

Written Evidence submitted by Lockheed Martin UK

Defence industrial policy: procurement and prosperity

Executive Summary

- The current Defence Industrial Policy is very broad. A more focused defence industrial strategy, which defines those industrial capabilities that need to be developed and sustained in the UK, would be beneficial.
- In some capability areas, the Ministry of Defence (MoD) and UK companies have not invested sufficiently over many years. If an advanced capability already exists elsewhere, it may be more cost-effective, faster and lower risk for the MoD to seek to acquire it, provided it has assured supply chains, can meet sovereignty requirements, and require that elements are indigenised over time.
- ‘Open competition’ is arguably no longer an effective means of procurement. The MoD does not have enough work to compete. The approach leads to a focus on lowest cost. It creates transactional relationships rather than collaborative partners, which are aimed at overall mission success and the long-term sustainment of critical capabilities. Long-term portfolio arrangements would be a better model.
- There is no evidence that the MoD assesses “prosperity” and “value for money” in its procurement decisions.
- There is significant variation in experience, business acumen, tools and techniques across the commercial and procurement teams in defence.
- Companies will not invest and build supply chains based only upon export potential. Domestic requirements are vital, and the most effective means of increasing volume and creating guaranteed economies of scale is through international collaborative programmes (such as the F-35).
- Traditional offset policies can increase cost and risks for industry. They also limit the spectrum of potential industrial projects that may be undertaken. If the MoD adopts a more formal offset policy, it should learn from best practice in other countries (such as the Australian Industry Capability (AIC) programme and Centre for Defence Industry Capability (CDIC)).
- Multinational companies are a critical enabler of international capability collaboration. The MoD should therefore be more transparent with industry about its international strategies.

Introduction

1. Lockheed Martin is the fifth largest supplier by revenue to the MoD with over 80 years of heritage in the UK. It employs approximately 2,000 people across 23 locations and is the majority shareholder of the Atomic Weapons Establishment (AWE). On average, Lockheed Martin spends more than £1.5 billion in the UK each year, supporting over 1,000 companies (three quarters of which are small and medium sized enterprises) and sustaining 10,500 jobs.

Is the current Defence Industrial Policy effective? Is a new Defence Industrial Strategy required?

2. The current Defence Industrial Policy is very broad. Lockheed Martin UK's (LMUK) views on each element are set out below:-
3. Economic value, international interests and industrial resilience as factors in procurement. LMUK has seen no evidence that the MoD assesses these factors as part of its procurement process. In practice, the MoD appears to favour "lowest cost, technically acceptable" proposals. The implications are two-fold. First, inability to deliver or cost growth, as some contractors bid low and seek to increase their margins within a programme over time. This can make programmes unsustainable. Secondly, the approach removes the MoD's levers for shaping company investment decisions, which might enable industry to generate future capability options for both national and international programmes.
4. Increasing competition and innovation. This is the most diverse section of the Policy. From LMUK's perspective:-
 - a. The MoD has been refreshing its policy towards Intellectual Property ownership and, in so doing, has increased its ability to take away rights from industry in the interests of facilitating competition. Original Equipment Manufacturers (OEMs) are disadvantaged in competitions where they seek to recover their investments in non-recurring costs, while third parties who are given the IP to compete have no such costs – a disincentive for any OEM to invest in capabilities;
 - b. 'Open standards' are often viewed as a way of increasing competition. As a range of different standards and architectures already exist, the focus should be on systems engineering alignment and integration of different architectures;
 - c. The MoD has generally struggled to develop new models for working with industry. The MoD's recent Acquisition Reform study emphasises the need to have more collaborative engagement with industry, but it is not clear that there is a robust strategy for how its procurement approach will be transformed in line with this objective. The Defence Science and Technology Laboratory (Dstl) recently signed an innovative, long-term 'collaborative arrangement' on Strategic Systems with LMUK, which aims to develop and sustain sovereign capabilities. The arrangement encompasses contracted R&D and, as importantly, the joint development of knowledge, skills and infrastructure. LMUK is also tasked to develop and coordinate a specialist supply chain. The arrangement is proving effective and could be applied to other areas;
 - d. The MoD is pursuing a range of 'innovation' initiatives. The large number of initiatives places a significant resource burden on suppliers, which must engage with multiple entities that lack coherence, funding transparency, and define

‘innovation’ in different ways. The MoD could usefully undertake a review of how effective its approach to innovation has been since 2015;

- e. Whilst the MoD has ‘support to defence exports’ as a core task, it is not yet structured in an optimal way for this. Except for a small number of strategic campaigns, there are no formal budget lines to allow personnel to support exports and there is a lack of accountability and ownership of this area;
 - f. On inward investment, companies invest in those markets which can generate the highest return. The UK’s investment appeal in the defence sector can be limited by a lack of clarity of programmes and budgets, a high level of incumbency in specific segments (such as space and complex weapons), poor linkage between R&D and the Equipment Plan, burdensome and fragmented procurement mechanisms, and a declining return on investment for companies;
 - g. The government’s guidance on contracting emphasises that contracts should not include unreasonable terms or contain unlimited liabilities.¹ However, the MoD has not yet sought to rationalise its contractual terms and conditions or seek limits of liability. The Commercial Enterprise & Acquisition sub-group of the Defence Suppliers Forum has found that this acts as a barrier to SMEs and can see companies remove themselves from procurement competitions; and
 - h. The MoD has improved its approach to supplier management, by appointing impartial relationship leads for key suppliers, putting in place regular strategic-level engagements, and adopting a formal and evidence-based approach to assessing performance and relationship maturity.
5. Doing business with defence. The Defence Industrial Policy refers to efforts to improve pre-competitive engagement with industry and increase the pace of contracting. There remains a lack of consistency in both areas across defence. Where early market engagement has been undertaken to inform procurement strategies, it is not clear that the process has been effective in establishing options and trade-offs against which industry can propose alternative solutions.
6. Overall, LMUK believes a more focused defence industrial strategy would be beneficial. The strategy should define those industrial capabilities which need to be developed and sustained for reasons of ‘Operational Advantage’ and ‘Freedom of Action’.² It should identify how the MoD’s procurement process and approach to international capability collaboration will support these ambitions.

What are the national skills and competencies needed for a successful UK defence industrial sector? How can the UK ensure, and assure, that these are maintained in the right place at the right time for the right cost?

- 7. There is a lack of clarity about those capabilities which the MoD believes should be retained or developed in the UK. Clarity about which capabilities are regarded as “strategic” would provide a basis for industry to decide how best to invest and structure in the UK. The MoD should work with industry to define those capabilities the UK needs for

¹ See Procurement Policy Note (PPN) 10/16 ‘*Onerous Practices in Procurement and Contracting*’ and the Cabinet Office’s ‘*The Outsourcing Playbook – Central Government Guidance on Outsourcing Decisions and Contracting*’.

² See definitions in section 3.1 of *National Security through Technology: Technology, Equipment and Support for UK Defence and Security* (Ministry of Defence, Cm 8278, February 2012).

future national requirements and how they should best be procured and delivered. The ongoing Radar Capability Review is an example of this approach.

8. As part of defining those capabilities which are regarded as “strategic”, the MoD should develop a proper and consistent policy on ‘Operational Advantage’ and ‘Freedom of Action’. Currently, these concepts are nebulous, and how they are applied varies between each defence programme.
9. In some capability areas, the MoD and companies have not invested sufficiently over many years. The MoD may therefore need to leverage investments made by allies; if a capability already exists elsewhere, it may be more cost-effective, faster and lower risk for the MoD to seek to acquire it, provided it has assured supply chains and, importantly, can require that elements are indigenised over time through knowledge transfer, technology transfer, educational programmes, and investment in next generation R&D.
10. In addition to skills and competencies within the defence industry, the MoD should review what organic skills and knowledge it requires – of both capabilities and market dynamics – in order to act as an ‘intelligent customer’. Without relevant core competences and internal skills, the MoD could struggle to deliver effective industrial and sector strategies.
11. Finally, the MoD should move towards multi-year budgeting. The current annualised approach creates uncertainty for programmes and investments. It also hinders the realisation of ‘spend to save’ initiatives.

Does the market for Defence systems, products and services have any specific characteristics, which differentiates it from other markets? Does international collaboration limit the potential for defence exports?

12. The defence market:-
 - a. Has a limited number of potential customers;
 - b. Is characterised by long-term programmes, so has different risk profiles to consumer-based industries;
 - c. Has government-owned or backed competitors (particularly from overseas);
 - d. Is subject to political and diplomatic factors outwith cost and capability; and
 - e. Derives most revenue from governments, so has low profit margins relative to consumer technology.
13. As the government is the only buyer in the defence sector, its approach to procurement has a significant effect on the levels of innovation, value for money, long-term cost growth and productivity. In some cases, contracts are sole sourced due to the unique nature of the work. In other cases, the MoD can put in place commercial constructs which establish monopoly positions and risk limiting innovation, cost effectiveness and viability of supply (for example, in relation to weapons). See paragraphs 15 and 16.
14. General defence exports are not guaranteed. Companies will not invest and build resilient supply chains based only upon export potential; domestic requirements are vital. The more effective means of increasing volume and creating guaranteed economies of scale is through international collaborative programmes. The F-35 programme is a good

example. 15 per cent, by value, of each F-35 aircraft is supplied by British companies. Whilst the UK's programme of record is for 138 aircraft, British companies are providing content for more than 3,000 aircraft in the overall programme.

Is tension between competition and strategic choice inevitable?

15. Open competition is often regarded as being the most effective means of securing world-class capabilities and value for money. However:-
 - a. The MoD arguably does not have enough work to sustain a large-scale defence industry through competition at the level of prime/systems integrator;
 - b. Open competition has in practice led the government and industry to focus on lowest cost. Suppliers are incentivised to bid as low as possible in order to maximise their chances of winning. This does not equate to value for money, as the supplier may not be able to deliver the scale or quality of work expected for their price. This ultimately makes contracts unsustainable. The supplier and MoD may also adopt a very strict and narrow interpretation of the contract's scope, despite threats and requirements changing; and
 - c. Open competition results in a transactional arrangement between the government and industry, with a focus on discrete deliverables rather than collaborative partnering aimed at overall mission success and the long-term sustainment of critical capabilities (including through investment in skills and technology).
16. Given these factors, the MoD should consider establishing long-term 'portfolio arrangements' with various companies, based on sector strategies. This would encourage collaborative long-term partnering to deliver and sustain critical capabilities, including by giving industry certainty to invest.

Should the UK adopt a formal Offset/Made in the UK policy? What impact would this have on the national and international defence markets?

17. The MoD's voluntary Defence and Security Industrial Engagement Policy (DSIEP) is being reviewed, as the MoD seeks broader engagements with its key suppliers.
18. In this respect, Lockheed Martin and the UK Government signed a 'Prosperity Framework' in July 2018. The Framework covers three areas: the creation and exploitation of innovative ideas and technologies, strengthening supply chains, and supporting the development of the advanced manufacturing and technology sectors. LMUK believes this arrangement, which encourages strategic collaboration between government and industry in different areas, is preferable to a formal offset policy.
19. Should the MoD choose to adopt a formal offset policy post-Brexit, it should learn from best practice in other countries. Lockheed Martin would highlight the Australia's AIC programme and CDIC as examples of best practice and innovation in industrial participation. Australia's approach does not rely on traditional offset elements such as credits, multipliers, and penalties but instead focuses on enhancing Australian defence companies' capabilities to compete on a global scale. Under the AIC programme, in order to participate in Australian defence programmes, foreign OEM's must submit plans on how they will work with Australian industry in strengthening indigenous defence industrial capabilities. Projects are proposed by foreign bidders and selected by the Australian Department of Defence on a best value basis, which is decided based on Australia's defence industrial strategies, associated costs and market potentials.

20. Importantly, any industrial participation programme works best when incentives exist for all stakeholders. The ability of a foreign OEM to partner with and invest in any companies, based on fundamental business cases rather than artificial rules and restrictive parameters, generates a higher probability of sustainable economic and industrial success. Traditional offset guidelines can increase cost and risks, which limit the spectrum of potential industrial projects and innovative solutions. Adopting a method which is conducive to industrial capability growth, which may in-turn strengthen company competitiveness, can better serve the UK's long-term defence industrial strategies.

What is considered in assessments of “prosperity” and “value for money” in defence procurement? What consideration is given to the local economy, skills retention and balancing the positive financial impact across the regions and nations of the UK?

21. LMUK has seen no evidence that the MoD considers “prosperity” and “value for money” in its procurement process. If the MoD were to do so, changes in both culture and the formal scrutiny and approvals process would be required. The Treasury's ‘Green Book’ may also need to be amended. The MoD would need to be open, clear and consistent about what factors it will assess and weightings applied, so companies can make an early assessment of the viability of participating in a procurement process.

Does the MoD understand the risks and opportunities in the Defence supply chain, and the procurement strategies of other buyers in the market?

22. The MoD could do more to develop its skills and knowledge in the following areas:-

- a. The actual costs of capability development and conducting business with the MoD;
- b. Industrial resilience within the defence sector;
- c. Different business models and contracting approaches; and
- d. Value-based evaluation, covering through-life cost, transparency, the sustainability and viability of the bidder and collaborative behaviours, rather than just upfront cost.

What has been the impact of reforms to defence procurement and acquisition? How should Head Office and DE&S acquisition reform be aligned to defence industrial policy and strategy?

23. The “Head Office” is taking a much greater role in overseeing requirements generation and procurement processes, to ensure coherence across the single services and hold Defence Equipment & Support (DE&S) to account for improved performance.³ This is welcome.

24. LMUK still observes significant variation in experience, business acumen, tools and techniques across commercial and procurement teams in defence. This inconsistency is a cost driver, as companies usually have a common commercial function that supports multiple contracts. Moreover, the MoD sometimes lacks subject matter expertise in major capability areas, which can hinder effective requirements setting and development of procurement approaches. The MoD's recent study into acquisition reform concluded that a “one-size fits all” approach is no longer relevant and more flexible approaches

³ In addition, it should be noted that significant defence programmes are being procured through newly formed “agencies”, including for the nuclear deterrent, new submarines, information services and communications satellites. The single services have also set up their own innovation units to try to achieve more rapid and direct procurement of capabilities.

should be taken. This change, which requires bespoke procurement lifecycles, will demand more of the skills of those charged with undertaking the procurement.

25. One of the most contentious aspects of procurement remains the handling of single source contracts. The Single Source Contract Regulations (SSCR) introduced a lower baseline profit rate based on industry comparators, largely unrelated to defence. Bloomberg publishes data that confirms the average weighted cost of capital is around eight to 10 per cent. If a company is not able to cover the cost of capital and meet return on sales expectations, it will not be able to invest in or sustain critical skills, competencies and R&D. This should raise concerns about the ability to sustain parts of the UK's defence industry.
26. The MoD can use its approach to procurement to support industrial policy and strategy by creating opportunities for market entry and expansion. It can also use procurement approaches to shape company investment decisions. See paragraph 16.

Given that major capability acquisition programmes are international by design – the Combat Air Strategy and Type 26 frigate for example – how does a modern national defence research and industrial policy successfully manage cross-border long term partnerships and align with the industrial approach of allies and partners? What lessons can be learnt from other defence exporting countries?

27. Multinational companies are a critical enabler of international capability collaboration. The MoD should therefore be more transparent with industry about its international R&D priorities and capability strategies. It should also identify where it believes the UK has unique capabilities, rather than trying to do everything itself.

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