



House of Commons
Defence Committee

Defence Procurement

Eighth Report of Session 2002–03



House of Commons
Defence Committee

Defence Procurement

Eighth Report of Session 2002–03

Report, together with formal minutes, oral and written evidence

*Ordered by The House of Commons
to be printed 9 July 2003*

The Defence Committee

The Defence Committee is appointed by the House of Commons to examine the expenditure, administration and policy of the Ministry of Defence and its associated public bodies.

Current membership

Mr Bruce George MP (*Labour, Walsall South*) (Chairman)
Mr James Cran MP (*Conservative, Beverley and Holderness*)
Mr David Crausby MP (*Labour, Bolton North East*)
Mr Mike Hancock CBE MP (*Liberal Democrat, Portsmouth South*)
Mr Gerald Howarth MP (*Conservative, Aldershot*)
Mr Kevan Jones MP (*Labour, North Durham*)
Jim Knight MP (*Labour, South Dorset*)
Patrick Mercer OBE MP (*Conservative, Newark*)
Syd Rapson BEM MP (*Labour, Portsmouth North*)
Mr Frank Roy MP (*Labour, Motherwell and Wishaw*)
Rachel Squire MP (*Labour, Dunfermline West*)

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/parliamentary_committees/defence_committee.cfm. A list of Reports of the Committee in the present Parliament is at the back of this volume.

Committee staff

The current staff of the Committee are Mark Hutton (Clerk), Steven Mark (Second Clerk), Simon Fiander (Audit Adviser), Dr John Gearson (Committee Specialist), Fiona Channon (Committee Assistant), Sue Monaghan (Secretary).

Contacts

All correspondence should be addressed to the Clerks of the Defence Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 5745; the Committee's email address is defcom@parliament.uk

Footnotes

In the footnotes of this Report, references to oral evidence are indicated by 'Q' followed by the question number. References to written evidence are indicated by the page number as in 'Ev 12'.

Contents

Report	<i>Page</i>
Summary	3
1 Introduction	5
2 The Defence Industrial Policy	9
The context for the Policy	9
The factors to be used in the MoD's procurement decisions	12
3 Opening up markets	17
Access to the UK market	17
The 'Framework Agreement' and the 'Declaration of Principles'	20
The ITAR Waiver	23
4 Managing Risk	28
Nimrod MRA4	29
Astute submarine	31
Future Carrier	36
Managing smaller firms at arms' length	38
5 Procurement 'Agility'	40
Smart Acquisition	40
Watchkeeper	43
Future Rapid Effects System	44
6 Conclusion	47
Conclusions and recommendations	48
 Annex: Letter from Chairman to members of the United States Congress	 52
Formal minutes	54
Witnesses	55
Written evidence	56
Reports from the Defence Committee since 2001	57

Summary

The MoD and the Department of Trade and Industry jointly published a Defence Industrial Policy in October 2002. It set out the factors that the MoD will take into account when making equipment procurement decisions. While insisting that competition remains the bedrock of MoD procurement policy, the document also clarifies government thinking on the circumstances when competition will not be used or have to be curtailed. It also recognises that firms should not be over-burdened with risk. The publication of the Policy therefore brings a useful, though long-overdue, increase in transparency to this important area, although its practical interpretation will depend on building-up a 'case law' of projects.

Although, the MoD's focus on open competition helps secure value for money in defence procurements, the Defence Industrial Policy properly recognised its limitations. As firms rationalise and their number in particular market sector diminishes, we will not be able to rely on open competition if that gives foreign suppliers a level of access to the UK's open defence market which is not reciprocated by other countries.

The UK must maintain pressure on its European and US partners to conclude already existing international agreements aimed at opening up defence markets. An aspect of the UK's agreement with the US—involving a waiver for the UK on the International Traffic in Arms Regulations—has been delayed in Congress. That has unfortunate consequences because it is a touchstone for our relations with our closest ally, and the delay risks conveying a message about the nature of the US-UK relationship.

The contracts for two major projects—Astute and Nimrod—have been renegotiated because of difficulties stemming from poorly managed risk. The contractor—BAE Systems—was over-ambitious about the technical risk and agreed with the MoD fixed priced contracts which held the firm to prices and delivery deadlines which underestimated the risks, either in error or by being blinded by the must-win nature of those competitions. Insisting on the firm delivering as promised would have been a hollow victory if that had left the projects stalled. In making the extra financial contributions necessary to rescue them, the MoD will have made a sensible use of taxpayers' money, provided that the bail-outs do not exceed the amount by which the firm under-priced risk in the first place.

The Future Carrier programme is following a very different track, with the MoD being part of an 'alliance' with the two firms that had been previously in contention for the programme. It will involve some very difficult negotiations to iron out the complex relationship between the alliance partners, and between the firms and the MoD which will be on both the customer and supplier side of the fence. But it deserves support as a model for trying to avoid some of the pitfalls of the Nimrod and Astute programmes.

The Smart Acquisition initiative, now five years old, has done much to reform the MoD's procurement processes, and has helped reduce cost and time overruns. There remains a question about the agility of these procedures, however, to provide equipment for the Armed Forces when they need it. The way new requirements, such as for the Watchkeeper

UAV and FRES armoured vehicles, are managed will be tests for the MoD's ability to increase its procurement agility. But on those programmes the conflicting pressures to reduce both their timescales and their risk have served to highlight how difficult it will be to balance such factors. We will watch with interest how the new Chief of Defence Procurement conducts his re-examination of Smart Acquisition in order to find that agility and to reflect the provisions laid down by the Defence Industrial Policy.

1 Introduction

1. Since the introduction of annual defence equipment debates in 1998, we and our predecessors have undertaken annual inquiries to inform those debates. This is the fifth report in that series, and is aimed at informing the next debate which we expect to be held this autumn. On each occasion we have taken as our starting point a survey of about a dozen or so major procurement projects whose progress we have monitored. Our aim in each inquiry has been to examine and report progress on a selection of the more significant of them, as particular programmes come to critical points in their progress.

2. Accordingly, over the four previous inquiries, we and our predecessors have focussed on a range of programmes at various times, as they were at particularly important stages in their development:

- In the first report¹ in the series, in 1999, our predecessors examined the UK's then recent withdrawal from the collaborative 'Horizon' frigate programme and its replacement by a national Type-45 destroyer programme. They also examined the vessel's Principal Anti-Air Missile System which was to continue as a collaborative programme.
- Their second inquiry² in 2000 focussed on 'Meteor' (the beyond visual range air-to-air missile for the Eurofighter Typhoon) and the strategic air-lift programme, the competitions for both of which had then just been decided, and the Bowman communication system whose competition was then on the brink of having to be relaunched.
- Our predecessors' third report³ in their series reviewed progress on: the Future Aircraft Carrier and its Future Joint Combat Aircraft; the Advanced Short-Range Air-to-Air Missile, intended for Eurofighter and other aircraft; the Roll-on Roll-off ships.⁴
- Last year, we mainly examined the MoD's division of work between shipyards for the Type-45 destroyer in the context of a review of the future capacity of shipbuilding in the UK, and the decision to decommission the Sea Harrier before the Future Joint Combat Aircraft comes into service.⁵

3. Our last but one inquiry also allowed us to consider equipment aspects of the Kosovo campaign, in particular the need for enhancements to the UK's precision-guided bombing capability, supplementing our predecessors' main inquiry on that conflict. In a similar way, we used the opportunity of this current inquiry to ask the Minister about the process by which equipment lessons would be taken forward from the war in Iraq, which is the subject

1 Eighth Report, Session 1998–99, Major Procurement Projects Survey: The Common New Generation Frigate Programme, HC 544

2 Tenth Report, Session 1999–2000, Major Procurement Projects, HC 528

3 Ninth Report, Session 2000–01, Major Procurement Projects, HC 463

4 This inquiry coincided with the 2001 general election, and without an opportunity to produce a substantive report the Committee had to content itself with putting the evidence it had taken in the public domain before it might be lost at the end of the Parliament.

5 Fourth Report, Session 2001–02, Major Procurement Projects, HC 779

of a separate ongoing inquiry. We do not comment on the Iraq war, however, in this report.

4. We have continued with our procurement monitoring exercise this year. In selecting our projects for tracking, we have retained many on our list from previous years, because they remain important in their own right but also because they allow us to continue to track the progress of important specific capabilities identified in the Strategic Defence Review (SDR), such as the Future Carrier and Ro-Ro ships. However, this year we expanded our list to take account of the growing importance of particular military capabilities linked to last year's SDR New Chapter white paper,⁶ to include Watchkeeper and the Future Rapid Effects System. Our starting point, as with our previous inquiries, was to request a detailed MoD memorandum, which we publish with this report,⁷ covering the following programmes:

- Future Aircraft Carrier
- Future Joint Combat Aircraft (currently planned to be the F-35 'Joint Strike Fighter')
- Type-45 destroyer
- Ro-Ro strategic sealift
- 'Bowman' communications system
- Future Rapid Effects System
- Eurofighter Typhoon
- 'Meteor' beyond visual range air-to air missile
- Advanced Short-Range Air-to-Air Missile
- A400M strategic airlift
- Nimrod MRA4
- Light Forces Anti-Tank Guided Weapon System
- Swiftsure and Trafalgar submarine Update
- Astute submarine
- 'Watchkeeper' unmanned aerial vehicles

5. This year, we have also sought to examine the *Defence Industrial Policy*, a paper produced jointly by the MoD and the Department of Trade and Industry last October.⁸ We took oral evidence from representatives of the Defence Industries Council, with whom that Policy paper had been negotiated (Sir Richard Evans and Mr Nick Prest, chairman and vice-chairman of the Council respectively,⁹ along with Mr John Howe of Thales-UK and Mr Colin Green of Rolls-Royce). We also took oral evidence from Sir Peter Spencer (Chief of Defence Procurement) and Lord Bach, Minister for Defence Procurement (who was accompanied by Sir Peter and Lt Gen Rob Fulton, Deputy Chief of Defence Staff (Equipment Capability)—heads of the MoD's 'supplier' and 'equipment customer' organisation respectively).

6. We received written submissions from the Defence Industries Council¹⁰ and the Defence Manufacturers Association,¹¹ and we took advantage of an offer from Lord Bach to have a

6 The Strategic Defence Review: A New Chapter, Cm 5566 I, July 2002

7 Ev 63–113

8 Policy Paper 5: Defence Industrial Policy, Ministry of Defence, 14 October 2002

9 Sir Richard Evans is also chairman of BAE Systems, and Mr Prest is also chairman and chief executive of Alvis-Vickers.

10 Ev 126

briefing from MoD/DTI officials on a recently agreed waiver from US licensing procedures for unclassified technology transfers to the UK (which we discuss later in this report).

7. In the process of our inquiries over the last few years we have sought to keep under review the progress made with the Smart Acquisition initiative, launched as part of the Strategic Defence Review in 1988. Our session with Sir Peter Spencer gave us the opportunity to hear the views of perhaps the key player in the MoD's Smart Acquisition initiative, only a month after he took up the Chief of Defence Procurement post. One of the suggested 'core tasks', agreed by the House last year,¹² is for select committees to examine key new appointments in the government departments they monitor. We were able to examine what approaches Sir Peter hoped to bring to his new post and his views on current procurement issues. In similar vein, in last year's inquiry we took evidence from Air Marshal Sir Jock Stirrup, Lt Gen Fulton's predecessor as DCDS(EC), soon after his appointment. Outside our annual procurement inquiries, we have also examined several other new appointments in recent years.¹³

8. Since our inquiry last year, there have been significant developments with the projects on our tracker list,¹⁴ many of which might have warranted closer examination:

- the selection of the Short Take-off and Vertical Landing variant for the UK's Joint Strike Fighters.
- signature of the Ro-Ro ship PFI contract, with delivery of the six vessels.
- the contract award for the Javelin anti-tank missile.
- the announcement of an 'alliance' approach for developing the Future Carrier.
- the maiden flight of the Typhoon series production aircraft and its delivery last month to the RAF.¹⁵
- the extension of the Bowman contract to provide, in due course, an operational planning and control package and an integrated commander's terminal for armoured vehicles,¹⁶ and connectivity with the Apache attack helicopters.¹⁷
- the revision of contracts for the Astute and Nimrod programmes.
- the down-selection of two firms as possible prime contractors for the next stage of the Watchkeeper UAV programme.

11 Ev 113

12 HC Deb, 14 May 2002, col 715

13 Mr Tony Edwards, as the new head of the Defence Exports Services Organisation in the MoD (Second Report, Session 1998–99, The Appointment of the new Head of Defence Export Services, HC 147); Sir Keith O'Nions (Sixth Report, Session 1999–2000, The Appointment of the new Chief Scientific Adviser, HC 318); Sir Michael Boyce (Minutes of Evidence, 2000–01, HC 298-i) and Sir Michael Walker (Minutes of Evidence, 2002–03, HC 771-i) as new Chief of the Defence Staff.

14 Ev 63–113

15 HC Deb, 30 June 2003, col 1W5

16 Ev 83

17 Ev 81

9. In this year's inquiry, however, we have focused on those projects with particular relevance to aspects of the newly-published Defence Industrial Policy. So, in regard to the management of risk, an aspect covered by the Defence Industrial Policy, we examine the lessons of the Nimrod, Astute and Future Carrier programmes. And in looking at how the Smart Acquisition initiative might be taken forward after last year's Defence Industrial Policy and SDR New Chapter, to make it more responsive, we examine how the Watchkeeper and Future Rapid Effects System programmes are being managed. But first, we examine the basis on which the Defence Industrial Policy was produced, and the prospects for developing a more open defence market in Europe and with the US, to match the UK's open market approach set out in the Policy.

2 The Defence Industrial Policy

The context for the Policy

10. The Defence Industrial Policy was launched in October 2002, after 18 months of discussion between the MoD, DTI and industry.¹⁸ Although ostensibly a product of MoD and DTI policy deliberation, it appears that this was at least in part the culmination of pressure from industry for some of its long-running concerns to be addressed more explicitly.¹⁹

11. The previous Defence Committee, jointly with the Trade and Industry Committee, examined defence procurement and industrial policy in some depth in 1998,²⁰ and their report described trends then already in train that were driving those concerns. Against a background of reducing global defence expenditure after the end of the Cold War and pressures on industry to rationalise, the committees examined the MoD's assessment criteria for considering equipment procurements. These, they were told, included 'industrial factors' which the MoD set out under four headings in the following words—

- Value for money in the longer-term, including the cost implications of the creation of a future monopoly;
- security of supply, especially when non-NATO countries are involved, and taking account of the likelihood of support in times of crisis;
- preservation of industrial capabilities, including a capability:
 - to meet operational requirements;
 - to support existing and future weapon systems, to provide industry support for military operations, and to regenerate critical equipment;
 - to contribute to collaboration;
 - to avoid the creation of a monopoly, or over-dependency on a company or country; and
 - to promote defence exports.
- the benefits to the MoD of possible defence exports, including potentially lower unit prices for the MoD's order, and the survival of some companies for strategic or competition reasons.²¹

12. The market, both at home and abroad, has been subject to continuing significant change since then. Industry has further rationalised and restructured as global defence budgets have reduced, while the cost of developing defence equipment remains high. Firms

18 Speech by the Secretary of State at launch of the Defence Industrial Policy, 14 October 2002

19 See eg Aviation Week, 23 September 2002

20 Seventh Report, Session 1997–98, Aspects of Defence Procurement and Industrial Policy, HC 675.

21 HC (1997–98) 675, paragraph 7

(particularly those outside the US) have had to collaborate and sell not just to their own 'national' markets in order to survive. The Defence Industrial Policy document considers industry consolidation to "look set to continue" and that "the process of consolidation has not concluded",²² which our industry witnesses confirmed.²³ The chief executives of BAE Systems, EADS and Thales have highlighted that "room still exists for additional restructuring in the area of land and naval platforms".²⁴ Industry restructuring has been different on each side of the Atlantic—in the US firms have merged to form "super primes", while in Europe there have been a mix of mergers (eg EADS) and joint-ventures (eg MBDA, Augusta-Westland).²⁵ It might be added that where mergers have occurred in Europe, they have more frequently crossed national boundaries on the Continent (eg EADS) than has been the case for UK firms (eg BAe and GEC to form BAE Systems; Alvis-Vickers). As we write there is continuing speculation about a possible merger of BAE Systems with a US firm.

13. The Defence Industrial Policy notes the importance of maintaining the UK's 'scientific base', but also asserts that the UK cannot afford to cover all technologies in its R&D work and must concentrate on 'towers of excellence' (which in turn envisage a division of work between the MoD and industry and research institutions in those key areas).²⁶ The Defence Industrial Policy speaks in terms of creating a favourable climate in the UK for undertaking research,²⁷ but as the MoD's research budget has continued to fall steadily over many years²⁸ this presumably refers to *industry* research. We are not surprised therefore by Sir Richard Evans' view that "we have been living in recent years off a technology basket that was created maybe 20 or 25 years ago, and a lot of us would certainly have the view that we have not been putting anything like enough back".²⁹ The Defence Industries Council's submission calls for a re-examination of "the many existing and developing facets of [Research & Technology] policy".³⁰ Nick Prest highlighted the need to focus our resources on defence Research and Technology expenditure more effectively in the UK—

...the R&T cycle and the procurement cycle were historically quite tightly linked in the UK, and then really from the 1980s onwards, with the introduction of a policy of international competition for individual procurements, the procurement cycle became somewhat decoupled from the R&T cycle, so the two things were not particularly well-related. In the meantime the R&T flywheel, in terms of spending money, continued to spin but not as part of an overall coherent plan related to the capability required in procurement.³¹

22 Defence Industrial Policy, paragraph 9

23 Q 28

24 Open letter from Mike Turner, Rainer Hertrich and Philippe Camus, and Denis Ranque, in RUSI Journal, June 2003.

25 Defence Industrial Policy, paragraph 8

26 Defence Industrial Policy, paragraph 47

27 Defence Industrial Policy, paragraph 51

28 HC Deb, 24 February 2003, col 308W

29 Q 1

30 Ev 126, para 7

31 Q 3

14. While one of the MoD's procurement factors is concerned with maintaining the UK scientific base for 'key technologies', the main purpose of MoD-funded defence research is not focussed on industry's needs. As our predecessors learned in the course of four inquiries on the privatisation of the larger proportion of the Defence Evaluation and Research Agency (now Qinetiq), the MoD's aim is to give it the informed access to the technology it needs for acquiring military capabilities, from whatever source.³² The Defence Industries Council, perhaps not surprisingly, appears to have a different perspective. It puts emphasis on maintaining UK defence research in terms of remaining competitive with the US,³³ and concludes that "relating future requirements to the industrial capabilities that UK industry has to offer, or might be able to offer in the future, will be key".³⁴ **From whatever direction one views the defence research environment, however, in terms of the adequacy of the MoD's long-declining research budget³⁵ or the aims to which it is applied, it is clear that great care will be needed to protect those parts of the UK's scientific base upon which the fighting effectiveness of the Armed Forces depend.**

15. Against the challenging background for defence research and the defence market, the Defence Industrial Policy's aim is for "a healthy and globally competitive defence industry", while developing "new strategies to take account of the transition to an evolving international defence market".³⁶ But the Defence Industrial Policy asserts that "the UK industry cannot grow by meeting domestic requirements alone, nor can all the technologies required by the Armed Forces be sourced solely from the UK".³⁷ The Defence Industrial Policy emphasises the importance of value for money considerations—"the efficient use of defence resources enables the UK to have the most effective armed forces in Europe: it is not in the interests of the taxpayer or our Armed Forces for an industrial policy to dilute this fundamental principle".³⁸ Underpinning those broad aims and conclusions, elements of the *Defence Industrial Policy* included:

- A definition of what constitutes the 'British' defence industry—the Defence Industrial Policy sees it in terms of where technology is created, where skills and intellectual property reside, where jobs are, and where investment is made.³⁹
- Four explicitly stated 'key factors' that the MoD takes into account in procurement decisions, along with seven 'wider factors';⁴⁰ "declared and explained" at the outset.⁴¹
- Competition remaining "the bedrock of procurement policy", but not continued beyond the point at which long-term advantage can be gained.⁴²

32 Ninth Report, Session 1998–99, Defence Research, HC 616, para 2

33 Ev 126, paragraph 5

34 Ev 126, paragraph 9

35 The defence budget has been in steady decline for more than a decade, although it has been static since 2001–02 (see HC Deb, 24 February 2003, col 308W; and HC (1998–99). 616, para 7).

36 Defence Industrial Policy, paragraph 2

37 Defence Industrial Policy, key conclusions

38 Defence Industrial Policy, paragraph 15

39 Defence Industrial Policy, paragraph 11

40 Defence Industrial Policy, paragraph 17–18

41 Defence Industrial Policy, paragraphs 19, 25

- Value for money assessed in a long-term context (taking account also of effects on other projects and on the industrial/technological base), and such assessments made “more systematically and deliberately”.⁴³
- Caution about “burdening prime contractors with unmanageable levels of risk”.⁴⁴
- Protectionism, which would harm UK exports, to be resisted.⁴⁵

16. Lord Bach highlighted what he saw as particularly important sections in the new Policy document—

The first is that our prime task, our prime effort, must be to make sure that we get best value for money for the taxpayer and the best equipment we can. That must be first. Secondly, we have to maximise the economic benefit to the UK and the development of a high-value, high-technology, skilled industrial base. That is very important, and I think how that works in practice is going to be interesting to see. Thirdly, I think our definition of what is a British company is crucial too...⁴⁶

The factors to be used in the MoD’s procurement decisions

17. The Defence Industrial Policy sets out ‘key’ and ‘other’ factors⁴⁷ which the MoD will use to make its procurement decisions:

‘Key factors’:

- The value for money on the individual project; including assessments of cost and operational effectiveness, whole-life costs, and risk.
- Affordability.
- Long-term value for money, cutting across projects.
- National security, requiring the retention of a strategic industrial capability.

‘Wider factors’:

- Security of supply.
- Implications for the UK science base, and research investment in ‘key technologies’.
- Future export potential.
- Industrial participation (known also as ‘offset’).

42 Defence Industrial Policy, paragraphs 21–22

43 Defence Industrial Policy, paragraph 22

44 Defence Industrial Policy, paragraph 23

45 Defence Industrial Policy, paragraphs 33–34

46 Q 240

47 Defence Industrial Policy, paragraph 17 and 18

- Wider policy framework considerations (environmental, security, personnel and estates policies).
- Industrial capabilities and their value to the economy (including the scope for generating economic activity through collaboration, and the impact on UK jobs).
- Foreign and security policy considerations.

18. Underpinning many of these factors is the question of what is ‘British’ industry, and to what extent that label should influence the selection of contractors. That argument has perhaps been keenest in the competition for the Future Carrier programme, where BAE Systems and Thales-UK “fought cat and dog” over that very issue.⁴⁸ The MoD’s policy on what constitutes UK defence industry states that it should be defined in terms of “where the technology is created, where the skills and the intellectual property reside, where jobs are created and sustained, and where the investment is made”.⁴⁹ The Defence Industries Council accepted that definition,⁵⁰ and indeed Colin Green of Rolls-Royce went further: “When one looks at the Britishness or otherwise of an entity in this market, it is not who owns the shares, it is where is the wealth generated and what is the freedom of use for technology generated in that programme?”.⁵¹ Thales-UK’s vice-chairman was clear about his company’s nationality—

...the Thales bid for the Carrier was itself a 100 per cent British bid. Had we won the contract, the work would have been done in the United Kingdom, the design would have been done here, the ships would have been made here, and it would have been no less British in terms of content than the BAE bid.⁵²

19. The Defence Industrial Policy’s clarity on this issue will probably not deter firms making simplistic appeals about their Britishness,⁵³ but those involved in such lobbying should at least have a better idea of what it means in the MoD’s eyes. There is increasingly in any case a blurring of industrial identities, when one looks “further under the skin”,⁵⁴ with some very complex supply chains and inter-dependencies. That complexity was highlighted in a recent report from the DTI-sponsored Aerospace Innovation and Growth Team,⁵⁵ in respect of that particular sector (Figure 1).⁵⁶ Their report is being examined by the Trade and Industry Select Committee as part of their inquiry into the Aerospace Industry.

48 Q 21

49 Defence Industrial Policy, paragraph 11

50 Q 19

51 Q 30

52 Q 22

53 Q 25

54 Q 26

55 An Independent Report on the Future of the UK Aerospace Industry, Aerospace Innovation and Growth Team, Department of Trade and Industry, June 2003, p34

56 Figure 1 is taken from Figure 2.12 in the Growth Team’s report, and is produced by SBAC/BAE Systems.

20. The Defence Industrial Policy envisages identifying where ‘wider factors’ impinge on a particular project at the earliest opportunity,⁵⁷ and then ensuring that these are “declared and explained to potential bidders as far as foreseeable”.⁵⁸ CDP told us that—

The important thing is that the contractors know this is the list [of factors] from which the project team leader will be working. Quite correctly the top four are starred,⁵⁹ because those are the primary drivers, but they get conditioned by other considerations and the only way in which you can determine the extent to which they are going to be conditioned is on a case by case basis. Industry understands that.⁶⁰

This would indeed be clearly welcomed by industry, as Sir Richard Evans told us—

...it would be much better for these issues to be dealt with as early on in the review process as is possible, rather than allowing the whole process to continue towards something of a conclusion at which point there is a huge amount of effort devoted in order to bring these issues out into the open in terms of influencing the outcome of the decisions one way or other...It will be much better for everybody if indeed these wider issues were clearly understood, openly debated, and taken into consideration before industry and the MoD expend huge amounts of money on going down the track that might ultimately produce a result that when these wider issues have been taken into account makes a lot of that expenditure quite nugatory.⁶¹

21. While our predecessors’ 1998 joint inquiry recognised that industrial factors were at that time being given more systematic consideration in procurement decisions, with a formalised input from the DTI,⁶² they also heard from industry that it had remaining concerns that the “long term industrial implications of MoD procurement decisions had not been given effective weight”.⁶³ But at that time the MoD’s list of industrial factors (paragraph 11) did not amount to an industrial policy. Sir Richard Evans told us in this latest inquiry that industry had argued for some time that “there needed to be some process by which we were able to create what we would like to see to be a pretty seamless focus on a number of critical areas”.⁶⁴ So while our industry witnesses thought that there was nothing startlingly new in the Defence Industrial Policy,⁶⁵ they saw its publication last October as “something of an industrial triumph...in that for the first time we had joint agreement on a number of specific objectives”, and welcomed in particular the fact that some previously implicit aspects of industrial policy were now made explicit.⁶⁶

57 Defence Industrial Policy, paragraph 19

58 Defence Industrial Policy, paragraph 25

59 The MoD’s guidance to project managers, Implementing Industrial Policy (MoD website: www.mod.uk/arms/content/docs/indpolgd.htm), states that they “attract significantly more weight” (paragraph 12).

60 Q 120

61 Q 7

62 HC (1997–98) 675, paragraph 8

63 HC (1997–98) 675, paragraph 9

64 Q 1

65 Q 3

66 Q 1

22. Sir Richard Evans cautioned that—

that is the relatively easy part of the task...The biggest challenge now lies ahead of us, which is all related to delivery.⁶⁷

I certainly do not think that this is the definitive statement on the subject...Unless this remains a dynamic policy document which is constantly being refreshed as experience is gained out of the implementation of the recommendations contained in there, then a lot of us would feel pretty disappointed and to some extent cheated by it.⁶⁸

Similarly, when we questioned Lord Bach on the sometimes different ways that the statements in the Defence Industrial Policy could be interpreted, he told us that he saw “case law” developing on the Defence Industrial Policy from procurement decisions made over the following few years.⁶⁹

23. We very much welcome the publication of the Defence Industrial Policy, bringing as it does a useful, though long overdue, increase in transparency to this important area. The way its provisions and statements should be interpreted will inevitably have to be developed; by further debate and through “case law”. Indeed, in some areas, including the use of competition and open markets and in risk management (two of the perhaps more contentious of its themes, and covered in the following section of this report), the Policy’s utility will be evident only with the passage of time. It does however provide a helpful launch-point for developing policy in this important area.

67 Q 1

68 Q 5

69 Qq 240, 245

3 Opening up markets

Access to the UK market

24. As industry rationalises, competition may be more difficult to sustain in some market sectors. Under the Defence Industrial Policy, competitions in the short term might be waived or curtailed to ensure that future competitions will be possible, and that might or might not entail ensuring the survival of *UK* industrial capacity to compete in future. While “competition will...remain the bedrock of our procurement policy”,⁷⁰ the use of competition will be influenced by long-term considerations of value for money, and will not continue “beyond the point at which long-term advantage can be gained”.⁷¹ “Competition”, as Nick Prest put it “has to be applied intelligently”.⁷²

25. Deliberations about the long-term value for money of running a competition will take account of the aggregate impact of decisions across a number of projects within a particular market sector, and the Defence Industrial Policy promises that these wider impacts will be assessed “more systematically and deliberately”.⁷³ The MoD’s revised guidelines for its project managers note that project teams’ submissions for initial and main gate approvals should identify the most cost-effective solution for that project but also separately “analyse and quantify the wider factors that may impinge on the decision”, and give “an opinion on whether the strengths of the wider issues justify influencing the cost-effectiveness arguments”.⁷⁴ The MoD’s guidance steers its project staff to consider the following questions:

- Will any of the options reduce the ability of the MoD to get value for money in the future (e.g. by creating a monopoly supplier)?
- Will any of the options affect the ability of the MoD to get value for money from existing MoD contracts (e.g. by reducing the financial viability of a current supplier, or overloading the available capacity)?
- Will any of the options nurture the development of a UK industrial capability that could contribute to value for money in the long-term, e.g. through the development of UK expertise in a particular field?

And to consider:

- current work being undertaken by suppliers;
- the future order books and capacity of suppliers;
- the financial health of suppliers; and

70 Defence Industrial Policy, paragraph 21

71 Defence Industrial Policy, paragraph 22

72 Q 14

73 Defence Industrial Policy, paragraph 22

74 Implementing Industrial Policy (MoD website: www.mod.uk/ams/content/docs/indpolgd.htm), paragraph 8

- market trends and the level of competition within the suppliers' global market sectors.⁷⁵

26. The MoD's Director General Equipment, as the lead officer for defence industrial policy within the MoD and as the liaison point on this issue with other government departments, would then weigh the balance of factors across projects and market sectors.⁷⁶ An example of where such wider factors would be critical is in the approach adopted for the Type-45 destroyer programme, which we covered in last year's procurement report. It seems to us that another potential example might be the armoured vehicle sector, where with the joining of Alvis and Vickers the MoD now has only one UK prime contractor. The issue of whether to avoid or curtail competitions in order to preserve national capabilities also arises in the choice of aircraft for the Advanced Jet Trainer programme, currently much in the news because of an unsolicited offer from BAE Systems to supply its Hawk 128 for that programme. We understand that the MoD is imminently expected to decide whether to select the Hawk 128 or open up the programme to international competition.

27. The Hawk case is an important early test for the Defence Industrial Policy, not just in terms of taking account of the long-term prospects for competition, but also in terms of managing risk (which we discuss in Part 4 of this report) because the aircraft chosen for the Advanced Jet Trainer programme will be likely to be subsumed in the Military Flying Training System PFI programme. As with any PFI, the MoD's aim is to allocate risks between the PFI contractor and itself according to which party is best able to manage them, and in most PFIs that usually entails the contractor being responsible for specifying, acquiring and maintaining the assets supporting the PFI service. In the Ro-Ro ship PFI, the MoD had to step in and take on the construction risk for the two vessels built at Harland & Wolff, but even then the PFI contractor retained the risks of the design and cost of the vessels.⁷⁷ In the Military Flying Training System case, there may be good grounds for the MoD selecting in advance the aircraft that the PFI contractor would then presumably have to use. Whichever way the MoD goes on the Advanced Jet Trainer programme, we expect it in its reply to this report to make clear how its decision fits with the value-for-money, competition and risk-management provisions of the Defence Industrial Policy.

28. We welcome the sensible and balanced approach to the use of competition under the Defence Industrial Policy, recognising as it does that the benefits of competition in the short-term may bring disadvantages later on. Though curtailing competition in order to secure such a more favourable scenario in a sometimes distant and uncertain future has risks of its own, it is right that the MoD should be alive to the issue and give it early consideration in each project.

29. As firms have rationalised and globalised, that has been reflected in the definition of what constitutes British defence industry. The Defence Industrial Policy notes that UK firms operate abroad, and foreign-owned firms "bring benefits...in this country". It stipulates therefore that "the UK defence industry should be defined in terms of where the technology is created, where the skills and the intellectual property reside, where jobs are created and sustained, and where the investment is made".⁷⁸

⁷⁵ *Ibid*, paragraph 17

⁷⁶ *Ibid*, paragraph 15

⁷⁷ HC (2001–02) 779, paragraph 66

⁷⁸ Defence Industrial Policy, paragraph 11

30. While *UK industry* defined in that way might account for a significant proportion of the economy,⁷⁹ there are likely over time to be fewer firms that are wholly incorporated and based in the UK and owned by UK shareholders. And that has implications for national governments' ability to exert control over industrial activity, and thereby ensure security of supply. The Defence Industrial Policy states that "we have to be realistic about the advantages [of onshore technology]. An increasing mutual reliance on security of supply is inevitable for all nations".⁸⁰ And, as a consequence, "governments need to accept the inevitability of greater mutual inter-dependence and manage it advantageously... There is much protectionist resistance to overcome".⁸¹

31. But the application of such caveats and caution about the use of competition does not hide the fact that, as the Defence Industrial Policy puts it, "the UK has led the way in encouraging an open and competitive defence market".⁸² It considers that "...inward investment...can in most cases be best addressed by promoting a favourable business and economic environment".⁸³ That requires a genuinely open market, as CDP emphasised—

The very worst of all worlds would be to give people the idea that we did not have a sensibly level playing field and that we were only interested in guys coming from overseas to be a stalking horse, to put the frighteners on the people we decided to give the project to in the first place. That is definitely not the intention.⁸⁴

32. The problem, however, as our industry witnesses complained, is that other countries do not do as much as the UK to open up their domestic defence markets. They told us that—

...the UK is the only country in the world that is a major procurer of defence equipment that actually has opened its market up. It is an interesting fact that the UK today is the second largest importer of defence equipment in the world, second only to Saudi Arabia... We are way out ahead of the pack.⁸⁵

The Defence Industries Council considered that "the Policy should vigorously address both the opening up of other markets and the securing of access for UK industry to technologies developed abroad for equipments that are to be acquired by the MoD".⁸⁶ Sir Richard Evans pleaded that—

I am not saying that we should necessarily change the policy that we have but we should be doing a hell of a lot more to force the others to actually come in line with us...I do not think protectionism is the answer to this...The answer to this is not to shut the door, it is to exercise quite cautiously the degree to which we allow the door to be opened whilst at the same time exerting the maximum amount of political and

79 Defence Industrial Policy, paragraph 3

80 Defence Industrial Policy, paragraph 18

81 Defence Industrial Policy, paragraph 34

82 Defence Industrial Policy, paragraph 3

83 Defence Industrial Policy, paragraph 11

84 Q 121

85 Qq 38–39

86 Ev 126, paragraph 12

industrial pressure on those other markets that are benefiting from entry to the UK to do the same for us.⁸⁷

It is extremely difficult to compete on equal terms unless there is some clearly definable and recognisable technological difference in the product that is being offered...In the UK—this is a point we have made repeatedly to government—we are probably the only country, certainly in terms of the western world, that has a pretty much open [position]...and that absolutely and definitely is not reciprocated by any of the other markets that we go into...Unless there is some sort of reciprocal opportunity offered, there are some serious questions to be asked.⁸⁸

...one of the things I think this [Defence Industrial Policy] has done here in the UK has been to re-energise a campaign at both political and official level in the context of some of these markets to try to address the issues of non-reciprocal arrangements.⁸⁹

33. We are happy to lend our weight, through this report, to such a campaign. Ministers and their officials must maintain pressure for reciprocal treatment from other defence manufacturing countries. An open market approach might help the MoD secure good value for money in its procurements, and as such might earn our commendation, but not if other countries fail to adopt a reciprocal approach which allows UK industry to compete overseas on merit, and if as a result the scope for home-grown competition dies.

The ‘Framework Agreement’ and the ‘Declaration of Principles’

34. The “political and industrial pressure,” called for by Sir Richard Evans, needs to be exerted on two fronts—in relation to individual projects, and in making better progress with international agreements aimed at opening up defence markets and facilitating industrial rationalisation. The previous Defence Committee reported on a six-nation *Framework Agreement* between the UK, France, Germany, Spain, Italy and Sweden (ratified in February 2001), and a *Declaration of Principles* between the US and UK (signed in February 2000) which encompassed similar measures.⁹⁰

35. The main features of the Framework Agreement concerning Measures to Facilitate the Restructuring and Operation of the European Defence Industry⁹¹ were:

- *Security of supply*: This focussed on consultation mechanisms to resolve problems and a commitment to develop legally binding assurances not to inhibit cross-border supplies. Irrespective of such assurances, our predecessors noted that countries will still seek to retain national capabilities, particularly where defence industries are still state-owned.⁹² Our predecessors concluded that “the main value of the Framework Agreement in

87 Qq 40–41

88 Q 17

89 Q 18

90 First Report, Session 2000–01, The Six-Nation Framework Agreement, HC 115

91 Cm 4895

92 HC (2000–01) 115, paragraph 9

seeking security of supply will be by providing a means to apply political pressure to those countries not following the spirit of the Agreement”.⁹³

- *Exports*: streamlined export procedures for items transferred between the six countries of the Framework Agreement, with mechanisms to agree third-party export destinations at the outset of those projects which would have components sourced by more than one of the six.
- Closer *collaboration on R&D programmes* between the six Framework Agreement countries: to be co-ordinated by a new agency, and with the allocation of work to be based on competition.
- *Treatment of classified/technical information*: The six, in sharing more information, would respect each other’s security provisions, and treat firms from other states as they would their own domestic industry.⁹⁴ Each of the six governments would be obliged to share government-owned technical information with the other governments and their firms.⁹⁵ In their inquiry our predecessors noted industry’s remaining concern, however, about safeguards for sharing commercially-sensitive data.⁹⁶
- *Harmonising military requirements*, through a separate prospective organisation for the six Framework Agreement states.

36. The US/UK *Declaration of Principles for Defence Equipment and Industrial Co-operation* (reproduced in our predecessors’ report⁹⁷) covered similar ground.⁹⁸ But of particular note was an undertaking to simplify technology and equipment transfers between the US and UK; for UK companies operating in the US to be treated no less favourably than US firms operating in the UK are treated here; and for each country to “give full consideration to all qualified sources in each other’s country” to meet national requirements.

37. Access to the US is important, not just because it is a large market but also because of the opportunities it provides to tap into “the most important creator of new defence technology”.⁹⁹ And in Europe, the Defence Industrial Policy sees “significant potential benefits to be gained from a better functioning European market...providing this can be implemented without damaging trans-atlantic co-operation”.¹⁰⁰ Accordingly, the Defence Industrial Policy concludes that “the UK defence industry, whose exports greatly exceed defence imports, and with its foothold in the US market, would suffer more than most [from a retreat into protectionism]”.¹⁰¹ **We can only agree with that sentiment. But it is precisely because of the success abroad of such UK firms that pressure must be**

93 HC (2000–01) 115, paragraph 10

94 HC (2000–01)115, paragraph 25

95 HC (2000–01) 115, paragraph 26

96 HC (2000–01) 115, paragraph 27

97 HC(2000–01) 115, Ev 50–53

98 HC (2000–01)115, paragraph 34

99 Defence Industrial Policy, paragraph 10

100 *Ibid*

101 Defence Industrial Policy, paragraph 33

maintained on the US and the European ‘framework’ countries to level the playing field. Sir Richard Evans, chairman of BAE Systems which has had one of the better track records of penetrating the US market, highlighted the difficulty of selling to the US. Even on a collaborative programme such as the Joint Strike Fighter, in which the UK is a major partner, industry had concerns about the willingness of the US—at government as well as at industry level—to share intellectual property with the UK.¹⁰² He also highlighted a lack of reciprocity from other countries, more generally (paragraph 32).

38. Our industry witnesses told us of their disappointment at the slow pace at which both the Framework Agreement and the Declaration of Principles have been implemented.¹⁰³ The MoD gave us a summary of the current state of progress on these two initiatives.¹⁰⁴ CDP recognised too the “frustratingly slow” progress with the Framework Agreement,¹⁰⁵ but also that he was encouraged that the agreements and arrangements that formed part of the Framework Agreement were at last being finalised, and he was looking forward “over the next couple of years to being able to start to deliver some real benefits from it”.¹⁰⁶

39. In the meantime, on a wider European front, the European Commission recently endorsed a paper on *European Defence—Industrial and market issues; towards an EU Defence Equipment Policy*,¹⁰⁷ which was agreed by the General Affairs and External Relations Council on 15 May 2003. The Commission’s report envisages the creation of an ‘EU Defence Equipment Framework’ encompassing collaborative procurement and research programmes. It urges Member States to harmonise equipment requirements and improve the regulatory regime in the EU to help create a more efficient EU defence market. As such it seeks to further many of the themes covered by the Framework Agreement, and indeed envisages measures which extend EU-wide what is already intended to be covered by the six nations of that Agreement (as well as by OCCAR,¹⁰⁸ the four-nation procurement agency).

40. The Secretary of State’s explanatory memorandum, published by the House of Commons European Scrutiny Committee,¹⁰⁹ stated that the Government shares the Commission’s goal of creating a more competitive European defence industrial base, but also makes clear the UK’s favoured course of promoting such initiatives through “a non-interventionist model”, taken forward “outside the EC Treaty”.¹¹⁰ It also indicated that it would not want any such agency cutting across a prospective ‘European Capabilities and Acquisition Agency’, proposed by the Convention on the Future of Europe and for which the UK signalled its support at the UK-France summit at Le Touquet in February.¹¹¹

102 Q 29

103 Qq 56–59, 73

104 Ev 116–120

105 Q 138

106 Q 140

107 EU paper: COM (2003) 113, 11 March 2003

108 The establishment of OCCAR (Organisation Conjointe de Cooperation en matière d’ Armement) was covered in the Defence Committee’s First Report, Session 1999–2000, The OCCAR Convention, HC 69

109 European Scrutiny Committee, Twenty-third Report of Session 2002–03, HC 63-xxiii, paragraph 22

110 *Ibid*, paragraph 22.15

111 European Defence—Industrial and Market Issues; Towards an EU Defence Equipment Policy, op cit, paragraph 4.1

