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MINISTRY OF DEFENCE

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*Yes no*

MO 26/2

3rd July 1984

*Prime Minister  
This is the paper for  
which you asked Mr.  
Heseltine. Policy unit  
advice attached. Agree to  
welcome the initiatives*

*Dear Charles,*

Further to my letter of 18th June and your reply of 19th June I now attach a paper which describes the steps which are currently being taken to promote competition in defence procurement and supply.

*look forward to savings?  
C.D.P. 6/2*

A copy of this letter goes to Callum McCarthy in Mr Tebbit's office who will wish to be aware that this paper was commissioned by Mr Heseltine following a short discussion he had with the Prime Minister. A copy also goes to Richard Hatfield.

*Yours sincerely  
Mike Evans*

(N H R EVANS)

C Powell Esq



file

bc', PC  
JP

10 DOWNING STREET

*From the Private Secretary*

9 July 1984

Thank you for your letter of 3 July with which you enclosed a paper describing the steps which are currently being taken to promote competition in defence procurement and supply.

The Prime Minister has read the paper. She welcomes the initiatives which your Secretary of State has taken and looks forward to these measures achieving significant savings in the defence budget.

I am copying this letter to Callum McCarthy (Department of Trade and Industry) and to Richard Hatfield (Cabinet Office).

C.D. Powell

Nick Evans, Esq.,  
Ministry of Defence

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MR POWELL

6 July 1984

COMPETITION IN DEFENCE

We welcome the initiatives which the Secretary of State is undertaking to promote competitiveness in the UK defence industry.

We shall not improve value for money until the percentage of contracts awarded following competitive tendering, currently some 20%, is significantly improved. An analysis of recent contracts shows an average saving of over 30% following the introduction of competition.

Nevertheless, it will not be easy to change the culture of the procurement process down the line. Peter Levene's forthcoming review will recommend a more commercial approach which will depend upon recruiting good people from industry who will need to be paid on results. The result should be a slimmer procurement executive (40,000 are employed at present) dedicated to value for money.

The defence industries are generally apprehensive about these changes as they correctly perceive that there will be losers as well as winners. However, industry has much to gain from becoming more competitive, both in a national and international context.

At the moment UK contracts and our share of international collaborative contracts amount to 95% of the defence equipment budget. There is a general tendency within the MoD to exclude overseas competition except for a few particular cases. This trend needs to be reversed.

We accept that overseas competition will need to be used judiciously in order to encourage our industries to become more competitive and to promote greater export and collaborative opportunities. Nevertheless, we should encourage a general presumption in favour of international competition. The Policy Unit are currently involved with the MoD and the Treasury in revising the guidelines for international tendering.

We recommend that the Prime Minister should welcome the Secretary of State's initiatives and look forward to these measures achieving significant savings in the defence budget.

*D.P.*

DAVID PASCALL

DAVAAM

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## COMPETITION IN DEFENCE

### MOD Procurement

1. During 1983/84 MOD spent some £7.5B with industry on defence equipment, including research, development, production, repair and maintenance. Expenditure on other goods and services amounted to a further £1.9B.
2. A large percentage of this expenditure was with high technology defence industries - accounting for 45% of the total output of UK aerospace industry and 20% of electronics. Major sums were also spent on fuel, food and clothing and a variety of routine off-the-shelf items. The totals also included expenditure on services of all kinds, from aircraft servicing to office cleaning.
3. Some 41,000 new contracts were placed by Headquarters purchasing branches during 1983/84. These, together with a similar number of contract amendments, were valued at approximately £7,800 million. In the same year, 450 units and establishments placed, under local purchase arrangements, approximately half a million orders, with a total value of £330 million, for the stores and services required for running these outstations. Payments on previous contracts accounted for the remainder of total expenditure.

### Instructions on Competition

4. The basic principle guiding the handling of all these contracts is that nothing should be bought by the Ministry except as a result of competitive tender. Exceptions will only be made in cases where competition is manifestly impractical or would not give best value for money. The vast majority by number of these contracts will be for quite small sums, less than 1% by number being for over £10M. It would be quite impractical for Ministers to scrutinise more than a very small minority individually. Instructions have therefore been issued to staff at all levels to ensure that there is a maximum of competition.



5. These can be summarised as follows as regards equipment projects:

a. At the early stages of a project. Competition should be used as much as possible, subject to value for money, to ensure the widest available choice of solutions, and to stimulate innovation. Research contracts should be placed with regard to the competitive situation which will result at later stages of the project.

b. At the development and production stages. Competition should be secured wherever possible. The arguments for giving the first tranche of production to the design contractor must be carefully scrutinised before a commitment is accepted. Subsequent production orders will be presumed to be always to be subject to competition. Any commitments to production will be agreed specifically in each contract. MOD rights in existing contracts to consider alternative production sources will be rigorously exercised.

c. In the purchase of proprietary items. Competition should not be dispensed with in favour of one contractor's product until staff are satisfied that no competing products meet the requirement or that continuing with existing products offers better value for money. Where further substantial orders for proprietary items are in prospect, staff should attempt to negotiate rights to facilitate subsequent competition.

d. International Collaborative Projects. The principle of securing maximum competition should be applied whenever possible in the light of the particular circumstances of the project.

e. Sub-Contracts. Instructions to staff on securing maximum competition at sub-contract level are discussed below. (para 11)



6. To ensure the rigorous application of these rules staff are also required, at stated levels of expenditure, to seek the approval of higher authority if they wish to dispense with competition. Cases of expenditure exceeding £10M, or which involve significant policy issues or potential political interest, must be submitted to Ministers.

7. The competition policy is being implemented in parallel with a drive to achieve the tautest possible contract terms, and a determined attempt to reduce the proportion of contracts subject to cost plus percentage fee terms. Taut fixed price contracts are to be achieved wherever possible, and should provide appropriate incentives to discrete activities within the contract. Above average performance should be rewarded; below average performance should suffer.

Limitations on the application of competition

8. There are inevitably some limits to the extent to which competition can be introduced in defence procurement. Many contracts are on a long term basis and frequently there is a need for and benefit from commonality of equipment and continuity of support. Furthermore there are only a limited number of UK suppliers for certain advanced defence equipment and in certain cases only one credible domestic supplier. Overseas firms are not excluded from invitation to tender when this offers the prospect of better long term value for money. But overseas suppliers must not be put to the expense of tendering merely to sharpen up competition. The value of a strong defence industrial base in the UK was vividly illustrated in the Falklands crisis. There is an equally important need to enhance the international competitiveness of UK industry. Both these points must be borne firmly in mind in determining the extent to which foreign competition should be sought in the interests of securing best value for money overall.



Monitoring application of the rules

9. Monthly statistics of the proportions of contracts placed competitively and by other methods have been submitted to Ministers since the beginning of this year. The results, compared to figures for the previous two years are as follows:

	1982/83	1983/84	Jan-May 1984
a. Competition	21%	24%	47%
b. Proprietary items subject to market forces	15%	20%	14%
c. Non-competitive fixed price or other incentives	48%	38%	33%
d. Cost plus percentage fee	16%	18%	6%

10. Thus the proportion of contracts subject to the discipline of market forces (a. and b.) has risen from 36% in 1982/83 to 44% in 1983/84. The figures for the first five months of this year, since the rules above were introduced, show the proportion let by competitive tender to have increased considerably. Figures compiled over such a short period must be interpreted with extreme caution. In particular the 47% shown against a. of the table contains high value contracts for oil and ships placed by competition during the period. A conjunction of this kind is unlikely to be repeated for some time and it would not be realistic to expect the percentage shown for the first five months to be maintained for 1984 as a whole. In this connection it is worth noting that the USA Department of Defence, with a vastly greater industrial base to call on, only achieves 40% by value of contracts let by competition. Nonetheless the returns so far are encouraging.

Competition at Sub-Contracting level

11. The figures in paragraph 9 above refer only to contracts placed on industry by MOD. But many of these contracts, particularly for advanced defence systems will embrace a large number of sub-contracts. For example, of the main contract for the development



of Rapier Field Standard C, some 60% is sub-contracted out, half of which is competitive; for the production of the Skyflash air-to-air weapon 50% is sub-contracted; and for the JP233 Airfield Attack Weapon some 60%. BAe have told the Secretary of State that they aim to contract out 70%, and Marconi Underwater Systems Limited 90%.

12. The true part competition is playing in defence procurement is therefore under represented by the figures in paragraph 9, and the potential is still greater. We are accordingly taking vigorous action to maximise competition at sub-contract level.

13. Staffs have been instructed to require main contractors selected non-competitively to seek effective competition for all major sub-contracts, unless they can satisfy us that dispensing with competition would give better value for money. Main contractors selected by competition are required to provide in their tender their proposals for competition at the sub-contract level, including their reasons where this is to be dispensed with. The work to be considered for competitive sub-contracting should include all areas where it is feasible, including sub-systems for which the main contractor has a capability of his own. We are discussing with industry the terms of a Code of Practice on competition at sub-contract level.

14. Staff are also being required to encourage main contractors to consider open day displays of a complete piece of equipment in its component parts, for detailed inspection by potential sub-contractors wherever they judge this likely to increase interest in tendering.

#### Contracting out and Competition

15. With regard to support services, the basic principle followed is that work will only be carried out within MOD's own support organisation if it is essential to do so for clearly proven operational reasons or where there is financial advantage for the taxpayer. The rules for competition described in earlier





paragraphs are, of course, applied as appropriate once it has been decided in principle that a given service is suitable for contractorisation. Contracting out thus provides a separate route to increased competition.

16. Contractorisation of support services has been implemented in contract cleaning, catering, defence accommodation stores, range support services, quality assurance and surplus vehicle sales. Some 20% of the ship refitting programme, consisting of Royal Fleet Auxiliary and minor vessels, is already placed to contract. Potential candidates include such areas as warship refit (two ships are to be refitted commercially rather than in the MOD Dockyards, on a trial basis) security guards, catering (ie the transfer of the task at more establishments), R&D marine technology, gardening, marine services, aircraft/MT repairs and servicing, schools and education services.

17. The potential for staff savings is considerable subject to case by case confirmation of cost/effectiveness. The numbers are:

Implemented: cleaning (6000), catering (300), range support services (200), quality assurance (150), vehicle sales (100) and defence accommodation stores (380).

Potential: catering (900), security guards (500), R&D marine technology (250), gardening (600), marine services (100), aircraft/MT repair and servicing (750), schools and education services (550).

### Conclusion

18. This paper describes how the measures initiated are opening up significant areas of defence business to competitive pressures. The approach to procurement has three main strands: first to increase the number of firms involved in bidding by broadening the field in the early stages of projects; second to give careful consideration of the timing, nature and extent of a commitment to the development contractor in respect of any initial production order;



and third to promote maximum competition at sub-contract level. Other measures to promote competition include the phasing out of preferred source policies, of which by far the most significant was that related to ROF products, and the initiatives on spin-off. Plans for a group of entrepreneurs with access to venture capital to facilitate exploitation in the civil market of inventions at our R&D Establishments are at an advanced stage. With the same objective in mind we are also discussing with industry arrangements for access to technology developed by firms under MOD contracts.

19. The results of the approach to competition are already becoming apparent, but the policy is essentially a long term one. Its effects will show over the years in the enhanced value for money we obtain for our defence equipment and in the international competitiveness of our defence industries.

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