cat Little: Could I provide a little data? I respect the fact that, as the NAO Report points out, our data is not perfect, but if you look at contract value over the last three years, around 36% is now under single source as opposed to 51% over the last nine years. Although it is not perfect data, we are seeing an increase in the amount of competition. The important thing, as Stephen said, is that the mindset in the Department has significantly changed. Competition is the norm and single source is the exception where we have really good cases for value for money or other reasons to do with the nature of the market to pursue a small source process.

Q48 **Gareth Snell:** But although it may have been 36% of the value of contracts, the number of contracts in 2016-17 was slightly over 50%—51%. A minority of your contracts are now let through a competitive process. How does that tally with what you just said about the fact that it is now the standard norm?

Cat Little: Sorry, it is a comparison over time. The NAO Report looks at it by value, and we are looking at it by number. I go back to the fact that our data is not perfect, but if you look the trend over time, and if you look at it by value, it has reduced.

Q49 **Gareth Snell:** How have you achieved that? Mr Lovegrove just said that that has not been possible, and you are saying that it has happened. How has that happened?

Cat Little: It is partly by mindset. The nature of some of the competitions we have run has necessitated broader competition. That is driven partly by the type of capability we are procuring, and partly by the way in which industry is working with us.

Stephen Lovegrove: There is an element in which we have tightened up, rather in the same way as Mr Bradley was talking about trying to make sure the procedures are more focused on going into contingent liabilities earlier on in the session. Our business cases now are more pointed in asking why it should not go to competition. While we can do that, we are clearly also subject to wider forces in the industrial base. It continues to be the case that smaller suppliers get bought by larger suppliers. It is a dynamic situation. I am afraid that a country the size of the UK buying kit as sophisticated as our defence industry requires is going to find itself using single-source suppliers a lot. It is also going to have to enter into international collaborations a lot to be able to get the kind of equipment we require. We need to build institutions around it to allow us to manage it. That is really what the SSRO—

Q50 **Gareth Snell:** What precautions are you putting in place and what work are you doing now? There is not going to be a seismic reversal of trend in which these large defence companies suddenly have to break up and start competing among themselves, as they did previously. What are you doing now to ensure that future contracts are going to be able to be dealt with through a competitive process, given that the circumstances in which you are procuring are unlikely to change in the short term?

Stephen Lovegrove: I am afraid that we will do more of what we are doing at the moment, which is to be very pointed about the fact that the default will be a competition. People have to make the case for why it should be a single-source process, rather than a competitive one. To the extent that it is a single-source one, we will make absolutely sure that the number of exceptions to single-source regulations are kept to an absolute minimum. It is, I am afraid, a question of dealing with the reality of the UK defence industrial base. We must keep trying as hard as we possibly can.

Q51 **Nigel Mills:** Mr Lovegrove, how do you find a balance if one of the commanders decides they want a particular helicopter and tries to write a specification that leads you to be able to go with only one particular supplier, rather than having a broader funnel at the start so you could allow more bidders in?

Stephen Lovegrove: There are two places where the correctives to that type of behaviour kick in. One is in DE&S, and one is in the approval mechanisms for the bigger contracts within the Department. Perhaps it is best to let Mr Elliott and Ms Little, who chairs that approval committee in the Department, talk to that question.

Nick Elliott: One of the initiatives that Tony Douglas instigated about six or seven months was to look at a thing called routes to market. We took the armed forces committee into that in November this year. Part of the agreement was that we were going to set up pre-sourcing committees within the frontline commands. The aim of those pre-sourcing committees is to have a much better understanding of what the requirements are and to specify them in much more output-based ways to allow us to look at what the totality of the fit might be to meet them, rather than going for a single solution. Those are being worked up at the moment, with a view to implementation from April of this year. So, there absolute identification at getting the customers to identify what they want and specify what they want in a way that allows us to go to competition; that is part of the solution. That is an ongoing activity.

Cat Little: From an investment approvals committee perspective, we obviously test the procurement strategy at every single stage of the business case development and procurement process, throughout the life of procurement. Right from initial gate, which is when we test the outline business case and the concept, we are constantly seeking to challenge any route where the procurement strategy is suggested to be single source. There are multiple examples of where we do push back.

Ultimately, if there are sensible reasons, for either sovereign capability or because of the nature of the market, while we continually test it, quite often the trick to it is having that conversation early on. Although our approval process is incredibly thorough and builds upon the work undertaken by the TRBs, there is still a challenge for us to have that discussion early on in the process. There are a few examples where we end up having that discussion at the final business case stage rather than right at the outset. I think that is one of our challenges; to ensure that that happens first rather than last in the approval process.

Stephen Lovegrove: If I may, Mr Mills, there is another aspect to your question, which in some ways is a bit more difficult to monitor. That is around the process of variation, where potentially a competitive process has been gone through, a supplier has been chosen and then the requirements for the particular piece of kit start being altered.

At that point, it becomes very difficult to reopen a competitive process and the supplier not only builds in cost and expense into the process but it is difficult to roll back from. In some ways that is almost more of a problem than the one that you identify, although it is a different aspect of it.

Q52 **Nigel Mills:** Are the commands enthusiastic about the advantages of competitive procurement or do they say, "We like those helicopters. We have always had those. Can't we just have them again?" Is it something that people buy into because they realise that, without the savings, they do not get all the kit they want, or is it a thing you have to force on them?

Stephen Lovegrove: Genuinely, I have not seen any push back from the commands to this. I think the reason for that is that, following the reviews of the defence organisational model in 2010-11 done by Lord Levene, a great deal of resource and cash was devolved to the frontline commands.

That has had a profound effect on the attitude of the frontline commands to spending money, because it is money that is theirs and, if they spend it foolishly on things that are overly gold-plated, it means they will have less money to spend on other things.

That has had made a very profound difference to it. So much so, that we are in the process of doing the same thing with infrastructure spending, to turn DIO, the Defence Infrastructure Organisation, in a way into an infrastructure analogue to DE&S, to be a speciality personal shopper and adviser to the commands, who are actually spending and are responsible for the money. That kind of realignment of incentive has been the most important thing in the past few years.

Q53 **Gareth Snell:** I would like to ask Mr Elliott a question. You mentioned a pre-procurement processor. I did not quite catch what you said.

Nick Elliott: What we call it is a pre-sourcing council: we try to identify the requirements in a more effective way. When you do the analysis of the single-source contracts, we have made a lot of effort and made a lot of progress in terms of the high-value contracts in creating a market that is more competitive. But a lot of the volume that we certainly talk about is the low-level, low-spend contracts, and that is where we need to get the customers to work towards a view of giving a more output-based specification, so that we can go to the board with a number of suppliers.

Q54 **Gareth Snell:** How effective would that be? To pick up on Mr Mills's point, if you have a piece of kit that you like, it is easy to just recommission it.

How do you make sure that even if you are not saying, "We want that bit of kit," you are not saying, "What we want is something that looks, sounds, smells and tastes exactly like that bit of kit," knowing that essentially what you are doing is recommissioning what you already have, even though you are doing it in a slightly longer way?

Nick Elliott: First of all, it is about having the control point where you ask those questions and specify what they are. Secondly, from a DE&S perspective, we are in the process of instigating a formal gateway, so that when we accept the requirements, we are testing all of those parameters at that stage and making sure it is not just, "This is the bit of kit we like and therefore we want to replace it with the same."

Q55 **Sir Geoffrey Clifton-Brown:** How often are you forced into a single-source contract by intellectual property considerations?

Nick Elliott: It would be difficult to give you a percentage. IPR is one of those areas where we are working very hard with the supply chain to come up with a new regime and a new paradigm whereby we are not forced down a single route. Of course, if a supplier has intellectual property rights to a particular piece of kit, they are very protective of those. It is a constant negotiation and a challenge in terms of getting to the right answer, but I could not give you a specific percentage.

Q56 **Gareth Snell:** At what point in that process do you start talking to potential suppliers?

Nick Elliott: Part of what process?

Gareth Snell: You've gone through the process of doing pre-sourcing, moving to more of an output than a product, but presumably at some point you will have conversations with suppliers about what is available to be purchased.

Nick Elliott: Part of the change programme is to have those conversations as early as possible. The generic conversations about what the market can supply need to happen right up front, in the very early stages.

Q57 **Gareth Snell:** Given that Mr Lovegrove has quite rightly pointed out that there is a contracting market of suppliers for defence equipment, what are the safeguards in those conversations so that you do not end up talking to the supplier about what they can supply you with and find yourself inadvertently simply writing a specification that meets something they can already sell you?

Nick Elliott: Because you are not talking to one supplier. This is about looking at what the market capacity has to offer and the variety of suppliers across the whole of that delivery piece. It is effectively about implementing category management—not looking at just one specific piece of equipment but looking at what the market can offer across a category.

Q58 **Gareth Snell:** When did that come into force? How long has that been operational?

Nick Elliott: We agreed that at the armed forces committee, and the pre-sourcing council. We are drawing up the specifics of what those look like, with implementation in April this year.

Q59 **Gareth Snell:** Given that the data from the NAO is that 51% of all contracts let in 2016-17 were done so under a non-competitive process, what do you see as the impact on that statistic under that new programme?

Nick Elliott: I don't think there is going to be a direct ability to look at a causal reduction in that number, because what we are doing at the same time is trying to reduce the number of contracts we have through consolidation.

Gareth Snell: The joy of a percentage is that it does not matter necessarily how many it is as an absolute, because it is relative to the overall number.

Nick Elliott: It does in terms of how you group and consolidate those contracts and whether or not we are going to put larger—

Q60 **Gareth Snell:** Would you expect, as a result of that programme, to see a greater number of contracts let through a competitive process as opposed to a non-competitive process?

Nick Elliott: If we can get the work that we are doing in the pre-sourcing council to be effective, I would see some reduction, but I would not see a massive reduction. It is going to come down, but it is not going to be huge.

Q61 **Chair:** It has been fairly stable. Mr Snell is talking about page 18, part 2, figure 3. There is a certain stability in the percentage of competitive and non-competitive processes over recent years. Are you not expecting to see a change to that graph?

Nick Elliott: At the end of the day, we need to get the right solution, not just try to drive down a percentage for the sake of it. It is all about understanding—

Q62 **Gareth Snell:** No, but if the Department recognises that the best way to get value for money is through a competitive process, surely one of the aspirations of whatever work you are doing in terms of procurement going forward would be to increase the number of contracts let through a competitive process. Otherwise, you are admitting that you may not be getting the best value for money.

Nick Elliott: I disagree. I think that you get the best value for money through a variety of things, including competition. Competition is the No. 1 thing we should follow, but the introduction of single-source regulations means that we are now starting to get really good value for money through the single-source activities we are undertaking as well, because we are getting complete visibility of cost data, which allows us to negotiate much better outcomes. We should always pursue a competitive solution where we can, but we are also now getting much better and much more effective value-for-money solutions through the single-source regime.

Q63 **Gareth Snell:** That sounds as if you are laying the marker very early on for justifying, when you come back to this Committee in however much time, why there has been no reduction in non-competitive procurement because of the new single-source regulations.

Nick Elliott: No, I think competitive procurements will increase, but I am saying I am not sure how that will play out in terms of the percentages when we are looking at consolidation of contractors. We would need to look at what the relative impact of that was.

Q64 **Gareth Snell:** Okay. Ms Little, can I ask you about the IAC, which you mentioned earlier, and the challenges that you make when a justification is put forward for non-competitive procurement? In its Report, the NAO says that it found only "14 occasions where the IAC had challenged the decision or indicated that a competitive solution would be expected." Do you know how many times the IAC has been successful in moving from a non-competitive outcome to a competitive outcome?

Cat Little: That is a very good question. I am afraid I do not have the detail, but I am very happy to write to you with a fuller response.

Q65 **Gareth Snell:** Would you be able to give the values of those contracts as well? You wanted to talk in specifics about contract values as opposed to absolute contracts, so having the value of those would be helpful.

Cat Little: I am very happy to do so. The other thing to bear in mind is that the IAC captures by value the most significant and highest-risk investments for the Department—we do not capture everything. Of course, things happen throughout the organisation, so while 14 might seem a small number, a huge amount of challenge happens throughout the investment process.

Q66 **Gareth Snell:** In that case, where is that challenge most robustly made? Can you provide any evidence that that challenge at earlier stages is having an effect of moving from non-competitive to competitive procurement?

Cat Little: Again, I do not have data—forgive me, I have only been in the Department for three months—but my sense is that that is happening at TLB investment level, and particularly with DE&S. We are actually undertaking a review of our investment approval process to make sure that we are capturing the right data for the whole lifecycle, not just at final approval at the very top of the Department. We think there is more we can do to capture issues earlier in the process.

Q67 **Gareth Snell:** While we are talking about data, the MOD resource accounts were qualified as part of the audit process. Why has it been so difficult to maintain accurate data and records, not just in that particular area but across the MOD? Is there a structural problem—a more significant problem—that we should be aware of?

Cat Little: I don't believe so. We are in the process of implementing the final part of our new financial ledger system, which is a contracting, purchasing and finance ledger. When the final stage is implemented, by the end of December this year, we will have the systems and the tools to capture the right information, specifically on contract management. At the moment we do have deficiency in our system capability. The Department's accounts were qualified because of a separate legacy issue to do with the application of an accounting standard, so I do not believe this is systemic. In many ways, we have far too much data and we do not have the technology to capture it and analyse it in the way you would expect.

Q68 **Gareth Snell:** Finally, Mr Lovegrove mentioned international collaboration in procurement. What contingencies are the MOD putting in place for future industry collaborations once we have left the European Union? We are not entirely sure what the regulations will be and what impact that might have on future commissioning and procurement.

Stephen Lovegrove: I am assuming that there will be some changes to the precise nature and application of the state aid rules when we leave the European Union. I have to say that I do not know what the precise nature of those changes will be, and I would be surprised if colleagues at the Treasury wanted that to signal a free-for-all in terms of going for British suppliers no matter what the cost. If they did signal that, we would not follow that guidance. I do not know what the answer is, but I imagine that there will be some changes.

As the UK, we need to be very careful not to lose the benefit of some of the European affiliations and alliances that we have at the moment, which have allowed us very successfully to create platforms, such as the Typhoon—the Eurofighter—that are the product of European collaboration. We need to make sure that UK industry continues to play an absolutely leading role in those alliances, and we have a team looking at that. It is one of the factors we constantly think about when we think about future UK involvement in burgeoning or emerging European defence institutions.

Gareth Snell: Thank you.

Q69 **Nigel Mills:** We'd better move on to the regulations themselves. I think they have been around for about three years, so what is your assessment of how effective the new approach has been?

Stephen Lovegrove: I would say they have been a great improvement on their predecessor regulations and that it is a very good start indeed. Perhaps the easiest way to notice that is that we constantly receive questions from our international peers as to how the regulations are developing, and expressions of envy that we have a new system in place. I should say that it is not just new to the UK; it is the only such organisation in the world. It is one of those bits of innovative UK regulatory practice that, I suspect, will probably find its way into application in other countries.

With a new organisation such as this, we would not expect that everything would be absolutely 100% perfect from day one. We certainly would expect there to be a degree of constructive friction with the suppliers. I have worked in a number of different Departments and industries, and I have not seen a situation with a regulator and an industry where there is not a little bit of constructive friction. Indeed, if there is an absence of it, you have a problem on your hands. I would not read anything too alarming into criticisms of it coming from the industry, most of whom understand the need for the regulations.

I would like to see the progress of the regulations and the regulatory office accelerated, for sure. They are a really important part of getting to the efficiencies that we absolutely need in order to make the Defence budget affordable, but I have no great concern at the moment that that will not be possible. One of the far-sighted things built into the arrangements by the legislators and the original policy designers of the regulations was the ability to come back and look at them on a fairly regular basis.

Q70 **Chair:** That is the three-year review?

Stephen Lovegrove: Exactly. The SSRO has a statutory requirement to make observations about improvements. The Secretary of State is looking at some of those at the moment. We have just had a consultation, and I would imagine that we will try to improve matters as we go on.

Q71 **Chair:** What is the timescale on that? It was supposed to be three years, and that was at the end of last year, wasn't it? Obviously, with a new Secretary of State, I can understand he might want to—

Stephen Lovegrove: The consultation has closed; the Department has synthesised the responses and placed them in front of the Secretary of State, and he is looking at them now. I would imagine that very soon, in the early part of this year, he will respond, but I can't give you an exact timetable. In general, I should say, good progress.

Chair: We need to be a little bit quicker with our questions and answers—or we could be here all day, if you want; it is up to you.

Q72 **Nigel Mills:** Well, we are here until seven anyway. Your Department values the existence and contribution of the SSRO, as well, does it?

Stephen Lovegrove: Certainly.

Nigel Mills: Reading this Report, it seemed that it was a chequered relationship at the start. Originally the SSRO could ask individual teams for information, and then that was filtered through the SSAT and there was quite a backlog. Are you doing everything you can to make sure that the SSRO can have all the information it needs on a timely basis?

Stephen Lovegrove: We certainly are. I do not really recognise that characterisation. We have a good relationship with the SSRO; it is a very important part of the landscape that we want to work with.

Q73 **Nigel Mills:** How effective is the progress you are making on ensuring that all suppliers, even those on existing contracts, have bought into going into this process and are not trying to opt out? Is that something you see coming to an end in the relatively near future?

Stephen Lovegrove: In all these situations what we try to do is to put the high-value contracts under the regulations as quickly as possible. So you are going to see, I think, some slight tailing off in terms of the value.

As I said before, there is a certain amount of bedding in between a new regulator and an industry in this kind of way, but I can see in my conversations with industry a real acceptance of the value of the regulations and of the office itself. It should be said that the regulations and the office are not there just to get the best possible price for Defence; they are there to ensure that the contracts that we sign, necessarily under single source, are fair, not only to Defence but to the suppliers. It is not in our interests to gouge the suppliers.

Q74 **Nigel Mills:** Paragraph 4.5 of the Report states: "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…will be covered by the Regulations." Is that a target you will be able to meet?

Stephen Lovegrove: It's a target we are still aiming to meet. I have no information to imagine that is an unrealistic target.

Nick Elliott: May I just add to that? Certainly in DE&S we are actually meeting that target at the moment, so lets since the regulations began are just under 1,000 single-source contracts; of those 1,000, 92 were within the realms of the legislation—over £5 million-worth in value—and of the 92, 90 became qualifying defence contracts and two for business reasons were put through the exemption process that exists under the regulations. In terms of new contracts, we are meeting that target today.

Q75 **Nigel Mills:** So where that paragraph states that "certain suppliers…are either refusing to be subject to the Regulations or will not provide the required information about costs and prices"—

Nick Elliott: That relates to contracts, on the main, where the regulations do not mandate the supplier to sign up to them. We have been targeting the high-value contracts, whereby we have had an amendment point. We have been quite successful in terms of the value that we have amended and brought into the regime as well. In terms of volume, there was initially, as the contractors and supply chain got to understand the regulations, a little reticence about moving towards bringing those contracts into regime.

Q76 **Nigel Mills:** What message are you giving suppliers that are disinclined to play along with these rules? Are you basically saying, "Well, if you don't play along, you won't be suppliers"? Isn't that going to have to be the fundamental message?

Stephen Lovegrove: It is a version of that type of message that will have to be given, yes.

Nick Elliott: And it has to be said, with the supply chain, that a lot of this was just them getting to grips with the regulations, understanding them and seeing that we have a focus on profit when actually what we want to do is to focus on the total cost. They now see that there is an advantage to working collaboratively in that space. There has been a lot of progress in the supply chain.

Q77 **Nigel Mills:** So even when it is about an amendment to previous contracts, which I think has been some of the difficulty, you are confident that we will get all of those within the regime in the relatively near future.

Nick Elliott: Well, because a lot of the existing contracts expire, you also have to look at the business case for bringing them into the regime. If the contract is going to expire in the next 12 months, it is not worth the time and effort to try to bring them into the regime, so we are focusing on those contracts with a longer lifespan and which have a greater value—we are bringing those into the regime as we go.

Q78 **Nigel Mills:** Mr Swift, we have let you off so far. What is your assessment of how the first three years of your organisation's existence have been?

Neil Swift: I think it's been successful. We play an important role and we are an integral part of the system for single-source procurement, sitting in an important space between the MOD and industry. We believe that we have achieved a lot in a relatively short period of time. We recognise our role and we recognise that we have a largely advisory role.

In relation to the non-competitive procurement regime, we recommend the baseline profit rate—the Secretary of State sets that rate. We monitor the submission of statutory reports but the MOD is responsible for enforcement. But actually, importantly, we have created a framework in which there is greater clarity and certainty over the allowability costs, the application of the profit rate and the steps that sit within it. That framework has been established and clarity has been provided, and that—or the discipline—has allowed the MOD to achieve efficiencies and savings while at the same time delivering a fair return to industry. So I think it has been successful.

Q79 **Nigel Mills:** It has been a slightly bumpy road at times, hasn't it?

Neil Swift: I think, as Mr Lovegrove has said, one would expect, in the establishment of a new regime which has not been subject to regulations in this manner before, there would be a degree of bedding in. One would not expect suppliers who are profit-maximising organisations to be entirely content when it is going to be more difficult.

Q80

Q81 **Chair:** That is a fair point, but if you look at the summary of the NAO Report—this jumped out at me—on page 9, the second half of paragraph 11 says, "This, and its sometimes confrontational public tone, has provoked differences of opinion with stakeholders, and limited the willingness of others to co-operate with it." Often, when there is a clearance on a Report, there is argy-bargy about sentences as bold as that, but it came through. Do you agree that there was sometimes a confrontational public tone from the SSRO?

Neil Swift: We recognise the comments that have been made. As I say, it was to be expected at the beginning of the new regime that there would be difficulties encountered, that people would need to understand how the regulations applied to them, and how we were going to apply our role and undertake our functions. We have recognised that. I think if you look at our more recent—

Q82 **Chair:** Particularly this "confrontational public tone" bit. There might be differences of opinion about how you assess costs, profit and so on—I can understand that industry would want to take you to the wire on that—but do you think there was sometimes an attitude issue at SSRO that made it a little more confrontational than it needed to be?

Neil Swift: I think we felt the messages we gave out were appropriate at the time. We have worked very hard under the chairmanship of George Jenkins over the last year to build further the relationships we have with both the MOD and industry, and I think we are making very good progress. I think that has been recognised in the NAO Report and also by industry and the Department itself.

Q83 **Chair:** You are interim CEO at the moment. Would you have any advice for your successor as permanent CEO—if it is not you, or if it is you—about this confrontational public tone and lessons you have learnt over the last three years about how you deal with industry?

Neil Swift: That is a challenging question. My advice would be that one of the most important aspects of the regime is the dialogue that takes place between the component parts of it—the Department, industry and ourselves. There has to be a clear understanding of our role. There has to be a clear understanding of their part in the system and their obligations under the system. I think we are much closer to a collective understanding of that and of the aims of the regime that are trying to be achieved.

There is a balance to be achieved between value for money for the taxpayer and fair pricing for industry. I believe we have worked very hard to achieve that and I think we have made good progress in delivering upon that settlement.

Q84 **Chair:** If you were writing a memo to your successor, what would you say about how you deal publicly with the pronouncements you make?

Neil Swift: As I say, the engagement is very important. We have to recognise that we need to listen to the views of our stakeholders and ensure that, in listening to those views, we take them on board and reach an independent view in providing advice to the Secretary of State and setting out our guidance and our methodologies. I believe we do that. That would be the advice that I would give: focus on those relationships and make sure that we are listening. I think we are doing a good job on that.

Q85 **Nigel Mills:** Figure 9 in the Report sets out the industry view on the effectiveness of the SSRO. It says, "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." Do you agree with that set of conclusions?

Neil Swift: No. The document set out our views on those issues, so clearly our views are set out already. On those particular matters—let me get the right page on that one—

Chair: Page 29.

Neil Swift: Thank you. I understand that a profit-maximising organisation is going to find it difficult when there are challenging questions around the levels that are being achieved. We believe we have a very robust and fair methodology that is empirically derived, based on comparability with similar organisations undertaking similar functions internationally. We think that is fair. We have a benchmark set for the baseline profit rate, which we make a recommendation on, that draws on actual costs and actual profits. So yes, I think that is fair, and I think that is recognised more now than it was previously.

In terms of our methodologies, I think we have provided far more detail through our recent consultations and provided sufficient information to allow others to undertake the same analysis themselves. We have provided a whole raft of information to the Secretary of State to support the robustness of the methodology and its application. I think we are in a good place there. In terms of the staff at the SSRO, we have assembled what I think is a very good group of staff; they have a challenging job, and they have the background with the skills that we need to undertake our role. We are constantly keeping that under review as staff cycle through. We recently made a number of appointments of ex-MOD and ex-industry staff. That is something that we have built on and we will always look to keep the skills that we need under review.

Stephen Lovegrove: I should say, Mr Mills, I think that if you were to conduct anonymous interviews with industry players in any regulated industry, you could cut and paste that observation.

Chair: You are a cynic, Mr Lovegrove.

Q86 **Nigel Mills:** I suspect I could probably cut and paste the organisation's own view of itself, but we have to ask some questions, don't we? That is what we are here for. The profit rate that you were just alluding to Mr Swift—we are down to 7.46%—seems quite high really for relatively low-risk cost-plus kind of arrangements. Are you tough enough on the profits that these contractors are making?

Neil Swift: As I said, we believe that the profit rate methodology has been robustly designed. We have consulted on it quite widely. It is based upon comparability with organisations that are undertaking similar activities internationally. It is based on actual cost and actual profits that are being earned, so we think it is fair. It is representative of what is being achieved elsewhere in similar industries undertaking similar functions. So yes, I believe that it is fair.

Q87 **Nigel Mills:** It has been coming down, hasn't it? I cannot remember what the numbers were, but they were over 10% at one stage, weren't they?

Neil Swift: Yes.

Q88 **Nigel Mills:** Do you think that the taxpayer has been robbed blind for 30 or 40 years by allowing those high levels of profit?

Neil Swift: I don't have the information to comment on what was there before the regime, unfortunately. The more important factor to bear in mind about the profit rate at the moment is that the baseline profit rate is just the starting point: there are six further steps. That rate can move up or down, and it does—that has been set out in a number of reports that we have made available publicly.

Q89 **Nigel Mills:** Yes; figure 11 on page 36 probably implies that most of the movements are up rather than down. When you advise the Secretary of State on that profit rate, are you under any pressure from the Department in terms of where it goes? Do you give completely independent advice?

Neil Swift: We are operationally independent: we have our own board; we are funded separately; we appoint our staff; we are able to make our own operational decisions. I am entirely confident that we are operationally independent.

Q90 **Nigel Mills:** You don't get a phone call saying, "That sounds a bit high or a bit low, can you nudge it around?".

Neil Swift: Absolutely not.

Q91 **Nigel Mills:** That's all independent. You have been consulting on your three-year review process. If you had a wish list of new powers for the office, what would they be? Would you rather be a regulator than a regulation office and an adviser? Would you rather be making decisions than recommendations?

Neil Swift: We have a statutory obligation to review the legislation. We have undertaken that task and we made our recommendations to the Secretary of State in June 2017. Our focus in undertaking that review was very much enhancing the existing provisions of the legislation, to ensure that it is better placed to achieve the objectives set out by Parliament in the original legislation. That was our focus.

Given that the Secretary of State announced the completion of the review, we look forward to seeing the detail of that. We will work with the Department and with industry to take forward any changes that come through following that.

Nigel Mills: That is a wonderful politician's answer but it did not really give me any information on what changes you might like or what new powers you might see.

Chair: Have another go, Mr Swift. You can be very open with us and trust us completely.

Neil Swift: I would not want to presuppose the outcome of the Secretary of State's considerations of the recommendations that we made at this point. I understand that there is due to be an announcement in the near future, and we plan to publish the recommendations that we made.

Q92 **Chair:** We recognise that there may be bits of information provided that effectively is advice to the Secretary of State, but you are in a slightly different position to Mr Lovegrove, and you are an organisation that practically is having to implement a policy, so it is not about the policy or the advice. The practicality is partly what Mr Mills is driving at. So in practical terms, where are glitches that could be ironed out, or areas that could be enhanced to make it work better in practical terms?

Neil Swift: We have made recommendations in a number of areas. Mr Mills asked about powers to the SSRO. One area where we have made a recommendation is around information access in support of the delivery of our functions.

Again, I know that is being considered by the Secretary of State and we look forward to seeing the outcome of that one, because that is one where we have made a particular recommendation. Other areas are around thinking on pricing of contracts and amendment. There are some recommendations we have made around qualifying defence contracts and transparency and the definitions involved in those.

There is a range of areas. As I say, the Secretary of State is reviewing those at the moment and I do not want to presuppose and read too much into what those are going to be at this stage. We have considered a whole range of issues based on a wide-ranging consultation, taking feedback both from the Department and industry over a long period of time.

Q93 **Sir Geoffrey Clifton-Brown:** Can I ask you two questions? It used to be the case that a lot of defence contracts were varied as they went through the course of their implementation, and the manufacturers made a lot of money on variations. Does that still happen and have you managed to have any influence to reduce it?

Neil Swift: I am not aware of what does or does not happen. My colleague may be able to help. What I can say is that the regime provides for much greater transparency in reporting, so there are statutory reports that are required to be provided by contractors on contract initiation, throughout the operation of the contract and then on completion of the contract.

So, there is going to be a wealth of information that will be available in the future. There is some available now. We have not seen any contracts come to completion yet, but we will do in the near future and they will set out the value of those contracts at the beginning, how they have been delivering throughout the duration of the contract and what the end result is.

That information will be incredibly powerful and useful to the Department and to contractors to inform future contract negotiations about how previous contracts have performed from start, through delivery, to conclusion.

Q94 **Sir Geoffrey Clifton-Brown:** What role do you in have in specifying or trying to preserve UK supply chains?

Neil Swift: There is a suite of information that is provided through the regulations. That includes information on supply chains. There are reports provided on qualifying defence contracts, of which there have been a number to date. The ceiling over which they are included is at £25 million, so it is quite a high ceiling to get to qualifying.

We do see down into the supply chain but that picture is building as more reports are coming in and more contracts are being let through the regime. I think this was mentioned previously. The number of contracts has grown and we are seeing an increase over time. It is growing at the rate of circa five a month, so that is to be welcomed. The more of those that come through, the more information we get and the greater transparency there will be to the supply chain.

Stephen Lovegrove: To make a link back to a previous question from Mr Mills. The requirement of the regulations and of the office to ensure a fair return for industry will over time, I hope, mean that we maintain an appropriate diversity within the supply chain at the smaller end in the UK and not possibly fall into some of the traps that we have had in the past, where much bigger companies in the UK supply chain are able to absorb some of the smaller companies, with the result that our ability to enter into competitive processes is inevitably reduced.

That will be an evolving picture but it is an interesting side line in a way on how the new regulations and the SSRO might actually allow us to increase the number of competitive situations, rather than actually rely on them. I am hopeful that it will be a mutually supportive set of initiatives and relationships there.

Q95 **Sir Geoffrey Clifton-Brown:** While you are "on your feet", Mr Lovegrove, would you like to comment on my question on variations, because you did refer to it earlier?

Stephen Lovegrove: Yes, you are absolutely right to identify variations as a particular weakness historically in UK defence procurement. By the time you have got to a variation you are effectively on a single source because you have got somebody on contract. On the whole it would be fair to say that—I look to Mr Elliott—we have had the wrong end of the stick when it has come to the variation discussion. There has been a lot of work in DE&S on trying to control that. The issue of where the single source contract regulations and the SSRO get involved in variations is another area where we will probably see quite a lot of evolution.

Nick Elliott: The reason for the variation is mainly because the customer has changed its mind about the requirement and has made a change to the requirement. Historically DE&S has tried to help the military customers in meeting those new requirements, but has not had a rigorous change control process that has identified what the impacts and costs of those changes might be. That is absolutely something we have been putting in place through our transformation programme over the last two years, so that if the customer wants that change, they understand what the implications of asking for it are in terms of the cost.

Q96 **Sir Geoffrey Clifton-Brown:** But, Mr Elliott, doesn't it really involve focusing the minds at the specification stage, long before it gets anywhere near a contract, of what is actually required?

Nick Elliott: That comes back to the conversation we were having earlier about taking the requirement discussion much earlier into the process to make sure that you are specifying something that is going to stand the test of time and will not need to be changed. Where you need to have agile procurements you specify that right from the outset, so you allow those change processes to take place throughout the lifespan of the programme because you get a better cost solution where you can fix things early. Where you can fix things early, you fix things early. That requires a different conversation much earlier in the process with the customer. That is exactly what we are trying to facilitate through the changes we discussed.

Q97 **Nigel Mills:** Just going back to your powers, Mr Swift. There is a handy table at figure 8 on page 27 that compares you to other regulators to a certain extent. Picking up on a couple of points, there is a reference there that you do not have the power to insist on getting copies of contracts and other documents that you think you need. Is that something that ought to be a priority to be changed to make sure you get the information?

Neil Swift: As I said, the information that is provided for the SSRO is set out in the regulations that the reports have come through. We have made recommendations to the Secretary of State, one of which is for greater information access in support of the delivery of our functions. As I say, I look forward to seeing the response from the Secretary of State on that matter.

Q98 **Nigel Mills:** Is that one you are inclined to accept, Mr Lovegrove?

Stephen Lovegrove: We are certainly looking at that particular proposal very carefully.

Q99 **Nigel Mills:** What about the point about the data submitted having to be signed off by somebody senior when they send it to you rather than presumably just sent over the internet somehow? Is that an important point?

Stephen Lovegrove: I think that is quite an important point. As I say, I do not want to pre-empt the Secretary of State’s views, but I think that is quite an important point. It is important that the regulations cannot be undermined, and the SSRO’s ability to enforce them when it comes to adjudications, by people disallowing the information off which they are working. So, yes, it is an important point.

Q100 **Nigel Mills:** So you might be inclined to look favourably on that as well. Okay. You set some targets or aspirations for the savings that could be achieved from these regulations, which were quite sizeable and probably quite important. How do you assess the performance of these regulations so far in achieving those targets?

Cat Little: So far we are very pleased because, as the NAO Report sets out, we have delivered £330 million of reductions to the initial contract price. Yes, there is a split in that between cost avoidance and genuine cashable savings, but the real test for me is that I have been able to take that money directly out of the budget for our top-level budget holders. That has been done in mutual agreement and we are able to track where that saving has been derived.

At the moment our forecast for the £1.7 billion is, I believe, on track. If I were to step back and look at the broader savings targets for the Department, we are undertaking some work to look at delivery confidence and to make sure that we have got a really transparent methodology for making sure we can assign savings and not just track them as we cash them out through the system. I would like, in a year's time, to be able to give you much more information about whether it is cost avoidance, a direct result of regulations or something that has enabled us to have a better competitive dialogue.

Q101 **Nigel Mills:** There is always a risk with these things that a cost you would have spotted under the old system and never paid in the first place is counted as a saving from these regulations. How do you know what impact the SSRO and the SSAT and things are really having, compared to what you used to do?

Cat Little: That is a really fair question. Part of the work we are undertaking at the moment is not only to have methodology for accounting and attributing our savings much more accurately, but to work with the SSRO to make sure what we understand by the impact on industry, as well as our customers. At the moment, it is fair to say that it is a fairly unsophisticated process. We have largely taken the saving and progressed, so there is more we need to do in that space.

Q102 **Gareth Snell:** Do you have any rough idea of what the split is between what is a cost avoidance that you have managed to find, and what is a genuine cashable saving?

Cat Little: As I said, the fact that we have been able to reduce budgets, while we are unable to directly attribute it in every single case to the regulations—

Q103 **Gareth Snell:** Roughly—?

Cat Little: I would say the vast majority is cashable.

Q104 **Nigel Mills:** The NAO Report, in paragraph 4.16, says that only £3 million has actually been reported as being achieved. It is quite a long way from there to £1.7 billion. Is that a timing thing that eventually unravels?

Cat Little: Over the projection of the next five years, the idea that we can reduce our contract prices along the same trajectory that we have historically been able to does project a fairly optimistic and, I think, positive assumption about the £1.7 billion. What I am saying is that here today, all I know is that I have been able to take the money off people, but I cannot attribute it directly to the regulations. We need to do much more work to give us, and you, the confidence that therefore the £1.7 billion is wholly achievable.

Q105 **Nigel Mills:** But how do we know how much of these savings are because the SSRO exists and is doing a good job, and how much is the fact that the Department itself is now doing a better job of this? Do you try to work out where the balance lies between those, and perhaps how much is it just suppliers having improved their behaviour because they will get caught now?

Cat Little: Some of it is qualitative and it is a judgment, but some of it we can quantify. I suppose the methodology we are currently working on and the process to improve our reporting is part of that. It is fair to say that some of the savings we are achieving are because we have created the conditions of transparency, and we now have better costing data, which has enabled our negotiators to go in and have a much more effective negotiation process.

Q106 **Nigel Mills:** But we still need the SSRO? We can't make the Department sufficiently competent that you could do it without it?

Cat Little: No. It is always a blend. You need the independent arbitration, assessment and advice of the SSRO, but ultimately the data we are collecting, through the costing and transparency work that the regulations have enabled, means that negotiators in DE&S have much more information to be able to justify our position.

Q107 **Nigel Mills:** That is a neat segue. Mr Elliott, this implies that your team, which does all this negotiating, can't get it right. Are you confident that your people negotiating these contracts have all the skills and capability they need to get the right price?

Nick Elliott: I think we are increasingly getting it right. You only have to look at the Type 26 contract, where the fact that for the first time ever we moved away from a cost-plus into a target cost incentivised framework for a first in class ship. We are driving the supply chain to move away from the cost-plus types of contract that we talked about before. The cost visibility and transparency that we get through the single source regulations give us much more opportunity to do that, because we can have informed discussions with the suppliers about what the true costs of their activity are. You can focus on the overhead costs and you can identify trends over time. The regime itself gives us much more information to allow us to undertake that negotiation in a much more competitive manner and get the best result for defence out of it.

At the same time, of course, when Tony Douglas was here at the last meeting he talked about the transformation programme and the increase in capability that we have put into DE&S. We have increased our commercial resources by 234 net in financial year 2016-17. As well as that, we have put into place a commercial delivery partner solution, whereby we have a joint venture between Turner and Townsend and Mace, supported by Ernst and Young, and Efficio is providing us with specialist capability support. If you bring all of that together with the capability enhancements we are undertaking, I think we are getting really effective at negotiating good-value contracts for defence, and that will only increase and improve over time.

Q108 **Nigel Mills:** Do you think you have sufficient skills and capability and enough individuals doing this work now, or do you need more?

Nick Elliott: I think you can always get better. There is a continuing journey of progress in doing that.

Q109 **Chair:** Can you say precisely how you are trying to get better?

Nick Elliott: Absolutely. What we have put in place is a regime whereby—

Chair: Can you tell me precisely and give me some examples of how you are trying to get better at this? Are you recruiting different people? Are you training up staff? Are you avoiding the headcount cuts that Mr Lovegrove has had to commit to?

Nick Elliott: What we have focused on in DE&S is reducing our opex costs but bringing in permanent staff as opposed to the highly expensive manpower substitutes that we had before. As I said, we increased our commercial core capability by 234 staff net in 2016-17, but we reduced by over 50% our manpower substitute cost at the same time. We need to then train those new people. A lot of those people are new people we have brought from outside of defence and from other industries. We need to give them the skills and capabilities to operate within the defence industry, and that is part of our ongoing commercial capability programme that we run across defence. To supplement that, we put into place—it went live in April—a commercial delivery partner solution, whereby we brought a joint venture partnership in to provide us with some additional skills. Where we do not have the core capability, we can draw into that organisation for those skills. We are doing an awful lot on increasing our capability resources and the total output capability of the organisation.

Q110 **Chair:** Is it costing you more to do that?

Nick Elliott: As I say, we are trying to offset in opex terms by reducing the very expensive PSS and manpower substitutes.

Chair: And that is working? Is it costing you more?

Nick Elliott: We have invested slightly more into the commercial organisation, but we have done that through savings we found through the opex reductions.

Q111 **Chair:** In this Committee, we think that spending money on people who understand how to do commercial contracts is probably a good investment, so costing more is not necessarily a bad thing in this instance.

Nick Elliott: You have to get the right balance of commercial people and delivery people. We have potentially had in the past not quite the right balance, so we have increased the commercial capability through reduction in expensive substitutes and by rebalancing the organisation, to take manpower from elsewhere into the commercial function.

Stephen Lovegrove: DE&S is exempt from the manpower targets that obtain in the rest of the Department because of the recognition that investment in its people can have multiple beneficial effects in terms of financial benefit. There is some thinking about that that we need to take possibly into the rest of defence. As has been said, DE&S is looked at on its operating expenditure, and effectively that is what we approve from the centre. I am content that the operating expenditure is on a downward trend as a result of swapping out expensive contractors for more long-term, properly qualified, high-quality internal employees.

Q112 **Chair:** I want to finish with a question about how healthy you think the UK defence industry is. We will start with Mr Lovegrove, but Mr Swift, you may want to add something. Especially in the light of Brexit, which we mentioned earlier, there are interesting challenges ahead. You mentioned smaller companies being swallowed up by larger companies. Do you think we have the onshore capability to deliver the needs of the Ministry of Defence and our armed forces in the future?

Stephen Lovegrove: Strictly, the answer to that question must be: no, we do not have the ability indigenously to supply all of the equipment that our armed forces need. We do have it in shipbuilding, and we do have components of it in aerospace. We have a bit less of it possibly in the land environment. We are always going to, as we always have, have to buy certain bits of our kit from abroad or to encourage our defence industry into alliances with countries from abroad that can either defray the capital costs or bring particular parts of intellectual property or capability to the table that we would not be able to. But I do not think that is a problem; it is a situation that we have lived with for decades, if not hundreds of years.

We must be vigilant that, in the process of leaving the European Union, our very important companies do not find themselves disadvantaged on the world stage, either in selling their own products or in entering international alliances. That is something that we are intensely aware of and are thinking about very hard with colleagues in the Cabinet Office, No. 10, the Treasury, the Department for International Trade and the Department for Business, Energy and Industrial Strategy. It is very much at the top of our list at the moment. It is clearly ongoing work, because Brexit has not completed, but are we aware of the issue? Yes.

Q113 **Chair:** And are you saying it is a very big risk to the British defence industry?

Stephen Lovegrove: I do not know how big a risk it is, but I do not want to be complacent about relationships that may emerge that disadvantage UK companies in an international environment. Part of what the Ministry of Defence is there for—certainly not all of it, because we need to get value for money in battle-winning technologies—is to encourage and help British industry to be successful in this area.

Q114 **Chair:** We have talked in the past about the foreign exchange rate, particularly with dollars. Do you envisage a challenge to your budget in the light of what you have just said about British industry struggling to compete because it is going to have the challenges of being outside Europe? Do you think there is going to be an increase in costs, apart from the dollar issue?

Stephen Lovegrove: It is very difficult to know how that will play out. It is perfectly possible that a weakening—

Q115 **Chair:** Are you making plans for it? You say it is possible. It could play out that way. Are you planning that in? Ms Little may want to comment, too.

Stephen Lovegrove: The impact is broadly negative for purchasers of kit such as ourselves. Weakening sterling could be very good news for exporters of British military kit. There are an awful lot of markets out there that want to look at British military equipment, much of which is absolutely world leading. If it became relatively cheaper for the Indians, the South Africans or the Americans to buy British kit, that would be a good thing. It is quite difficult to know—this will be a balance—but I would like to assure the Committee that this is not something that we are remotely oblivious to or not thinking about hard. We are putting resources in place, in a cross-governmental way, to try to deal with the actual issues when they become a bit clearer.

Q116 **Chair:** From the point of view of your financial planning, Ms Little, do you have contingencies, or a risk range, in place for this particular issue?

Cat Little: Yes. The majority of my time is spent trying to anticipate what financial risks might be around the corner on a 10-year basis and, for some of our big programmes, over a much longer period. We hold contingencies for unexpected cost increases within the equipment plan, but we also spend quite a bit of time making sure that we hedge against the risks in foreign exchange rates. We spend about £3 billion every year on both US dollar and euro-based contracts. We hedge about 80% three years in advance. Of course, there will be some impact post-Brexit on our ability to predict and manage those forward contracts. So absolutely—it is my job.

Q117 **Chair:** You have not yet quantified the potential risk. Do you have a range?

Cat Little: Not specifically for Brexit, but there are ranges in each of our specific programmes for cost estimation that could be wrong—for a number of factors. Of course, some of that will be in relation to what we think might happen with industry as a whole.

Chair: There is a lot more to explore there, and I am sure that our sister Committee—our sister Committees, if you take the BEIS Committee as well—will be looking into this. Thank you very much indeed for your time.