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MR. COLES

MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1

Telephone 01-~~990-7000~~ 218 2111/3

MO 26/2

27th January 1984

Dear John,

In your letter of 6th January you said that the Prime Minister would like to see a paper on competitiveness in the UK defence industry. The steps we are taking in our own interests to combat the real cost growth in defence equipment were touched on in the paper sent with my letter to you of 22nd September last. These are also relevant to the question of competition. Greater emphasis on an early dialogue with industry about new requirements, eradication of gold plating in these requirements, increased emphasis on saleability of equipment, pressure on cost-consciousness and competitiveness in industry through competition and taut contractual terms are all designed to secure equipment from UK industry which not only meets the needs of the Armed Forces but is also competitive in price and performance on the international market. An Open Government Document - Value for Money in Defence Procurement - published in the Autumn, of which I attach a copy, may be of interest to the Prime Minister. All staff in MOD concerned with procurement are working to internal instructions following the line of the OGD.

On the particular question of competition Mr Heseltine, as he told the Prime Minister, regards it as a major objective for competition to be applied whenever it is practicable and sensible to do so. I attach a copy of instructions he has issued to the Department. The Prime Minister may also wish to see the attached note which sets out how these instructions are being carried forward. A paper on similar lines has been circulated to industry for discussion at the meeting on 23rd February of the National Defence Industries Council. The Prime Minister may have noted that a major step forward in the application of the new policy has already been secured in relation to the new infantry fighting vehicle for the Army (the MCV80 project). I attach a copy of the written Parliamentary answer given on Monday 23rd January on this project.

Yours ever  
Nick Evans

(N H R EVANS)  
Private Secretary

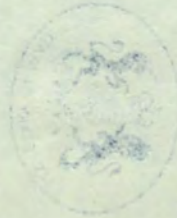
A J Coles Esq

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Служба по делам печати

МУНИЦИПАЛЬНОЕ УПРАВЛЕНИЕ ГОРОДА САНКТ-ПЕТЕРБУРГА  
УПРАВЛЕНИЕ ПО ДЕЛАМ ПЕЧАТИ





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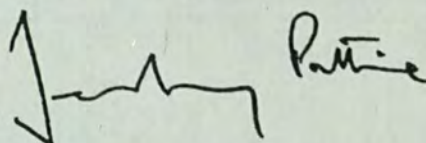
**VALUE  
FOR MONEY  
IN  
DEFENCE  
EQUIPMENT  
PROCUREMENT**

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VALUE FOR MONEY IN DEFENCE EQUIPMENT PROCUREMENT

Over the last two years in particular, much attention has been devoted in the Ministry of Defence to ways of securing better value for money, in both defence and national terms, from the significant financial and skilled manpower resources engaged in meeting UK Service equipment requirements. In that period the Ministerial structure of the Ministry of Defence has changed to allow two Defence Ministers to concentrate primarily on defence procurement issues; and in 1981/82, the Defence Committee of the House of Commons conducted an enquiry with particular reference to defence procurement and sales, and issued a report (1) in July 1982 which gave general encouragement to the policies being adopted.

Throughout the period the Ministry has been seeking through discussion within Government and with Trade Associations and individual companies to develop an approach to procurement which recognises the wider potential benefits of its equipment expenditure, while at the same time trying to meet the cost pressures on its budget. This document makes public the way in which that approach is being implemented, with some commentary on the background and objectives in mind. Its content relates to the majority of the Ministry's purchasing, but not to those goods and services whose procurement is governed by our obligations as members of the European Communities and of GATT which in any event seldom give rise to the cost, development and investment issues under discussion.



GEOFFREY PATTIE  
MINISTER OF STATE FOR DEFENCE  
PROCUREMENT

Ministry of Defence October 1983

Defence Open Government Document 83/01

Further copies of this document can be obtained from: Industrial Policy Division  
MINISTRY OF DEFENCE  
Main Building, Room 2388  
Whitehall, London SW1A 2HB

(1) HC(1981/2)22-1

## I - THE BACKGROUND

1. The Ministry of Defence, with a planned equipment budget of over £7.2 billion in 1983/4, is the largest single customer of British Industry. In certain sectors, the Ministry is the dominant customer; defence procurement accounts for about half the output of the aerospace industry and one third of the output of the electronics and shipbuilding industries. Further, in many sectors (eg electronics, aviation, control systems and marine technology) the Ministry sustains, through the MOD Research and Development Establishments and extra-mural R & D contracts, much of the R & D base without which those industrial sectors could not function effectively. In 1981/82 defence equipment expenditure supported some 242,000 jobs directly in British Industry and another 193,000 indirectly; sales of defence equipment abroad another 145,000 jobs. There are more than 60 contractors with each of whom the Ministry does more than £5M-worth of business each year; at any one time more than 10,000 British companies are working on defence contracts. The defence industrial base is a major national asset, whose health and future is of concern to all.
2. At the same time, defence equipment procurement accounts for an ever-increasing proportion of the Defence Budget. Five to ten years ago, the proportion was around 35%; it now stands at over 45% - among the highest in NATO. This switch in the allocation of resources represents a considerable success in the Ministry's conscious drive to keep down personnel costs, reduce its own overheads, and equip the Armed Forces as fully and as effectively as possible.
3. There is, however, a limit to how much further this trend can be taken; and increasing expenditure on equipment does not necessarily result in the deployment of greater numbers of units of equipment with the Armed Forces. New equipment usually shows remarkable qualitative improvements over the items it replaces, but there is also a trade-off between quality and quantity. The importance of the latter should not be underestimated.

## II - REVERSING THE TREND

4. It is accordingly of paramount importance - to the Services, the defence industries and all who work in them - that everything possible is done to halt (and where possible to reverse) the rise in defence equipment costs and ensure that the Defence Budget is spent in the most cost-effective way.
  
5. The various elements of our approach to this issue were set out in Chapter 4 of last year's Statement on the Defence Estimates (Cmnd 8529). Major themes continue to be:
  - a. promotion of cost-consciousness and competitiveness in Industry;
  - b. capitalisation, through exports, of the national resources devoted to defence R & D;
  - c. eradication of over-elaboration in our own equipment requirements;
  - d. sharing of risks, and costs, through international collaboration and/or joint ventures with Industry;
  - e. streamlining of administrative procedures and reductions in staff numbers within the Procurement Executive.
  
6. Measures employed in furtherance of the above include those recommended in the Public Purchasing Guidelines issued by HM Treasury in early 1981 (Annex A) and subsequently endorsed in 1982 by the Public Accounts Committee, which stressed the need to ensure that the policy is applied as consistently and fairly as possible from the point of view of both the taxpayer and competing suppliers. The MOD is for example developing as widely as possible its dialogue with industry on equipment requirements. Discussions with Industry are now taking place before the formulation of a staff target begins and the Operational Requirements staff are being urged to make the staff targets themselves shorter and simpler - and to state the problems, objectives and constraints but not the solution. Additional steps include the establishment of a programme of detailed briefings for Industry on specific aspects of the threat to the UK and NATO, greater emphasis on competitive procurement and the use where possible of incentive pricing.

7. Competition is important not just because it contributes to keenness in pricing but also because it stimulates innovation and enterprise, and the encouragement of new ideas for the solution of defence problems. It will therefore be the determination of MOD to secure competitive proposals whenever this is practicable and reasonable.

8. On incentive pricing, the Ministry's objective is to make the maximum practical use of such arrangements wherever it is realistic and cost effective to do so. Some 80% by value of MOD contracts are subject to fixed price or other incentive arrangements which encourage Industry to carry out the work as efficiently and economically as possible. The cost-plus-percentage-fee method of contracting remains very much a method of last resort, to be used only where the work cannot be defined with sufficient precision to enable a fair and reasonable price to be agreed by the Ministry and Industry.

9. Consistent too with the objectives of the Government's purchasing policy is our emphasis on the marketability of defence products. Increased stress is being placed on adjusting operational requirements and technical specifications within acceptable limits to make the prospective equipment more saleable abroad, thus assisting firms to be less dependent on MOD for their markets and profits, and benefiting MOD directly through the reduced unit costs which can result from larger production runs. MOD will also consider, wherever possible, adopting or building on commercially developed or other existing products. Industry, likewise, must take account not only of the likely size of the Services' demands, but also of the potential export market. If there is a good chance of increasing sales prospects by modification of an MOD specification, they should not hesitate - the early consultations referred to above should facilitate this - to suggest such a modification. A full market forecast<sup>t</sup> will usually be an essential feature of the preparatory work to be carried out before defence funds are committed to a major project. The Defence Sales Organisation, the recent review of which has placed more emphasis on marketing in support of Industry, will have an important role to play in this. The MOD is also examining in conjunction with the Department of Trade and Industry ways in which civil spin-off from defence technology might be enhanced.

10. Industry, too, has its own role to play in taking positive steps to reduce costs, to promote greater efficiency in the use of our industrial resources and generally to improve the marketability of its products. A particular responsibility devolves on the Department's prime contractors in their dealings with sub-contractors. Having deliberately decided, in the interests of greater managerial efficiency, to place greater responsibility with the prime contractors for managing major defence projects, it is no longer possible, even were it desirable, for the Department to intervene in all cases in the detailed allocation of individual sub-contracts. But the greater power of management afforded to prime contractors carries with it its own responsibilities. Many of the objectives of the Government's Public Purchasing Policy are also relevant to the relationships between prime contractors and sub-contractors, and where such is the case the Department expects its prime contractors to have appropriate regard to them and to maintain the same close dialogue with these sub-contractors as they have a right to expect the Ministry to maintain with them. Sub-contractors for their part will have to be responsive to market requirements and the need to contain costs and cannot expect to be shielded from competitive forces. On both sides sensitive judgements will be called for if the purchasing power represented by the Defence Equipment Programme is to be used to its best advantage in enhancing industrial performance and benefiting the national economy generally.

11. As to reductions in staff numbers and streamlining of operational procedures, a great deal has already been achieved. Between 1974/5 and 1982/83, while the defence equipment budget was rising by some 40% in real terms, staff numbers in the Procurement Executive fell by over 30%. In 1982 the Ministry improved the effectiveness of its procedures for the scrutiny of requirements and projects. Organisational changes were made in the central machinery and staffs both military and civilian to facilitate a better overview of the equipment programme, and the delegated financial powers of the Service Departments were enlarged in order to streamline the implementation of procurement decisions within constraints laid down centrally.



### III - PROCUREMENT SOURCING: CRITERIA

12. The Ministry will inevitably however continue in future to face difficult procurement and investment decisions, and there will be a need to adopt a co-ordinated and consistent approach to ensure the most cost-effective use of the defence equipment budget. We will accordingly be considering the procurement source for new requirements within the following framework:

- a. importance of the project in absolute terms to the Services, and the military need for and benefit from the associated indigenous industrial capabilities, whether at the system or component level;
- b. affordability, having regard to the effect on cost of the likely size of the MOD demand, the potential export market, and the prospects of sharing the R&D costs through acceptable collaboration and/or joint ventures with Industry, founded on confidence of achieving a viable market share. The feasibility of product improvement and the availability of suitable commercially developed products are also relevant;
- c. the extent to which non-UK sources are likely to be available to meet Service needs at acceptable cost (initially and whole life). This should be considered in terms both of whole and sub-systems and components and address questions of security, eg in relation to software, and ease of modifications in emergency. Such considerations should also cover possible political restrictions on use for sales and/or national interest operations;
- d. the relative position of UK industry compared to overseas sources and whether, and how, industrial competitiveness will be improved, including the extent to which opportunity can be taken to further the aim of securing the alignment of industrial capacity with likely levels of requirement.

13. The considerations above will not always point in the same direction; and some aspects will be of greater relevance than others at different times and to different projects. But it is the Ministry's view that only by bearing all these considerations in mind can:

- a. The Services obtain (at the right time, in the right quantities and at an economic cost) the equipment they need to discharge the tasks they have been allotted;

b. the various sections and levels of the UK defence industry maintain and develop capabilities of value to the Ministry and increase their general competitiveness, recognising that these capabilities will inevitably change in response to the nature of defence requirements and as decisions are taken with an eye to value for money;

c. the Government, having regard to its national and international obligations, be seen fairly and responsibly to allocate large sums of public money in a field engaging much of the country's most highly qualified resources, both of manpower and material;

d. the need to secure long term value for money, on a national basis, be respected. This is the final test.

## PUBLIC PROCUREMENT POLICY; GUIDELINES

1. It is the Government's policy that, as a matter of enlightened self interest, public sector purchasers should use the influence their purchases give them to help develop the design, technology and competitiveness of their suppliers.
2. The procurement practices needed to ensure that the Government's policy has the maximum effect are as follows:
  - a. the adoption of a clarified 'value for money' criterion;
  - b. the use of best purchasing practices in relations with suppliers;
  - c. clear instructions to public sector purchasers to ensure that the policy is carried out.

Value for money

3. The individual purchaser's objective is to purchase what is needed at the right time and in such a way as to ensure the best value for money. Value for money has sometimes been judged within the context of each individual purchase without taking into account the broader cumulative effect which public sector purchasing can have on the efficiency of suppliers.
4. Value for money should not be judged solely on the basis of the lowest initial cost. Design, reliability and maintainability, for example, will affect the total cost over the life of a product. Factors such as these may justify a higher initial cost. Actions to promote the industrial viability and hence the trading competitiveness of suppliers can justify an additional initial cost or greater technological risk if over the longer term the purchaser expects to gain improved value for money.
5. The annex to these guidelines provides advice on the factors which may be relevant to individual decisions, and on how they should be assessed.

## Enlightened Procurement Procedures

6. There are a number of practices which public purchasers can adopt. These include:

- a. early dialogues about possible requirements with potential suppliers (including the manufacturers of major components). Such dialogues are more likely to be relevant for large or important contracts, especially those incorporating new or improved technology, than for low volume orders for everyday products;
- b. encouraging both product and process innovation;
- c. specifying requirements in performance terms rather than specifying detailed designs which take no account of other industrial applications;
- d. maintaining as far as practicable an even ordering pattern to allow efficient production planning;
- e. de-briefing suppliers on request (within the bounds of commercial confidentiality) when a major contract has been placed elsewhere, including the identification of specific deficiencies in bids.

## Dissemination

7. The practices outlined in these guidelines are already part of best practices in both the public and private sectors. Economies of long-term benefit both to suppliers and to purchasers can be achieved through rationalised requirements, more organised volume production and through improvements in production planning. But the principles have not been applied widely enough. It is essential, therefore, that the approach set out in these guidelines becomes an integral part of procedures for the award of public sector contracts.

VALUE FOR MONEY

A CHECKLIST OF FACTORS RELEVANT TO PROCUREMENT DECISIONS

SHORT-TERM CONSIDERATIONS

1. STATUS OF FIRMS INVOLVED

- Financial viability
- Design capability
- Production capacity
- Quality Assurance status and track record
- Cost Management arrangements and track record
- Delivery record

2. EQUIPMENT OFFERED

- Extent to which it meets minimum requirement
- Design/artistic qualities (where appropriate)
- Compatibility with equipment already in use
- 'Extras' above minimum requirement which offer cost effective advantage
- Scope for improvement or 'stretch' by later modifications or 'add ons' etc
- Conformity with standards (national, international, NATO etc)
- Scope for value engineering
- Reliability - proven record?
- Maintainability
- Defect reporting and rectification arrangements
- Repair/servicing arrangements

3. IMMEDIATE COST OF ACQUISITION

- Initial price
- Firmness of price (eg fixed, with or without VOP, cost plus etc)
- Basis for agreeing prices on associated or follow-on orders
- Differences in cost escalation formula
- Foreign exchange risks and costs
- Payment terms (on delivery or progress/stage payments etc)
- Cost of financing interim payments

- Financial guarantee requirements
- Duties and taxes
- Credit terms
- Transport costs
- Installation costs
- Cost of working capital for stocks
- Discounting factors
- Differences in administrative cost (including overheads) to purchaser
- Warranties and technical guarantees offered
- Product liability arrangements
- Scope for, and cost of, accelerating or delaying procurement

#### 4. DELIVERY

- Conformity with requirement
- Reliability of offer
- Operation and financial effects of earlier/later availability
- Cost and trade offs with stockholding costs at various locations
- Liquidation of Damages

### MEDIUM-TERM CONSIDERATIONS

#### 5. OPERATING COSTS

- Running costs
- Cost of spares - present and future
- Servicing and maintenance costs
- Storage and other support costs

#### 6. PRODUCT SUPPORT

- Quality of after-sales facilities
- Ease of legal recourse to supplier

#### 7. REPLACEMENT ARRANGEMENTS

- Receipts for eventual disposal
- Commitment to particular replacement equipment
- Replacement timeframe

## LONGER-TERM CONSIDERATIONS

### 8. STRATEGIC AND STRUCTURAL

- Safeguarding of vital sources of supply
- Length of the supply chain and its vulnerability to disruption
- Offset considerations
- Effect of procurement on price, availability and competition for future supplies (eg arising from dumping or artificially depressed quotations) including, as appropriate, supplies for other public purchasers.