



House of Commons  
Defence Committee

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# Defence Procurement

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**Eighth Report of Session 2002–03**





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*Report, together with formal minutes, oral and written evidence*

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## 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.

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### 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).

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### 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'.

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## Summary

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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

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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 report<sup>1</sup> 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 inquiry<sup>2</sup> 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 report<sup>3</sup> 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.<sup>4</sup>
- 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.<sup>5</sup>

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

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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,<sup>6</sup> 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,<sup>7</sup> 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.<sup>8</sup> 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,<sup>9</sup> 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 Council<sup>10</sup> and the Defence Manufacturers Association,<sup>11</sup> and we took advantage of an offer from Lord Bach to have a

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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,<sup>12</sup> 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.<sup>13</sup>

8. Since our inquiry last year, there have been significant developments with the projects on our tracker list,<sup>14</sup> 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.<sup>15</sup>
- 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,<sup>16</sup> and connectivity with the Apache attack helicopters.<sup>17</sup>
- 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.

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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

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### 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.<sup>18</sup> 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.<sup>19</sup>

11. The previous Defence Committee, jointly with the Trade and Industry Committee, examined defence procurement and industrial policy in some depth in 1998,<sup>20</sup> 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.<sup>21</sup>

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

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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",<sup>22</sup> which our industry witnesses confirmed.<sup>23</sup> 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".<sup>24</sup> 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).<sup>25</sup> 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).<sup>26</sup> The Defence Industrial Policy speaks in terms of creating a favourable climate in the UK for undertaking research,<sup>27</sup> but as the MoD's research budget has continued to fall steadily over many years<sup>28</sup> 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".<sup>29</sup> The Defence Industries Council's submission calls for a re-examination of "the many existing and developing facets of [Research & Technology] policy".<sup>30</sup> 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.<sup>31</sup>

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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.<sup>32</sup> 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,<sup>33</sup> 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".<sup>34</sup> **From whatever direction one views the defence research environment, however, in terms of the adequacy of the MoD's long-declining research budget<sup>35</sup> 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".<sup>36</sup> 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".<sup>37</sup> 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".<sup>38</sup> 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.<sup>39</sup>
- Four explicitly stated 'key factors' that the MoD takes into account in procurement decisions, along with seven 'wider factors';<sup>40</sup> "declared and explained" at the outset.<sup>41</sup>
- Competition remaining "the bedrock of procurement policy", but not continued beyond the point at which long-term advantage can be gained.<sup>42</sup>

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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”.<sup>43</sup>
- Caution about “burdening prime contractors with unmanageable levels of risk”.<sup>44</sup>
- Protectionism, which would harm UK exports, to be resisted.<sup>45</sup>

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...<sup>46</sup>

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

17. The Defence Industrial Policy sets out ‘key’ and ‘other’ factors<sup>47</sup> 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’).

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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.<sup>48</sup> 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”.<sup>49</sup> The Defence Industries Council accepted that definition,<sup>50</sup> 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?”.<sup>51</sup> 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.<sup>52</sup>

19. The Defence Industrial Policy’s clarity on this issue will probably not deter firms making simplistic appeals about their Britishness,<sup>53</sup> 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”,<sup>54</sup> 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,<sup>55</sup> in respect of that particular sector (Figure 1).<sup>56</sup> Their report is being examined by the Trade and Industry Select Committee as part of their inquiry into the Aerospace Industry.

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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,<sup>57</sup> and then ensuring that these are “declared and explained to potential bidders as far as foreseeable”.<sup>58</sup> 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,<sup>59</sup> 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.<sup>60</sup>

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.<sup>61</sup>

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,<sup>62</sup> 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”.<sup>63</sup> 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”.<sup>64</sup> So while our industry witnesses thought that there was nothing startlingly new in the Defence Industrial Policy,<sup>65</sup> 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.<sup>66</sup>

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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](http://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.<sup>67</sup>

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.<sup>68</sup>

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.<sup>69</sup>

**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.**

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67 Q 1

68 Q 5

69 Qq 240, 245

## 3 Opening up markets

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### 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”,<sup>70</sup> 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”.<sup>71</sup> “Competition”, as Nick Prest put it “has to be applied intelligently”.<sup>72</sup>

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”.<sup>73</sup> 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”.<sup>74</sup> 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

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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](http://www.mod.uk/ams/content/docs/indpolgd.htm)), paragraph 8

- market trends and the level of competition within the suppliers' global market sectors.<sup>75</sup>

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.<sup>76</sup> 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.<sup>77</sup> 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".<sup>78</sup>

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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,<sup>79</sup> 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".<sup>80</sup> 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".<sup>81</sup>

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".<sup>82</sup> It considers that "...inward investment...can in most cases be best addressed by promoting a favourable business and economic environment".<sup>83</sup> 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.<sup>84</sup>

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.<sup>85</sup>

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".<sup>86</sup> 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

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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.<sup>87</sup>

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.<sup>88</sup>

...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.<sup>89</sup>

**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.<sup>90</sup>

35. The main features of the Framework Agreement concerning Measures to Facilitate the Restructuring and Operation of the European Defence Industry<sup>91</sup> 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.<sup>92</sup> Our predecessors concluded that “the main value of the Framework Agreement in

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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”.<sup>93</sup>

- *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.<sup>94</sup> Each of the six governments would be obliged to share government-owned technical information with the other governments and their firms.<sup>95</sup> In their inquiry our predecessors noted industry’s remaining concern, however, about safeguards for sharing commercially-sensitive data.<sup>96</sup>
- *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’ report<sup>97</sup>) covered similar ground.<sup>98</sup> 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”.<sup>99</sup> 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”.<sup>100</sup> 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]”.<sup>101</sup> **We can only agree with that sentiment. But it is precisely because of the success abroad of such UK firms that pressure must be**

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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.<sup>102</sup> 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.<sup>103</sup> The MoD gave us a summary of the current state of progress on these two initiatives.<sup>104</sup> CDP recognised too the “frustratingly slow” progress with the Framework Agreement,<sup>105</sup> 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”.<sup>106</sup>

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*,<sup>107</sup> 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,<sup>108</sup> the four-nation procurement agency).

40. The Secretary of State’s explanatory memorandum, published by the House of Commons European Scrutiny Committee,<sup>109</sup> 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”.<sup>110</sup> 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.<sup>111</sup>

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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

41. We welcome any initiative that encourages movement towards a rationalised and efficiently managed defence market in Europe. It is important, however, that any developments on that front do not create agencies and programmes which foster European preference at the expense of the UK's two-way trans-atlantic trade. In that regard, we join the House of Lords European Union Committee in its warning about the need to guard against the Commission report becoming “a tool for protectionism or constraining the ability of Members States to order armaments independently”.<sup>112</sup>

42. Our other concern about a formalised vehicle to take the Commission's agenda forward is that it might risk undermining the prospects for further progress by the six nations of the Framework Agreement and the four of OCCAR.<sup>113</sup> The membership of those bodies were countries that were ostensibly the most determined to open up the market and to dispense with inefficiencies such as *juste retour* work-shares that have blighted many past collaborative programmes. **Trying to do what the Framework Agreement and OCCAR are intended to do, but with three of four times the number of countries, risks being a backward step.**

### The ITAR Waiver

43. The provisions of the US/UK Declaration of Principles dealing with export procedures included stipulations that—

- The Participants...will explore possible approaches to achieving greater transparency and efficiency in their national procedures for exports of defence articles and defence services.
- The Participants...will explore means of simplifying the procedures for export of defence articles and defence services between themselves for their own use.
- The Participants will seek to ensure that their national laws and regulations for defence exports to third parties are implemented in a spirit of cooperation and with maximum efficiency. They will reinforce their cooperation and promote convergence in the field of conventional arms exports. They will pursue necessary measures to harmonise their conventional arms export policies as far as possible, and examine means of establishing common standards of implementation.<sup>114</sup>

44. Following the signing of the Declaration of Principles in 2000, those aspects dealing with export procedures were taken forward under the US 'Defence Trade Security Initiative', which amongst other things examined the scope for a waiver for unclassified transfers of products and intellectual property to the UK (and Australia) under the International Traffic in Arms Regulations (ITAR). The UK and US already had a mutual 'Defence Priorities and Allocations System' where the two governments can seek urgently needed (often classified) equipment through firms that have signed up to special

112 Twenty-third Report of European Union Committee, The Future of Europe: Constitutional Treaty—Draft Articles on External Action. Session 2002–03, HL 107, paragraph 26

113 OCCAR currently manages eight collaborative projects, in three of which the UK is a partner—COBRA, Boxer and the A400M (HC Deb 6 May 2003, col 575w; and since when the A400M contract was placed with OCCAR on 27 May 2003).

114 Declaration of Principles for Defence Equipment and Industrial Cooperation, reproduced in HC (2000–01) 115, Ev 51

streamlined order-processing procedures.<sup>115</sup> We took up an offer from Lord Bach to have a briefing on the details of the progress in negotiating the ITAR waiver from officials from the MoD and DTI. We were provided with draft copies of the US/UK Agreement to implement the waiver, and Memoranda of Understanding on the various obligations under the Agreement of the US, UK and UK firms.

45. Bilateral negotiations on the waiver had made little real headway by the close of the Clinton Administration, and effectively stopped for a time under the new Bush Administration because it was slow to put the relevant officials in place. Then the events of 11 September 2001 prompted a further pause. Negotiations had to reconcile the different philosophies of the US and UK systems of export controls. The UK relies on a dual approach of licensing and security classification controls. The US system focusses on licensing which subsumes classification concerns, and most of US defence exports (around 80%) are therefore unclassified. So to introduce a waiver from their licensing system was, on that aspect at least, perhaps a bigger issue than it might have been for the UK. The issue for the US was not it seems about exports to the UK, but rather about controls over re-export by the UK.

46. Rather than the US directly tying granting of the waiver to an imposition of export controls over UK firms, the draft final agreement allows the UK authorities (the Defence Export Services Organisation and the DTI) to control UK firms' adherence to the ITAR waiver conditions under a *politically*-binding Memoranda of Understanding. That MoU would sit under an overarching *legally*-binding US/UK government-level treaty. Under this arrangement, the UK authorities will preserve their territorial sovereignty because UK firms have legally-binding obligations to the UK government, not to US government agencies. The legally-binding treaty at government-to-government level was needed after the US passed the Security Assistance Act in 2000; a development that had also made the negotiations more difficult by removing some flexibility otherwise available to the US side.

47. Lord Bach explained some of the benefits of a prospective ITAR waiver. Those included—

...unclassified US-origin defence products bought by the Ministry of Defence will not be subject to the United States licensing delays; the equipment that we buy will no longer be subject to the vagaries of the licensing process. Companies with a significant presence in the US and the UK will be able to transfer material and technology between these component parts without licensing. It is absurd that we cannot do that at the present time.<sup>116</sup>

Sir Richard Evans also highlighted the benefits in that area—

...the principal benefit would be a much greater degree of interchange between individuals engaged in our companies on joint programmes...there are clearly always going to be a number of areas...where, quite rightly, any country has to create protections... That apart, having the complete ability to have people treated equally

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<sup>115</sup> Since 1990, the UK has received such US assistance under these provisions on 170 occasions (including on eight for the recent war in Iraq), while the UK has assisted the US four times (MoD article in Defence Contracts Bulletin, 4 June 2003).

in the context of security is an absolute fundamental principle...consolidation cannot actually take place without it... Unless people can actually be treated as equals...in the context of the application and access to technology, the synergies that are required to support a deal in consolidation terms cannot be generated.<sup>117</sup>

48. Another advantage of a prospective ITAR waiver for UK firms is that they will be able to get technical data from the US (which would itself otherwise need a license) early enough to be able to respond to US invitations to tender, and thus be better able to compete for US programmes. As Lord Bach put it, “US companies will be able to deal more freely with qualified UK companies, and UK companies will be able to bid into US defence programmes more readily”.<sup>118</sup> And there would be benefits for the US too—

I think it will strengthen their export controls because we will be carrying out new checks on their behalf for items that are transferred to the UK. It will improve co-ordination and co-operation on export control policy and implementation between our two countries.<sup>119</sup>

49. The US and UK authorities had largely secured agreement on the UK waiver in 2002, but then the Congressional approval process appears to have got caught in US domestic rivalries. Our Defence Industries Council witnesses highlighted that Congress had concerns about protecting US industry,<sup>120</sup> and Lord Bach conceded that motives in the US on this issue were “mixed—some good, some not so good”.<sup>121</sup> Our industry witnesses also highlighted, however, that Congress had concerns about ‘leakage’ to some European countries—

One of the principal arguments that is deployed by the US in the context of maintaining its existing policies is the question of leakage...It is very much a hangover from the old Comecon days when there were genuine and absolutely correct concerns about leakage into the Eastern Bloc countries. I have to say that I think in recent times, and certainly post September 11, these issues are more difficult to deal with than they were prior to that... There are some parts of Europe that are clearly more focused for attention than maybe they were a few months ago. These are all territories with whom we have important programmes in the UK...<sup>122</sup>

50. Congress has to approve the text of the Waiver Agreement (now agreed between the US and UK sponsoring authorities) in both Houses, but in the House of Representatives the International Relations Committee<sup>123</sup> has indicated its likely unwillingness to pass the Agreement. It has put a ‘Chairman’s marker’ on the document which replaces the waiver with a counter-proposal to speed up the processing of licences for items to be exported to the UK to 10 days (from the current norm of perhaps five times as long). If the Senate and House persist in approving different forms of draft treaty, then a new compromise text will

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117 Q 67

118 Q 292

119 *Ibid*

120 Q 35

121 Q 294

122 Q 37

123 Chaired by Henry Hyde

have to be prepared and returned for their consideration. In the meantime this year's House Armed Services Defense Authorities Bill includes provisions which could undermine the operation of an ITAR waiver, including a potential amendment to prevent the waiver superseding the test of US 'public interest' when applying the Buy American Act.<sup>124</sup>

51. In the UK, no new legislation will be needed for the waiver, but the Agreement (a treaty) will be laid as a Command Paper, late this year or early next, and will be subject to Parliamentary scrutiny under the Ponsonby Rule. Once agreed, we understand that the UK does not need to introduce new UK export controls to make them 'comparable in effectiveness' to those of the US (as required by Article 3 of the Agreement). A list of 'qualified persons and entities' in the UK, to whom the waiver will apply (Article 2a), will have to be compiled, however, and the 'penalties and sanctions' on firms not complying—criminal as well as contractual—will have to be agreed (Article 6). The latter, we were told, are likely to be of a similar scale to those applying to US firms who breach similar rules, so should not weigh heavily with our larger firms. The Defence Manufacturers Association told us, however, that for smaller firms the penalties might be "so severe that many [smaller firms] will be deterred from participating".<sup>125</sup>

52. As John Howe of Thales-UK noted—

...what is actually being asked for is something quite modest, it is a waiver of ITAR regulations in relation to unclassified information, so it ought not to raise any heroic problems of security classification or national security at all.<sup>126</sup>

**We are disappointed therefore about the suspicion with which some in Congress have viewed the ITAR waiver, not only because the benefits for both the US and UK remain unfulfilled, but more importantly because of the message that the delay conveys about the nature of the UK-US relationship.**

As Lord Bach said—

...the present relationship in the field of defence industry and the transfer of technology, of data and of equipment is still deeply unsatisfactory. It is because we work so closely with our American allies in such an intimate way on intelligence operations that it almost stands out starkly that as far as defence industrial relations are concerned there is somehow a process by which we are still treated as though we are any other country in the world. We think that is unsatisfactory. I believe the Administration think that is unsatisfactory... We are absolutely determined to ensure that there is a more satisfactory relationship between the United States and us in this absolutely vital field...<sup>127</sup>

53. Another concern is that the reluctance to agree the waiver bodes ill for possible reform of US-UK regulations on other types of transfers, and for progress with other aspects of the

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<sup>124</sup> The Bill (HR 1588), introduced in the House on 20 May 2003, seeks to authorise appropriations for 2004 for Department of Defense activities and prescribes military personnel strengths for the year, but also subsumes each year a range of other miscellaneous defence legislation.

<sup>125</sup> Ev 114

<sup>126</sup> Q 78

<sup>127</sup> Q 288

Declaration of Principles more generally. The currently envisaged waiver could be a first step towards closer co-operation on an industry-to-industry level. If it is seen to work, it might allow streamlining for classified exports too. As Lord Bach told us—

...if an ITAR waiver is agreed, and the changes that need to be made in Congress for this to happen are carried through, it will do a huge amount to set the ball rolling to some extent in this field. It will do a great amount for US/British relations too in this field...an important start to establishing a more satisfactory relationship.<sup>128</sup>

**54. The importance of the waiver extends beyond its immediate procedural and legal scope, because it is a touchstone for our relations with our closest ally. A failure to implement this first modest step in bringing closer together the industrial side of that alliance has the potential to become the thin end of a damaging and undesirable wedge in the political side.** We have therefore written to key Senators and Representatives in Congress, as outlined in the Annex to this report, making our concerns plain.

## 4 Managing Risk

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55. Part of the ‘Smart Acquisition’ initiative (see Part 5 below) involved greater effort being put into the ‘assessment’ phase of projects, before designs are firmed up (at the ‘Main Gate’ stage) and before costs and timescales are contracted for, so allowing risk to be identified and managed at the early stages when it is easier to do so. The NAO’s report on the *Major Projects Report 2002*<sup>129</sup> noted that while Smart Acquisition envisages (as a guide) up to 15% of total procurement costs being spent on a project’s assessment stage only around 5% was being spent on average, though the trend was rising.<sup>130</sup> For Nick Prest of Alvis-Vickers, risk reduction had been one of the central pillars of the Smart Acquisition initiative, but “there was not the same attention being applied” to it as the others (the other pillars being the creation of the integrated project teams, and empowering leadership and decision-making at lower levels).<sup>131</sup>

56. The Defence Industrial Policy identifies this as an area where further improvement is needed. It notes that “we need to manage technological risk effectively. Burdening prime contractors with unmanageable levels of risk will not lead to efficient project performance”.<sup>132</sup> Colin Green of Rolls-Royce singled out managing risk as the most important aspect of the Defence Industrial Policy—

If I were to pick out one thing in it that I thought was really good it is the recognition that we need to work together to, first of all, identify risk and then to reduce risk, and then have the appropriate contracting vehicles put in place as that risk is retired together.<sup>133</sup>

57. And, for CDP, risk reduction was a core theme of the Defence Industrial Policy.<sup>134</sup> In a list of his short, medium and long-term aims, he included the need for the Defence Procurement Agency—

...to get a much better understanding of the industrial base, a much better understanding of the suppliers, much better understanding of estimating in advance the risks which are being taken-on in any development programme, the right point at which to go to contract, the right way of assessing or attributing those risks and then working out the contracting risk/reward strategies accordingly.<sup>135</sup>

58. To explore how a failure of risk management can jeopardise projects, we explored the circumstances that had forced the MoD to renegotiate with BAE Systems its contracts for the Nimrod aircraft and the Astute submarine—perhaps the most significant of such cases in recent years. BAE Systems has suffered financially as the programmes hit difficulties because the contracts were fixed-priced, but the MoD (despite such contracts) has also had

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129 Report by the Comptroller and Auditor General, *Major Projects Report 2002*, Session 2002–03, HC 91

130 *Ibid*, paragraph 2.9

131 Q101

132 Defence Industrial Policy, paragraph 23

133 Q 3

134 Q 117

135 Q 111

to pay more to bring them back on track. Nimrod and Astute have common themes. Both pre-date the Smart Acquisition initiative<sup>136</sup> (see paragraph 86 below). They have the same prime contractor. Both have been delayed because of technical difficulties which have prompted the MoD to renegotiate the development contracts, so that a halt will be called (after the first three aircraft, and after the first submarine) before decisions will be made to continue with the rest of the potential orders.

## Nimrod MRA4

59. The original contract for the Nimrod MRA4 maritime patrol and anti-submarine/anti-ship attack aircraft was signed in 1996, for the refurbishment of 21 existing Nimrod MR2 aircraft, along with new sensors and other systems. Since then the MoD has revised its requirement down to 18 MRA4s and the contract has been renegotiated three times, most recently in February 2003.<sup>137</sup> In the latest change the fixed-price contract was restructured to a ‘target cost incentive fee’ contract.<sup>138</sup> The start of production of the bulk of the 18 aircraft, we were told, would be considered after “an appropriate level of maturity that has been proved on the first three aircraft during the flight trials programme”. The MoD would contribute a further £270 million on top of the £3 billion budget, while BAE Systems was taking an £800 million charge on its Accounts (£300m in 2000 and £500m in 2002) for losses on the programme. The delay in the programme now stands at four years, with an in-service date of 2009.<sup>139</sup>

60. CDP said told us that “the Nimrod MRA4 design challenge was hugely underestimated by industry”, perhaps a result of continuing to see the project as if it were the adaptation of an existing aircraft, as it was originally intended to be, when in fact some 95 per cent of the aircraft is new,<sup>140</sup> thus effectively creating a new aircraft. That greater than expected technical challenge required ‘engineering concurrency’, with design and engineering overlapping with production. The danger from this, Lord Bach told us, was that as production continued, so did the development work, and costs were added.<sup>141</sup> He explained that—

We thought that the only way of stopping this was to make sure there was this production pause [after the third aircraft].

So the production pause...will allow, we believe, the design to reach an appropriate level of maturity before embarking on the main production programme.<sup>142</sup>

CDP elaborated—

...we need to make sure that we build to the right design, otherwise it is going to be even more expensive as we keep on having to modify the production models and

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136 Q 219

137 Ev 91

138 The ‘Target Cost Incentive Fee’ approach allows savings/over-runs to be shared, by an agreed formula, between MoD and the service provider.

139 Ev 91

140 Q 219

141 Q 218

142 *Ibid*

keep on re-modifying them in the light of the design not having been finished off. The design maturity had not been achieved. We also needed to make sure that we got the information in terms of flying some of the early aircraft, so we proved the systems.<sup>143</sup>

We have learned that if you drive so hard toward an in-service date that you start to try to build the product before you have finished designing it, you end up in a ruinously expensive iterative process of design changes...Modification on modification on modification is very expensive. That has been at the heart of this.<sup>144</sup>

61. With the MoD having negotiated a fixed price contract with the prime contractor to manage the risk of delivering this project, the puzzle is why the firm (and indeed the MoD) so badly miscalculated. The previous Chief of Defence Procurement, Sir Robert Walmsley, told us in January 2002 that from the Nimrod case there were lessons to learn about accepting too readily a bid from industry (BAE Systems in this case) which was going to be too technically demanding to deliver within the cost and time offered.<sup>145</sup> In this current inquiry, Sir Richard Evans (in his capacity as chairman of BAE Systems) perhaps not surprisingly saw the Nimrod case as having lessons for both sides—

...the problem was...‘concurrency’ where because of the compression on the delivery time scales we really were required to move to production before we had got sufficient stability in design...both sides need to understand as early as possible what the risks are. We need to be able to orchestrate the way in which we contract these programmes in a way that does not inescapably tie-in the purchaser to a programme that, clearly, has got risks that are not being managed out of the design.<sup>146</sup>

62. Lord Bach highlighted the lessons of the project in terms of the unsuitability of contractual arrangements used for some high risk projects—

...the balance of risk and reward may not have been perfectly judged. We need to be anti-costs but not anti-profit, and we need to choose contractual pricing mechanisms that best reflect the degree of risk in our major development and production programmes. We think therefore that a target cost incentive fee is right for the restructured Nimrod programme. Firm and fixed pricing arrangements of course very much have their place in our procurement strategy, but they need to be targeted judiciously.<sup>147</sup>

63. Having again renegotiated the Nimrod contract, CDP was positive about the programme’s future prospects—

...industry and the [MoD] project group are now very much closer in terms of working together on this...There is a very much stronger attention to measuring the risk levels of each of the key components of the technology...There is very much more emphasis being put on identifying some anchor milestones, perhaps two or

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143 Q 170

144 Q 166

145 Second Report, Session 1999–2000, Ministry of Defence Annual Reporting Cycle, HC 158 (Qq 508–09)

146 Q 93

147 Q 218

three each year, which have visibility at board level in the company and at board level at [the Defence Procurement Agency], so that we...can spot the points at which things are beginning to go awry.<sup>148</sup>

...I find it hard to believe that we will get back into those [earlier] circumstances. A contract is a deal between consenting parties and the industrial side of these arrangements has learned that lesson, and very clearly.<sup>149</sup>

64. As well as ironing out technical issues, the MoD hopes that the pause after the third aircraft is delivered might provide an opportunity to enhance the Nimrod design to be an “adaptable aircraft”.<sup>150</sup> The aircraft might be capable of deep-strike and network-enabling roles, in addition to its originally planned maritime surveillance and attack roles, “building upon the results of experience in Afghanistan”.<sup>151</sup> The MoD envisages a possibility that the fourth and subsequent aircraft could have the “new adaptable standard” needed for any such wider capabilities.<sup>152</sup>

65. The main problem with the hiatus between aircraft 1–3 and aircraft 4–18, however, is its implications for the BAE Systems work force. In March 2003, the firm announced 1,000 job losses at the four sites involved in Nimrod production, reducing the Nimrod workforce by half.<sup>153</sup> The MoD reported that with the company they were studying the most cost-effective way to bring production of aircraft 4–18 to a “controlled stop”.<sup>154</sup> **This will have to be very carefully managed. Although the MoD and the firm are considering continuing some low-risk production work to maintain skills,<sup>155</sup> there remains a real risk that vital skills will be lost and will be very difficult to replace.** Indeed, the Minister will no doubt draw the lessons from the Astute programme, which we cover below, where he himself attributed that programme’s difficulties to a loss of skills—

Industrial capability is [a] point I would like to raise in regard to Astute. It is a long time since a submarine was completed at Barrow... So key skills were lost in the gap before Astute commenced production.<sup>156</sup>

## Astute submarine

66. The Astute attack submarine programme has also been significantly delayed, showing some similarity to the Nimrod programme. Its in-service date was moved back from 2005 to 2008 as part of the renegotiation of its contract in February 2003.<sup>157</sup> Under that new agreement, BAE Systems will build the first vessel (HMS Astute), and the production of the second and third boats will only go ahead “once confidence in BAE Systems’ ability to

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148 Q 167

149 Q 165

150 Ev 92

151 *Ibid*

152 *Ibid*

153 Ev 93

154 *Ibid*

155 Letter from Lord Bach to Sandra Osborne MP, 30 June 2003, placed in the Library of the House of Commons

156 Q 218

157 Ev 105

undertake the work has been established”.<sup>158</sup> The MoD has increased its funding for the Astute programme by £430 million (now expected to total £3.6 billion),<sup>159</sup> while BAE Systems have added £250 million.

67. As with Nimrod, the problem was one of inadequately managed risk; specifically, the unexpected complexity of using Computer-Aided Design (CAD) tools—“the first comprehensive application of CAD techniques to UK submarines”.<sup>160</sup> For help with the CAD aspects, BAE Systems and the MoD will turn to a US submarine designer.<sup>161</sup> Lord Bach explained—

The introduction of computer-aided design was much more difficult, much more troublesome, than we had expected, either by the contractors or by us at contract-award. Transferability from a surface ship design has been of less benefit than expected because of the much more demanding component density and placement accuracy in a submarine. We now know, but we could not have known before, that the US Navy was having a similar experience with CAD with the design of their Sea Wolf submarines ten years ago in the early Nineties. In response, we have facilitated the assistance of General Dynamics Electric Boat Company to provide key design management expertise.<sup>162</sup>

**68. In many ways, the root causes of Astute’s problems had some similarities with Nimrod’s. There was again, in particular, a degree of over-ambition in terms of sizing up the technical risks.** In the Astute case, however, CDP saw both parties at fault—

The question is: was the ambition we had when the contract was priced misplaced and was the company’s ambition in terms of their ability to use Computer-Aided Design Computer-Aided Manufacture too great? I think the answer to both questions is yes.<sup>163</sup>

69. There was also, as with Nimrod, a focus on contracting in a way that passed perhaps too much risk to the firm—

We were in an era of believing that we could negotiate very highly incentivised contracts and transfer risk hugely in one direction, and both sides at the time thought it could be done.<sup>164</sup>

...having let highly incentivised contracts in good faith and believing both in industry and in the Ministry that “eyes-on hands-off” here was the way of letting them to get on with it, we discovered, with the benefit of hindsight, that that did not give us enough visibility of progress. The new arrangements which are being put into place have a much more integrated management process with both parties working more closely together, which is easier to do with the target cost incentive

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158 *Ibid*

159 Ev 107

160 Ev 106

161 *Ibid*

162 Q 218 (see also Q 224)

163 Q 184

164 *Ibid*

arrangements,...than if you have a highly-incentivised, fixed or firm price arrangement.<sup>165</sup>

...if you stand back now, with the benefit of hindsight, and look at the impact we have had on the industrial base, driving some of the very tightly incentivised contracts which we have done, you find that what you actually get is perverse behaviour. We thought we were doing the right thing; we were putting it into context. Moving away from the old cost-plus regime into an incentivised contracting regime, all of which brought huge benefits. But you rarely get ought for nought in life and it brought a down side. The down side is an implicit but unthought through assumption that industry's resources are infinite and they can absorb any risk and that we could transfer total or huge amounts of risk...<sup>166</sup>

If you have something which is really just putting together well-established technology in a slightly different form and you recognise there is very little real technology risk in the programme, you are probably going to be veering towards a more highly incentivised contractual regime. If, on the other hand, you recognise that there are some things which again have to continue to be actively managed because, for reasons beyond your control, you have not managed to get the technology risk down to the levels you want...you get a different pricing regime.<sup>167</sup>

70. Another similarity with the Nimrod programme was that under such contract arrangements the MoD had little visibility of the impending crisis in each project,<sup>168</sup> and perhaps more remarkably neither did the senior levels of the firm—

The particularly disappointing aspect of the Astute programme is the fact that the difficulties had not been recognised at the senior levels in the company...since the contract has been let there have been seven different managing directors of the company which was created to run Astute...the metrics which you look for in terms of design and build of submarines, when you do them the old-fashioned way, are easier to spot than when you are putting together a hugely complicated piece of design in computers.<sup>169</sup>

The previous CDP, Sir Robert Walmsley, drew attention earlier this year to the problem of 'must-win' competitions—"which contractor has ever turned away work when asked if they are sure they have the resources to do it?"—which prompted the the Defence Procurement Agency to establish a 'Key Supplier Management System' to monitor the strains within 60 of the MoD's leading suppliers.<sup>170</sup> Such arrangements will play their part in adding early-warning visibility for the MoD.

71. And finally, the ambitious timescales meant that with Astute, as with Nimrod, construction and design were being progressed together, and tripping over each other—

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165 Q 219

166 Q 114

167 Q 231

168 Q 168

169 Q 184 (also Q 168)

170 Smart Acquisition: The next steps, speech at RUSI conference, January 2003

They had already started the construction and they realised that the design work was not keeping pace with the construction...<sup>171</sup>

72. The problems with Astute, however, also have wider implications for another programme—the *Type-45* destroyer. In our procurement report last year, which focussed on that programme’s importance in terms of the future of the UK warship building industry, we noted that a RAND study which shaped the MoD’s ‘block allocation’ strategy for building the destroyers warned that scheduling of the construction and delivery of the blocks would have to be closely managed; a block arriving late at the assembly yard at Barrow might have caused significant delays in not only the *Type-45* programme but also in the Astute programme.<sup>172</sup> In the event, it was delays with Astute that had an impact on the plans for *Type-45*, because of the likely congestion between modules of *Type-45* destroyers and Astute submarines in Barrow’s Devonshire Dock Hall.<sup>173</sup> In March 2003, following MoD agreement to a company request, BAE Systems announced that all of their *Type-45* production work planned to be undertaken at Barrow would be transferred to their yards on the Clyde because of the Astute delay.<sup>174</sup>

73. If these difficulties were not enough, the Astute programme also depends on the delivery of another programme—the *Swiftsure & Trafalgar Update*, whose prime contactor is also BAE Systems. Astute submarines will replace existing *Swiftsure & Trafalgar* submarines, and will include the enhancements of the final phase of the Update (as well as using the nuclear power plant of the *Trident* submarines.)<sup>175</sup> The final-phase of the Update programme—to give a new sonar (‘Sonar 2076’) to the four newest *Trafalgars*—has already been delayed by at least two years,<sup>176</sup> because of technical difficulties experienced by Thales-UK (the contactor for the sonar) with the sonar system’s signal and data processing software.<sup>177</sup> A new phased programme was agreed in November 2002 to introduce the capability of the final phase of the Update more gradually<sup>178</sup>—an initial capability on the first of the four boats involved is now expected in 2004, and will then be rolled out to the other three in the following years.<sup>179</sup> Lord Bach however made it clear that risks with this programme at least were less acute—

HMS Torbay...is due to receive the first increment of the sonar 2076 stage-four update during a repair and maintenance period starting in November this year, to meet the in-service date of August next year...I do not see this as a major risk or one of the biggest risks to the Astute programme at the moment.<sup>180</sup>

74. We have discussed how the contractual arrangements for both *Nimrod* and Astute were a significant part of the cause of their difficulties, requiring some renegotiation of the

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171 Q 186

172 HC (2001–02) 779, paragraph 17

173 Q 224

174 Ev 74

175 Ev 104

176 Major Projects Report 2001, 2001–02, HC 330, p143

177 Ev 101

178 Ev 102

179 These dates were given to the Committee, but are classified.

180 Q 223

contracts. But given valid contracts, to which the prime contractor freely signed up, why should the MoD not insist that the firm make whatever financial contribution (or loss) is necessary to get them back on track? CDP provided part of the explanation, but only part, when he told us that “if you drive a competition too hard and you get people into position that they spend so much money on bidding that they cannot countenance losing, you actually drive them through competition into a contract which is unsound”.<sup>181</sup>

75. Perhaps more tellingly, CDP told us in connection with the Nimrod contract—

[Nimrod] was not capable of being prosecuted to completion all the while the company felt that it was exposed to so much financial risk. The whole of the [contract] negotiation centred on the need to enable the company to close down that risk, bearing in mind that they have already incurred big losses which they have declared, in order then to establish the framework in which we could actually start to concentrate on bringing it to completion, as opposed to a mindset which was damage-limitation under the terms of the original contract.<sup>182</sup>

76. Lord Bach defended the MoD’s extra financial contribution for the two programmes as “a sensible use of taxpayers’ money”.<sup>183</sup> Those contributions, it seems, reflected the MoD’s “acceptance of a share of the responsibility”,<sup>184</sup> but it is noteworthy that the figures were agreed before the new financial structures of the contracts were agreed.<sup>185</sup> When we questioned why the MoD should shoulder any blame in this affair, Lord Bach told us—

...I think on Astute we both misjudged, as I say, the influence of the CAD system and I think that is demonstrated by the amount that the Ministry is paying, in order to make sure that this does not happen again, compared to what the company is paying.<sup>186</sup>

...we needed to make sure that, as with Nimrod, confidence was restored in the company that they had actually capped that risk, so they could then get on more positively moving forward to finish off the design of the submarine as opposed to damage limitation... This very damaging period of uncertainty needs to come to an end as soon as it can...<sup>187</sup>

**77. On one level the MoD could stand by its Nimrod and Astute contracts and insist on delivery by the firm against the terms of those contracts. But the MoD needs those programmes to be delivered, and would have only a hollow victory if its insistence left the programmes stalled. In hindsight, it is clear that the firm discounted its bids by under-pricing its risks—either in error or by being blinded by a must-win determination. If the MoD now has had to renegotiate the contracts in a way which more reliably reflects those risks, then digging into its pockets to rescue these**

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181 Q 163

182 Q 176

183 Q 228

184 Ev 106

185 Ev 125

186 Q 219

187 Q 186

programmes might indeed be a “sensible use of taxpayers’ money”. It is important, however, that in bailing out the contractor the MoD does not pay more than that earlier unwarranted discount—to do so would send a message that commitments made in firm-priced contracts are in reality little more than a basis for further negotiation at the first sign of trouble .

## Future Carrier

78. Unlike Nimrod and Astute, the Future Carrier programme involves the MoD having a role in the ‘Alliance’ team that will produce the vessels, rather than contracting at arms’ length. It plans on taking on about 10% of the risk; “a sensible rule of thumb estimate at this stage as to how we feel about it and...a means of making clear the relative weights which will go on the participation of the three components in this alliance”.<sup>188</sup> This should allow it to be part of the decision-making process as the Alliance develop the Carrier programme. The other members of the Alliance are BAE Systems (prime contractor), and Thales-UK (designer and ‘key supplier’).

79. We explored how the Alliance model might help in terms of risk-sharing and providing earlier MoD visibility of the programme’s progress—two of the weaknesses in the Nimrod and Astute programmes. CDP explained how negotiations were continuing on the Alliance configuration,<sup>189</sup> and described his role as a “marriage counsellor”.<sup>190</sup> BAE Systems’ chairman pointed out that the Alliance approach has never been done before, and that to make it work there would need to be clear lines of responsibility and accountability between the parties.<sup>191</sup> It was, CDP told us, a relationship which combined the intellectual energy of two companies, based on the results of the MoD’s continuous assessment, which gave the MoD—

...more understanding of the risks in this programme than we would have had with any one of [the two firms]. We also have in the aircraft carrier...a very well designed process of identifying the risks of the various components of the carrier and the very clear process of assessing the technology readiness levels...at the point at which we place this contract, the design maturity of the carrier will be more advanced than for any other warship [contract] we have placed... But there is great conscientiousness in looking at all of those things which could go wrong and at what is in place to deal with it, so that at the point at which we place a contract we are confident that the level of risk is containable. Part of the discussion will be the value that industry puts on that risk. If they are not persuaded that the level of risk is containable, then the risk contingency will be unaffordable. We will be very careful to ensure that we get the right sort of balance between a manageable amount of risk when we fire the gun at the beginning of the demonstration and manufacture contract and an affordable amount of contingency to cover those risks, and much greater transparency and involvement between a real integrated team...<sup>192</sup>

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188 Q 202

189 Qq 191–192

190 Q 198

191 Q 96

192 Q 191 (see also Q 230)

80. As part of the Alliance, the MoD hopes to be able to work with its industrial partners to “head off the problem, as opposed to trying to react to it after it has happened”.<sup>193</sup> CDP cautioned, however, that—

...we are still learning what partnering actually means...It is how we draw up the arrangements to ensure that success rewards each of the [three] components [of the Alliance] equally...Everybody is great friends when it is going well. It is when the thing starts to wobble, when people start to worry about a time or cost overrun, that the test of whether or not you have something different will take place...If it is done properly...they will be too busy solving the problem so it does not degenerate into that. That may sound rather idealistic, but you have to find some way of working more like that more often.<sup>194</sup>

...Where we are all feeling our way a little bit is how to involve the Ministry team in that alliance in a way that everybody knows where the sensible boundaries of responsibility are, and where the liabilities are...It is going to be very important to document that in a way that is unambiguous, so it does not end in tears later.<sup>195</sup>

81. When the decision to follow an Alliance approach was announced by the MoD in January 2003,<sup>196</sup> it attracted some scepticism in the press about what seemed to some to be a compromise decision that kept both BAE Systems and Thales-UK in the UK warship market, and then later on concerns about the workability of choosing a prime contractor to deliver another firm’s design. We had two briefings from Mr Ali Baghaei, the Carrier’s project team leader in the Defence Procurement Agency, which have persuaded us that **there is significant merit in this novel arrangement. There may be some very difficult issues to iron-out, which may yet defeat the MoD. But we welcome the way the Alliance model is trying to avoid some of the pitfalls of the Nimrod and Astute programmes.**

82. In the latter stages of the Carrier programme, the MoD has begun sharing technical data with France. CDP told us that—

We will listen sympathetically to the needs we have got from the French. If there are options open to us, about which we are entirely neutral, which appeal to the French in some sort of way, then it is possible that it would go in a direction which they would find attractive.<sup>197</sup>

They were examining the scope for “co-operation” (not “collaboration”<sup>198</sup>) on a possible second carrier for the French navy. This, Lord Bach told us, was more likely to be on an industry-to-industry basis and directed towards “weapon systems rather than the ship itself”.<sup>199</sup> However, although the discussions on the two countries’ carriers had expanded recently to include “operational and policy aspects”,<sup>200</sup> **we welcomed Lord Bach’s**

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193 Q 191

194 Q 192

195 Q 193

196 HC Deb, 30 January 2003, col 1026

197 Q 236

198 *Ibid*

199 *Ibid*

200 Q 233

**assurance that the discussions with France would not be allowed to jeopardise the UK Carriers' in-service dates**, when he told us that—

I am not prepared for our Carrier programme, which is on a very tight schedule, leading up we hope to signing of contracts quite early next year, to be put back by my officials having to spend too much time on discussions with whoever it may be.<sup>201</sup>

### Managing smaller firms at arms' length

83. Before the Defence Industrial Policy, and even before the Smart Acquisition initiative, the MoD's approach to managing risk in equipment programmes involved dealing with prime contractors, putting the onus on the prime contractor to manage the risks of integrating components and sub-contractors' input. As we have discussed, the Defence Industrial Policy puts forward a raft of measures for how the MoD will deal with the firms—the prime contractors—from whom it acquires defence equipment. However, as our industry witnesses identified, typically only up to 30% of a project's development and production costs would lie with the prime contractor, with 70% or more typically sub-contracted to second-tier firms.<sup>202</sup> A more stark example of that dividing line is that each of the top five contractors in the aerospace sector, relies on some 1,500 small and medium sized enterprises.<sup>203</sup> Sir Richard Evans told us that competitive pressures on the primes, and its manifestation in seeking efficiency savings and lean manufacturing, is driving prime contractors to reduce the number of suppliers they directly engage, however, causing 'clusters' of suppliers to form around those primes.<sup>204</sup>

84. We therefore sought from the Defence Manufacturers Association their perspective on the position of smaller firms in the light of the Defence Industrial Policy and the MoD's focus under Smart Acquisition on prime contractors. Their submission<sup>205</sup> highlighted a number of concerns:

- The focus of the MoD's Integrated Project Teams on the larger ('prime') firms means smaller firms do not have direct communication with MoD project teams. This means added bureaucracy of having to deal with several Integrated Project Teams and prime contractors running projects which smaller firms hope to supply.
- The MoD focus on prime contractors, with the Defence Industrial Policy also centred on providing transparency for the primes, means that "there is no clear MoD mechanism for assessing and influencing...the [sub-contract] procurement decisions of the primes".
- Because of the financial penalties of not complying with the ITAR waiver controls (paragraph 43) smaller firms may choose not to sign up. If that happens, UK primes (who have signed up) may not turn to UK sub-contractors.

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201 *Ibid*

202 Q 83

203 The Importance of SMEs, Mr Stan Porter (Director General Commercial, MoD), article in Defence Contracts Bulletin, 4 June 2003

204 Q 85

205 Ev 113

85. When we asked him about the challenges for smaller firms, Lord Bach was clearly familiar with the issues for small and medium enterprises (SMEs)—

...there is some concern...as to whether Smart Acquisition leaves them out in the cold, particularly in relation to the [Defence Procurement Agency] and the Ministry, in a way that did not happen so much before because of the obligations that we put on prime contractors to be responsible for their own sub-contracting...I am concerned that we do not lose sight of SMEs in the Smart Acquisition process, and I am also concerned, and this is a personal view, that the sub-contractors, small companies, are dealt with fairly always by prime contractors. This, I think, is crucial. There can be a tendency for prime contractors, the big beasts, as it were, to make their sub-contracts go sometimes not necessarily to the places where they ought to go. When small and medium firms write to me and say, ...“We are not happy that we were not given a chance in this contract”...I am not prepared to accept the answer [within the MoD] “Well, actually it is nothing to do with us. It is a matter between the prime contractor and yourselves”. It is that area where I think we can perhaps start looking carefully at what we do with SMEs. You know that there are codes of practice of course, but the codes of practice of course are toothless and not legally binding. It is essential that if the codes of practice are breached by prime contractors, and I am not saying this happens as a regular thing, but if they are, then I think we should be prepared to take some action against the prime contractors which will affect them. It is keeping that confidence between SMEs and the Department that I consider to be one of my priorities...<sup>206</sup>

**We welcome the Ministers’ robust approach. Smaller firms provide the essential foundation for the UK defence industry, and the MoD must ensure it considers the implications for such businesses as it develops its procurement processes and policies, including efforts to make it more ‘agile’. In our future inquiries we will ask the MoD how being part of the prime contacting ‘alliance’ in the Future Carrier programme might have given it a clearer perspective on life for the second-tier firms with whom the alliance will be dealing.**

## 5 Procurement 'Agility'

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### Smart Acquisition

86. In this Part of our report we examine how Smart Acquisition (formerly 'Smart Procurement') stands up, five years after it was launched as part of the original SDR in 1998 and in the light of the recently published Defence Industrial Policy.

87. In our predecessors' inquiry on the original Strategic Defence Review in 1998, they described the main features of the then new arrangements, which included:

- multi-disciplinary 'Integrated Project Teams' in the Defence Procurement Agency and the Defence Logistics Organisation, under IPT Leaders responsible for managing individual equipment programmes. The teams' multi-disciplinary composition was intended to encourage a through-life perspective, with procurement and in-service aspects traded-off to give an optimal balance of through-life costs and performance.
- A clear division in the MoD between a 'customer' organisation (the Deputy Chief of Defence Staff (Equipment Capabilities)) and 'supplier' (the Integrated Project Teams).
- Rationalising the approval process down to two new decision-points—'Initial Gate' and 'Main Gate'—with sufficient work in an intervening 'Assessment' stage to be able to fix budgets and timescales with confidence at the Main Gate stage.
- 'Incremental acquisition' of capabilities—with platforms to be modified as technologies mature rather than going for a full capability from the outset.
- 'Capability Working Groups'—50 in all—to consider how equipment concepts might fill the capability gaps identified by DCDS(EC), which include industry as well as MoD representatives.

88. We welcomed the introduction of Smart Procurement, as it then was, concluding that—

There are aspects of smart procurement...that are new and radical, and do appear to offer scope for genuine progress. In particular, the inclusion of industry in project teams will help engender a fundamental shift in culture towards a partnership approach. With properly delegated authority, and the streamlined procedures now envisaged, team leaders might also be able to make some progress in reducing the long delays and cost overruns many projects experience.

...The challenge for smart procurement will be to develop concrete improvements on the reforms of the last 20–30 years, to secure tangible and demonstrable improvements in project timescales and costs, but at the same time ensure sufficient controls to prevent the recurrence of some of the major procurement failures witnessed in the last few decades.<sup>207</sup>

89. Since then, we have continued to monitor the initiative, including in 2001 when we examined what evidence the MoD had on its performance against each of the “faster, cheaper and better” objectives it had for the initiative.<sup>208</sup>

90. Another, and more detailed series of snap-shots of Smart Acquisition performance is provided in the NAO’s annual inquiries on the Major Projects Reports, which examine the project management of the 20 largest projects having passed main gate, and the 10 largest projects still in their assessment phase. In its most recent report, published last December, the NAO noted that the MoD was “maintaining the trend of cost control established over the past few years”.<sup>209</sup> Estimated costs for the projects covered again fell, although that subsumed an overall cost increase for newer projects introduced under the Smart Acquisition initiative.<sup>210</sup> The NAO’s analysis also found that 98% of equipments’ ‘key user requirements’<sup>211</sup> were forecast by the MoD to be met,<sup>212</sup> and it was noteworthy that delays attributed to ‘technical factors’ had reduced by more than half over three years<sup>213</sup> (although since the period covered by the last Major Projects Report, Nimrod and Astute programmes have suffered further on the cost and time fronts).

91. In regard to risk management, which we discussed in Part 4, the NAO’s most recent report on the 2002 Major Projects Report examined what progress was being made in the application of ‘technology readiness levels’ for projects in their assessment phase, which is now a requirement for all projects submitted for initial gate approval.<sup>214</sup> As CDP pointed out—

You cannot retrospectively suddenly wave a magic wand over something which has been going since the late 1980s and turn it into what you think a Smart Procurement project would have out-turned. Unfortunately, we are still going to be saddled with the painful consequences of these things as they keep on registering slippage against the original agreed in-service date, and escalation over the original agreed cost... All of the measures we have at the moment point to the fact that the programmes which are being set up in a more enlightened way are making measurably better progress.<sup>215</sup>

92. We described above how under Smart Procurement up to 15% of procurement costs should be spent before reaching the main gate decision point, to reduce risk (paragraph 55). While money spent during that assessment phase of a project should pay dividends in terms of projects’ overall cost and timeliness, however, the NAO analysis found most of these pre-main gate projects were taking longer than planned to complete that assessment work.<sup>216</sup> And particularly telling, an analysis in the NAO report shows that of the five projects which were given ‘main gate’ approval in 2000–01, three had already suffered

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208 Eighth Report, Session 2000–01, The MoD’s Annual Reporting Cycle 2000–01, HC 144, paragraphs 80–93

209 Comptroller and Auditors General’s Report, HC 91, paragraph 1.5

210 Comptroller and Auditors General’s Report, HC 91, paragraph 1.6 and figures 2 & 3

211 Usually up to about 10 aspects of operational performance required of the particular equipment—eg payloads, accuracy, or lethality.

212 Comptroller and Auditors General’s Report, HC 91, paragraph 1.14

213 Comptroller and Auditors General’s Report, HC 91, figure 9

214 Comptroller and Auditors General’s Report, HC 91, paragraphs 2.6–2.8

215 Q 194

216 Comptroller and Auditors General’s Report, HC 91, figure 16

slippages by the following year (Meteor, A400M and Type-45) and four had suffered increased costs (Eurofighter, Meteor, Type-45 and JSF).<sup>217</sup>

93. The NAO's analysis also shows that slippage continues to be a problem, particularly with older 'legacy' projects that pre-date the Smart Acquisition initiative. But three of the ten newer, post-Smart Acquisition, projects slipped during the year, by 31 months between them.<sup>218</sup> **Even in regard to newer projects which should be able to be fully moulded according to Smart Acquisition principles, there remains a question about the agility of the Department's procurement systems.** In our inquiry last year on Major Procurement Projects, Sir Jock Stirrup told us that—

...Since the Cold War...we cannot afford to [have] hollow [forces] because we would not succeed. The changing strategic environment has had a significant impact. Equally, the pace of technological advance and the sort of technological advance that is available relatively easily to...potential adversaries has become quite widespread. The sort of asymmetric threats that we face are relatively easily available, and we need to be able to respond to those. That presents us with a particular challenge...[so] we need short term agility in terms of delivering equipment capability.<sup>219</sup>

94. In similar vein, the Defence Industrial Policy noted that “a manpower-intensive, platform-heavy and predictable doctrine [of the Cold War] has been replaced by the requirement for sophisticated, rapid and precise military solutions”.<sup>220</sup> And looking to a future of network-centric warfare, it envisages—

a further shift of emphasis away from platform-based acquisition, towards the development of sub-systems... This will require a high degree of cross-project working, and cooperation among defence suppliers... It will also amplify the need for international cooperation at defence industry level...to meet the need to network with coalition partners.<sup>221</sup>

Our report on the SDR New Chapter concluded that “the Committee has seen little evidence of the urgency that the MoD has claimed to be devoting to acquiring new capabilities”.<sup>222</sup> One of our industry witnesses in this current inquiry, John Howe of Thales-UK, noted that “responsiveness, in terms of compressing the timescale of projects has been slower to respond” to Smart Acquisition than cost or performance aspects.<sup>223</sup>

95. The 2002 Spending Review, which was published at around the same time as the SDR New Chapter white paper, produced a financial settlement for the MoD for the three years beginning 2003–04. The MoD memorandum told us that the New Chapter focus on ‘precision of control’ (of which the ‘Watchkeeper’ programme, which we examine below, is a part) was likely to have the largest proportion of extra New Chapter spending.<sup>224</sup> Within

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217 Comptroller and Auditors General's Report, HC 91, figure 17

218 Comptroller and Auditors General's Report, HC 91, figure 6

219 HC (2001–02) 779, paragraph 129

220 Defence Industrial Policy, paragraph 1

221 Defence Industrial Policy, paragraph 58

222 Sixth Report, Session 2002–03, A New Chapter to the Strategic Defence Review, HC 93–I, paragraph 113

223 Q 102

224 Ev 64

the ‘rapidity of effect’ capability area, FRES—another project covered below—was likely to be the most significant component.<sup>225</sup>

96. However, the MoD’s memorandum also suggests that the budget settlement of the Spending Review came before any detailed assessment of what the additional expenditure was for.<sup>226</sup> The SDR New Chapter will involve a rebalancing of equipment programmes to reflect what is “no longer necessary against the strategic context”.<sup>227</sup> Indeed the MoD’s memorandum noted that “we did not need to restructure our capabilities fundamentally in response to 11 September”,<sup>228</sup> and the equipment measures identified by the New Chapter working groups were “essentially aspirational”.<sup>229</sup> In our SDR New Chapter inquiry, Lt Gen Fulton told us last October that in auditing available capabilities “we are ...reviewing all the equipment programmes”.<sup>230</sup> One of his MoD colleagues quoted to us a letter written by the Secretary of State that the New Chapter “means being prepared to take a hard look at other areas which no longer add capability in the way they once did...”<sup>231</sup> and the MoD’s Finance Management director indicated that such deliberations would feed into advice to be submitted to Ministers in January or February 2003.<sup>232</sup> We are now told that we will have to wait for the Defence Policy White Paper in the autumn before Ministers announce their decisions. **We are disappointed that the MoD has so far been unwilling to share its thinking with us on where programmes may be subject to a “hard look”.**

## Watchkeeper

97. Our report on the New Chapter noted the MoD’s aim of accelerating Watchkeeper (to an in-service date of 2006), but that it would not be armed.<sup>233</sup> Despite the intention of the New Chapter White Paper to down-select from four to two consortia last summer, this only happened in February 2003. Thales and Northrop Grumman are now developing UAV designs in the period up to “early 2004”, after which one firm will be selected for a production contract,<sup>234</sup> with an initial operational capability planned for “early 2006”.<sup>235</sup> Sir Peter Spencer, from his position as a newly appointed CDP, owned up to us that he was “curious” as to why Watchkeeper will take three years.<sup>236</sup>

98. We expressed our concerns about the lack of urgency with the Watchkeeper programme in our report on the New Chapter,<sup>237</sup> and we need not repeat them here. We did however use the opportunity of this inquiry to ask the Minister why it would not be

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225 Ev 65

226 Ev 63–64

227 HC (2002–03) 93, paragraph 113 [Sir Michael Boyce, former Chief of Defence Staff]

228 Ev 63

229 *Ibid*

230 HC (2002–03) 93-II, Q116

231 *Ibid*, Q 40

232 *Ibid*, Q 108

233 HC (2002–03) 93, paragraphs 109–112

234 Ev 86

235 *Ibid*

236 Q 206

237 HC (2002–03) 93, para 113

further speeded up. Lord Bach explained how Watchkeeper's in-service date had over recent months been brought forward, and then put back, as its assessment phase work progressed.<sup>238</sup> But whatever the date finally settled upon, the MoD see the preceding interval to be needed to develop a capability "to inflict military effects",<sup>239</sup> which goes beyond simply fielding a UAV platform. Lt Gen Fulton told us "we will be wasting our money if we do not get the product of this system directly into the hands of the right people, which is both down to the ground station and the ability to get that into a headquarters... What we are buying... is a generation on from Predator".<sup>240</sup>

## Future Rapid Effects System

99. The MoD memorandum boasts that FRES, another project cited as a key component of the SDR New Chapter, "will be the first land combat vehicle able to exploit fully the capabilities of command and battlespace management" and will have network-enabled capability.<sup>241</sup> FRES is intended to be a suite of armoured vehicles lying between heavy armour and light forces, which can have some of the reach and endurance of heavy armour and the air-deployability of light forces.<sup>242</sup> In a recent speech touching on the need to rebalance force structures following the New Chapter and Iraq war, the Secretary of State singled out the importance of FRES for land forces operations, which would be part of a "more graduated and balanced structure of light, medium and heavy forces".<sup>243</sup>

100. The New Chapter White Paper puts the in-service date at 2009, and the MoD memorandum states that its in-service date will be finalised at its 'initial gate' approval which was due in "spring 2003".<sup>244</sup> Press reports had recently speculated that at that initial gate stage the MoD might opt for a UK consortium of Alvis-Vickers/BAE Systems/General Dynamics UK, rather than launch an international competition. Other reports now suggest that the assessment phase will be split into two components, each of 18 months, one before and one after the 'main gate' decision point. The first, it has been reported, would refine customer requirements, and the second would be focussed on risk reduction and trade-off studies, aimed at bringing forward the planned in-service date.<sup>245</sup>

101. We sought an up to date estimate of when the initial gate decision for FRES would be taken, given that the "spring 2003" target for the initial gate has been missed. CDP told us that he now expected the 'customer' for FRES to have to take stock of the lessons of Iraq before completing the FRES assessment phase.<sup>246</sup> Lord Bach emphasised the need to bring the sometimes "pretty cutting-edge technology" in FRES to a sufficient stage of maturity

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238 Q 246

239 HC (2002–03) 93, para 110

240 Qq 248, 250 (see also Q 208)

241 Ev 83

242 *Ibid*

243 Britain's Armed Forces for Tomorrow's Defence, speech by the Secretary of State at the Royal United Services Institute, 26 June 2003.

244 Ev 83

245 Janes' Defence Weekly, 2 July 2003

246 Q 211

before it is applied, and “it is more important that we get it right than that we rush it in”.<sup>247</sup> Indeed, Lt Gen Rob Fulton told us that—

...there is a case which says that [a planned in-service date of] 2009 is actually almost too soon for some of those technologies because...it may well be that actually they cannot be delivered in that timescale.

...What gives me confidence that we are not dragging our feet is the very, very close link that we have with the American [Future Combat System] programme which is asking precisely the same questions at precisely the same time, and there are other countries doing the same, for example Sweden’s CEP programme... We, in conjunction with the Americans and the Swedes, clearly have an interest in producing something that is very, very similar...The FCS programme is a very close one and the American team are in the country at the moment and I have a session with them this afternoon [25 June].<sup>248</sup>

102. Nevertheless, CDP told us that he sees it as one of his priorities to address how agility in procurement can be improved.<sup>249</sup> He wants the MoD to use as benchmarks “equally complex projects” in the civil sector “in order to find out...why it is that they are so much faster than we are”.<sup>250</sup> Part of the solution lay in greater use of ‘incremental acquisition’, to reduce project slippage—

...if you allow yourself to be driven towards meeting very, very demanding bits of requirement, and actually spend far too long meeting the last little bit of requirement...you will overrun and you will waste a lot of time.

... it is absolutely fundamental to me that we stop the slippage, and that we may need to be more pragmatic than we have been in the past about precise definitions. So long as something has an initial operational capability...and the scope to be improved economically through an incremental acquisition process, then we should be driving to meet those dates.<sup>251</sup>

103. **We are impressed with Sir Peter’s determination to make Smart Acquisition truly agile and responsive to equipment customers’ needs. He appears to share Sir Richard Evans’ view, and our own, that “we need to be prepared periodically to refresh Smart Procurement”,<sup>252</sup> telling us that he saw it as one of his short term goals to do what he called “a sort of ‘policy evaluation’...on the extent to which the Smart Acquisition changes are actually delivering...asking how far we have come and where we go now.”<sup>253</sup> In that context, however, the Watchkeeper and FRES programmes are instructive. They are interesting case studies, beyond their increased relevance following the New Chapter, on two counts. First, they both exemplify the MoD’s efforts to explore opportunities to**

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247 Q 255

248 Qq 256–257

249 Q 111

250 Q 111 (see also Q 264)

251 Q 112

252 Q 102

253 Q 111

bring important new capabilities into service more quickly. Second, and to some extent in conflict with that desire to speed up their progress, the MoD has maintained a cautious approach in both with a view to reducing project risks. In the case of Watchkeeper, the caution has been directed at reducing the likelihood of fielding a UAV platform unable to contribute fully to 'networked' capabilities; and in the case of FRES, to deal with the "cutting edge" technologies involved and to explore opportunities to take advantage of US experience in developing very similar capabilities in a similar timeframe. As such, these programmes demonstrate that the MoD is still finding some difficulty in balancing increased agility against decreased risk, and it may continue to do so unless, to pave the way, it facilitates greater investment in technology demonstration research.

## 6 Conclusion

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104. The defence industry has already created single national prime contractors in some sectors, and further rationalisation seems likely. That presents a situation where the MoD is likely to face difficult decisions in judging whether the (possibly short-term) benefits of competition might be outweighed by the need to preserve a competitive environment in the longer term. An added complication is the continuing pressure to strike the right balance between the wider value for money and security of supply that comes from preserving UK industrial capabilities, and the benefits for the limited defence budget of being able to buy equipment from competitively attractive foreign sources. These have always been difficult challenges, but will be more so in future as the defence market becomes increasingly global and inter-dependent.

105. Five years after Smart Procurement was launched, its reforms have done much to contain project costs and are beginning to bring programme timeliness under control. However, with a changing security environment that makes long term planning difficult, and technological change that continues to accelerate, more still needs to be done to make defence procurement more agile, so as to provide new capabilities for our Armed Forces when they need it. Following the extended procurement timescales of the Cold War is not an option. Taking advantage of new technologies will enable more closely ‘networked’ capabilities and warfare to be conducted ever more ‘efficiently’. That is essential—if we do not remain in the vanguard of new technologies, others may use them to threaten our security.

106. Agility will only be achieved through a willingness to put more resources into key areas to bring forward essential new capabilities as soon as possible—and Watchkeeper and FRES might be tests of such a new approach. But that must not be at the expense of managing risk more effectively. That will involve being prepared to introduce technologies in a way that provides interim capabilities earlier, but building-in the potential for enhancements as those technologies develop further. Risk can be contained in that quicker fielding of capabilities, however, only if it is tied to the maturing of the technologies being developed. But managing risk also means providing the contractual environment that incentivises industry while giving the MoD a stake in projects’ success, and visibility of their progress. And finally, risk management also means building-in the flexibilities—political and contractual—needed to adjust programmes as priorities change.

107. The previous CDP, Sir Robert Walmsley, played perhaps the central role in developing Smart Acquisition and making it work in practice. The appointment of his successor presents a valuable opportunity to reshape the initiative to meet these further challenges, and in his early days Sir Peter Spencer shows every sign of wanting to do so. If the route-map to the sort of responsive procurement systems we need is yet to be drawn, the publication of the Defence Industrial Policy does at least point us in the right direction.

## Conclusions and recommendations

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### The Defence Industrial Policy

1. 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, the Policy’s utility will be evident only with the passage of time. (Paragraph 23)
2. From whatever direction one views the defence research environment, in terms of the adequacy of the MoD’s long-declining research budget 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. (Paragraph 14)

### Opening up markets

3. We welcome the sensible and balanced approach to the use of competition under the Defence Industrial Policy, recognising as it does that its benefits 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. (Paragraph 28)
4. We are happy to lend our weight to a campaign to address the lack of open markets in other countries. 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. (Paragraph 33)

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

5. The UK defence industry would suffer more than most from a retreat into protectionism. It is precisely because of the success abroad of UK firms that pressure must be maintained on the US and European countries to level the playing field. (Paragraph 37)
6. We welcome any initiative that encourages movement towards a rationalised and efficiently managed defence market in Europe. It is important, however, that any developments on that front do not create agencies and programmes which foster European preference at the expense of the UK’s two-way trans-atlantic trade. In that regard, we join the House of Lords European Union Committee in its warning about the need to guard against a European Commission report on ‘a Defence Equipment

Policy’ becoming “a tool for protectionism or constraining the ability of Members States to order armaments independently”. (Paragraph 41)

7. Another concern about a formalised vehicle to take the European Commission’s agenda forward is that it might risk undermining the prospects for further progress by the six nations of the ‘Framework Agreement’ and the four of the OCCAR organisation. Trying to do what the Framework Agreement and OCCAR are intended to do, but with three of four times the number of countries, risks being a backward step. (Paragraph 42)

### The ITAR Waiver

8. We are disappointed about the suspicion with which some in Congress have viewed the draft agreement on a UK waiver for the US International Traffic in Arms Regulations, not only because with the delay in implementing it the benefits for both the US and UK remain unfulfilled, but more importantly because of the message that the delay conveys about the nature of the UK-US relationship. (Paragraph 52)
9. The importance of the waiver extends beyond its immediate procedural and legal scope, because it is a touchstone for our relations with our closest ally. A failure to implement this first step in bringing closer together the industrial side of that alliance has the potential to become the thin end of a damaging and undesirable wedge in the political side (Paragraph 54)

### Nimrod MRA4 and Astute Submarine

10. The way production of the Nimrod MRA4 aircraft is brought to a stop will have to be very carefully managed. Although the MoD and BAE Systems are considering continuing some low-risk production work to maintain skills, there remains a real risk that vital skills will be lost and will be very difficult to replace. (Paragraph 65)
11. In many ways, the root causes of the Astute submarine programme’s problems had some similarities with Nimrod’s. There was, in particular, a degree of over-ambition in terms of sizing up the technical risks. (Paragraph 68)
12. On one level the MoD could stand by its Nimrod and Astute contracts and insist on delivery by BAE Systems against the terms of those contracts. But the MoD needs those programmes to be delivered, and would have only a hollow victory if its insistence left the programmes stalled. In hindsight, it is clear that the firm discounted its bids by under-pricing its risks—either in error or by being blinded by a must-win determination. If the MoD now has had to renegotiate the contracts in a way which more reliably reflects those risks, then digging into its pockets to rescue these programmes might indeed be, as the Minister put it, a “sensible use of taxpayers’ money”. It is important, however, that in bailing out the contractor the MoD does not pay more than that earlier unwarranted discount—to do so would send a message that commitments made in firm-priced contracts are in reality little more than a basis for further negotiation at the first sign of trouble. (Paragraph 77)

### Future Carrier

13. There is significant merit in the novel 'Alliance' arrangement for the Future Carrier programme. There may be some very difficult issues to iron-out, which may yet defeat the MoD. But we welcome the way the Alliance model is trying to avoid some of the pitfalls of the Nimrod and Astute programmes. We welcomed Lord Bach's assurance that the discussions with France on a possible co-operation with its carrier programme would not be allowed to jeopardise the UK Carriers' in-service dates. (Paragraphs 81, 82)

### Managing smaller firms at arms' length

14. We welcome the Ministers' robust approach to safeguarding the position of smaller firms. Smaller firms provide the essential foundation for the UK defence industry, and the MoD must ensure it considers the implications for such businesses as it develops its procurement processes and policies. (Paragraph 85)

### Procurement 'Agility'

15. Slippage continues to be a problem, particularly on older 'legacy' projects. But even in regard to newer projects which should be able to be fully moulded according to Smart Acquisition principles, there remains a question about the agility of the Department's procurement systems. (Paragraph 93)
16. We are disappointed that the MoD has so far been unwilling to share its thinking with us on where the capabilities added by some programmes may be subject to a "hard look". (Paragraph 96)
17. We are impressed with Sir Peter Spencer's determination, as the new Chief of Defence Procurement, to make Smart Acquisition truly agile and responsive to equipment customers' needs. He appears to share the view of the Chairman of the Defence Industries Council, and our own, that "we need to be prepared periodically to refresh Smart Procurement". (Paragraph 103)

### The Watchkeeper and Future Rapid Effects System programmes

18. The Watchkeeper UAV and Future Rapid Effect System programmes are instructive. They are interesting case studies, beyond their increased relevance following the Strategic Defence Review New Chapter, on two counts. First, they both exemplify the MoD's efforts to explore opportunities to bring important new capabilities into service more quickly. Second, and to some extent in conflict with that desire to speed up their progress, the MoD has maintained a cautious approach in both with a view to reducing project risks. In the case of Watchkeeper, the caution has been directed at reducing the likelihood of fielding a UAV platform unable to contribute fully to 'networked' capabilities; and in the case of FRES, to deal with the "cutting edge" technologies involved and to explore opportunities to take advantage of US experience in developing very similar capabilities in a similar timeframe. As such, these programmes demonstrate that the MoD is still finding some difficulty in balancing increased agility against decreased risk, and it may continue to do so

unless, to pave the way, it facilitates greater investment in technology demonstration research. (Paragraph 103)

## Annex: Letter from Chairman to members of the United States Congress

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### Letter from Chairman to members of the United States Congress, 2 July 2003

The Committee understands that Congress will shortly be examining the issue of the proposed waiver for the UK from the International Traffic in Arms Regulations. This agreement will greatly assist defence industrial co-operation between the UK and US strengthening our mutual defence through more efficient equipment acquisition and improved interoperability of our forces. We hope that in examining these proposals Congress will also be aware of the significant additional benefits to the US:

- An actual strengthening of US export controls—since the UK will be carrying out new checks on behalf of the US (i.e. that US consent has been obtained before material is re-exported from the UK).
- Improved Customs enforcement cooperation as well as greater coordination and cooperation on export control policy and implementation between the UK and US.

We hope also that Congress will recognise that US material would be effectively safeguarded in the UK. Indeed, given that UK export controls are as effective as those of the US, the close convergence of US and UK policies and objectives in the national security arena, and the close relationship between the US and the UK at the operational level—both military and intelligence, Congress should be confident that this is the case.

The Committee are also extremely concerned about the Defence Industrial Base provisions that are contained in this year's House Armed Services Defense Authorisations Bill (HR 1588), particularly their implications for the UK's defence co-operation with the US. We share the US Administration's view that the provisions would undermine efforts to promote cooperation and interoperability between the US and its allies, and thus reduce our ability to work together to meet our common threats. Similarly, if we cannot cooperate on equipment programmes, this will result in a reduction in the level of value for money achieved by both the US and UK taxpayer, restrict US access to certain state of the art technologies and industrial capabilities, as well as impact very significantly on major international programmes such as the Joint Strike Fighter. The HR1588 industrial base provisions are also in stark contrast with the UK's open defence market; we hope that Congress will understand the threat to our common enterprise and agree to remove them before the final Bill is produced.

Joseph Biden, Senate Foreign Relations Committee

J Dennis Hasert, Speaker, House of Representatives

Steny Hoyer, House Minority Whip

Duncan Hunter, Chairman, House Armed Services Committee

Henry Hyde, Chairman, House International Relations Committee

Tom Lantos, House International Relations Committee

Richard Lugar, Chairman, Senate Foreign Relations Committee

Nancy Pelosi, House Minority Leader

Pat Roberts, Chairman, Senate Intelligence Committee

Ted Stevens, Chairman, Senate Appropriations Committee

## Formal minutes

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**Wednesday 9 July 2003**

Members present:

Mr Gerald Howarth, in the Chair

Mr James Cran  
Mr David Crausby  
Mr Mike Hancock  
Mr Kevan Jones

Patrick Mercer  
Syd Rapson  
Mr Frank Roy

The Committee deliberated.

Draft Report (*Defence Procurement*), proposed by the Chairman, brought up and read.

*Ordered*, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 107 read and agreed to.

Annexes agreed to.

*Resolved*, That the Report be the Eighth Report of the Committee to the House.

*Ordered*, That the Chairman do make the report to the House.

*Ordered*, That the provisions of Standing Order No. 134 (Select committees (reports)) be applied to the Report.

*Ordered*, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

The Committee further deliberated.

[Adjourned till Wednesday 10 September at 2.30pm]

# Witnesses

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## Tuesday 13 May 2003

Page

**Sir Richard Evans** Chairman BAE Systems, **Mr Nick Prest**, Chairman and Chief Executive Alvis-Vickers, **Mr John Howe CB OBE**, Vice-Chairman Thales-UK, and **Mr Colin Green** President Defence Aerospace Rolls-Royce.

Ev1

## Wednesday 21 May 2003

**Sir Peter Spencer KCB**, Chief of Defence Procurement, Ministry of Defence.

Ev 21

## Wednesday 25 June 2003

**Lord Bach**, Minister for Defence Procurement, **Sir Peter Spencer KCB**, Chief of Defence Procurement and **Lt General Rob Fulton**, Deputy Chief of Defence Staff (Equipment Capability), Ministry of Defence.

Ev 43

## Written evidence

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Major Projects Memorandum from the Ministry of Defence:	Ev 63–113
SDR New Chapter	Ev 63
Future Carriers – CVF	Ev 66
Future Joint Combat Aircraft	Ev 70
Type 45 Anti-Air Warfare Destroyer and Principal Anti-Air Missile System	Ev 73
Roll-On Roll-Off (Ro-Ro) Ships	Ev 77
Bowman	Ev 79
Future Rapid Effects System (FRES)	Ev 83
Watchkeeper Unmanned Air Vehicle Systems	Ev 85
Airlift Assets: A400M	Ev 87
Nimrod Maritime Reconnaissance Aircraft 4	Ev 91
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Advanced Short Range Air-to Air Missile (ASRAAM)	Ev 110
Defence Manufactures Association	Ev 113
Supplementary memorandum from The Ministry of Defence	Ev 115, Ev 125
Correspondence from The Ministry of Defence	Ev120, Ev 121, Ev122, Ev 123, Ev 124
Defence Industries Council	Ev 126

# Reports from the Defence Committee since 2001

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## Session 2002–03

First Report	Missile Defence	HC 290 ( <i>HC 411</i> )
Second Report	Annual Report for 2002	HC 378
Third Report	Arms Control and Disarmament (Inspections) Bill	HC 321 ( <i>HC 754</i> )
Fourth Report	The Government's Proposals for Secondary Legislation under the Export Control Act	HC 620
Fifth Report	Strategic Export Controls: Annual Report for 2001, Licensing Policy and Parliamentary Scrutiny	HC 474
Sixth Report	A New Chapter to the Strategic Defence Review	HC 93-I & II
Seventh Report	Draft Civil Contingencies Bill	HC 557

## Session 2001–02

First Report	Ministry of Defence Police: Changes in jurisdiction proposed under the Anti-terrorism Crime and Security Bill 2001	HC 382 ( <i>HC 621</i> )
Second Report	The Threat from Terrorism	HC 348 ( <i>HC 667</i> )
Third Report	The Ministry of Defence Reviews of Armed Forces' Pension and Compensation Arrangements	HC 666 ( <i>HC 115</i> )
Fourth Report	Major Procurement Projects	HC 779 ( <i>HC 1229</i> )
Fifth Report	The Government's Annual Report on Strategic Export Controls for 2000, Licensing Policy and Prior Parliamentary Scrutiny (Joint with Foreign Affairs Committee, International Development Committee and Trade and Industry Committee)	HC 718 ( <i>Cm 5629</i> )
Sixth Report	Defence and Security in the UK	HC 518 ( <i>HC 1230</i> )
Seventh Report	The Future of NATO	HC 914 ( <i>HC 1231</i> )

Government Responses to Defence Committee reports are published as Special Reports from the Committee (or as Command papers). They are listed here in brackets by the HC (or Cm) No. after the report they relate to.