



House of Commons
Defence Committee

**The Defence Industrial
Strategy: update:
Government Response to
the Committee's Sixth
Report of Session 2006–07**

Eighth Special Report of Session 2006–07

*Ordered by The House of Commons
to be printed 24 April 2007*

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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Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at:

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Committee staff

The current staff of the Committee are Philippa Helme (Clerk), Eliot Wilson (Second Clerk), Ian Rogers (Audit Adviser), Stephen Jones (Committee Specialist), Adrian Jenner (Inquiry Manager), Richard Dawson (Committee Assistant), Camilla Brace (Secretary) and Stewart McIlvenna (Senior Office Clerk).

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Report

The Defence Committee published its Sixth Report of Session 2006–07 on the Defence Industrial Strategy: update on 15 February 2007, as House of Commons Paper HC 177. The Government's response to this report was received on 19 April 2007. This is appended below.

Appendix: Government response

With the notable exception of the Maritime sector, good progress was made in implementing the Defence Industrial Strategy in 2006. We congratulate the Minister for Defence Procurement for driving the process forward at a fast pace. (Paragraph 8)

1. The Department is grateful for the Committee's validation of our work to date and also of their support in our implementation of the DIS. The Department shares the Committee's frustration at the slow progress in the maritime sector but note that progress is being made with discussions on industrial restructuring in this sector.

We are disappointed that the required restructuring of the surface ship industry has not taken place and that this has delayed the main investment decision on the Future Carriers. It is possible, though not inevitable, that this may result in later delivery of the carriers. This in turn may lead to a capability gap which could be both damaging to the defence of the country and expensive to deal with. On the other hand it might lead to the project being better managed. We accept that the MoD is right to insist on the speedy restructuring of industry, and we will be keeping a close eye on this important matter as it progresses. (Paragraph 19)

2. We are working hard with our industrial partners to achieve managed reform within the sector and are beginning to see real progress. The proposed BAES/VT Joint Venture, announced in December 06, demonstrates real commitment by industry and offers the prospect of a through-life entity managing major surface warships from design to disposal. The parties involved in the restructuring initiative continue to take an active role in the Carrier project as part of the CVF Alliance.

We were concerned to hear reports that the Future Carrier programme might have been cancelled because of budgetary pressures. The programme is a key element of the 'Carrier Strike' capability needed by our Armed Forces and vital to the future of the UK maritime sector. We welcome the assurance provided by the Minister for Defence Procurement of the Government's continuing commitment to this programme. (Paragraph 20)

3. The Department remains fully committed to the Carrier programme. The project is continuing its Demonstration phase, aimed at maturing the design and identifying risks to the point that a main investment decision can be taken.

The surface ship sector needs clarity about future design and build work, and maintenance and repair work, to make appropriate decisions about the best way to restructure. However, until the outcome of the Spending Review 2007 is known, the level of future funding for naval equipment and support remains unclear. It is hoped that the outcome of the Spending Review, expected in the Summer, will provide the clarity the surface ship sector needs to proceed with the restructuring required to deliver equipment and support in the most efficient way. (Paragraph 25)

4. The Department agrees the recommendation. The surface ship sector needs clarity on future loading if it is to make informed investment decisions. We are already working with industry to agree the level of business required to sustain key skills across the maritime

sector. We hope to give further clarity on future build and support programmes in the second half of the year.

It is disappointing that the consolidation in the submarine industry did not take place in 2006 as expected. We look to the MoD to continue to encourage industry to integrate, as this will be vital to ensuring that there is a focus on Through Life Capability which should deliver substantial savings to the MoD. If the Government's proposal for a new generation of nuclear missile submarines is accepted, it will be essential to have an efficient submarine industry focused on through-life costs. (Paragraph 29)

5. The Department notes the Committee's comments. However, the Department together with the key industrial players, have been working to develop principles for collaboration and to define how, commercially, collaboration may operate to deliver reduced cost and the improved performance needed to ensure a viable enterprise well into the future. Discussions are progressing well and there has been agreement on the route map to a Long Term Collaboration Agreement. In the meantime, the parties are working ever more closely together and there is evidence of positive behavioural change and innovation.

We note the Minister for Defence Procurement's confidence that the submarine industry is making the value for money improvements required by the MoD, which should enable the MoD to make a decision on Astute boat 4 in early 2007. Given the importance of this contract to maintaining capability in the UK's submarine industry, we plan to watch this closely. (Paragraph 30)

6. The Department notes the Committee's comment. A 22-month construction drumbeat has been put in place for contracted boats (1–3), and assumed across the remainder of the planned Astute Class, in order to optimize resource utilization and maintain capability in the supply chain.

7. Value for money improvements to Boat 4 are already available from construction lessons on Boats 1–3, e.g. through the increased use of modularization and vertical outfitting. A formal MoD programme of work is also in place, jointly with key industry suppliers, to deliver unit and through-life cost reductions for Boat 4 and beyond through such areas as design improvement, specification challenge and collaborative working.

We note that the MoD is still working with BAE Systems and other companies in the aerospace sector to reach agreement on the appropriate size of the sector given current and future demand. (Paragraph 33)

8. The Department welcomes the Committee's interest in the fixed wing aircraft sector and the plans to explore with BAE Systems the viability of a Long Term Partnering Agreement (LTPA) to help sustain the key industrial skills and capabilities—wherever they may be in the supply chain—needed to support and upgrade the current and future aircraft fleet. On 1 March 2007, the Ministry of Defence signed a Foundation Contract with BAE Systems—a key step towards the delivery of a full and legally binding LTPA by the end of 2007. Specifically, the Foundation Contract is intended to help establish the key elements of the LTPA and inform the detailed negotiations ahead. It also incentivises BAE Systems to further transform its air sector business and the efficient delivery of the key through life defence industrial capabilities the Armed Forces require.

The Typhoon aircraft needs to be upgraded so that it can take on the ground attack role required in current operations. We support the MoD in its aim to improve the industrial structure of the Typhoon collaborative programme, so that the required upgrading of Typhoon aircraft can be undertaken as efficiently as possible and better value for money delivered across the whole Typhoon programme. (Paragraph 36)

9. The Department welcomes the support of the Committee to this initiative and are continuing negotiations with our collaborative partners and industry.

We welcome the MoD's decision to fund a four year UAV Technology Demonstrator Programme. UAVs have the potential to provide a new dimension to the force mix in the future. (Paragraph 38)

10. The Department agrees with the Committee's conclusion and would add that as well as informing future decisions on the mix of manned and unmanned aircraft, targeted investment in UAV TDPs such as TARANIS should also help sustain many of the aerospace engineering and design capabilities in UK industry that provide assurance of MoD's ability to operate and support our future fixed wing aircraft. This programme also provides UK industry with the opportunity to develop a competitive edge in a potentially lucrative military and civil market.

We welcome the formation of Team Complex Weapons which should help sustain key skills and capability within the UK. We look to the MoD to ensure that the required agreement in this area is concluded and signed early in 2007. (Paragraph 40)

11. The Department welcomes the Committee's continuing interest in the Complex Weapons sector. Work to develop a Strategic Partnering Agreement (SPA) with Team CW is making progress, with the overall construct and performance measures that will underpin an agreement being refined. Despite initial expectations that this work might conclude early this year, the complexity of an agreement with five separate companies means that final negotiations and, subsequently approvals, for both industry and the Government, will take longer than expected.

It is regrettable that the reshaping of the defence industry required by the Defence Industrial Strategy has resulted in job decreases in some sectors of the defence industry. However, a more streamlined defence industry will better match the MoD's current and future requirements and ensure that the industry remains competitive when bidding for overseas defence contracts. We note that the MoD, the Department for Trade and Industry, the Regional Development Agencies and the devolved agencies are working closely together to provide appropriate support to those areas affected by reductions in defence work. Value for money in defence procurement is important to the defence budget as well as to industry. (Paragraph 46)

12. The Department notes the Committee's concerns regarding job losses but welcomes the acceptance of the longer term aim of the DIS of a sustainable defence industry. The Department will continue to work with other Government Departments and agencies to provide the necessary support to those areas affected.

We consider it vital that the MoD and the defence industry continue to recruit and retain high quality staff, in particular, engineers, scientists and technicians, in this

period of change. Such staff are key to ensuring that the benefits of the DIS are delivered. We welcome the joint “team defence” initiative which has been launched to promote the opportunities in the defence industry. We look to the MoD and industry to continue to review career development opportunities to ensure that high quality staff in specialist areas are not lost. (Paragraph 48)

13. The Department welcomes this comment. The retention and upskilling of essential staff is a key tenet of the DIS.

We plan to examine in a future inquiry the MoD’s progress in implementing the recommendations of the Enabling Acquisition Change report and whether the expected improvements in equipment acquisition are delivered. (Paragraph 53)

14. The Department welcomes the Committee’s intention to examine the progress made in implementing the recommendations of the Enabling Acquisition Change Report and looks forward to assisting the committee with such an inquiry

Improving the skills of MoD staff, particularly commercial and technical skills, will be crucial to ensuring that the expected benefits from the DIS are delivered. The MoD is seeking to address skills gaps through training or external recruitment. The appointment of the first MoD Commercial Director is welcome, but he must be given the resources needed to develop the commercial skills of MoD staff. (Paragraph 56)

15. The Department welcomes the support provided by this report. A comprehensive programme to enhance commercial skills through training and promote increased professionalism is being implemented. Resources to deliver this are being identified.

We note the publication of the Defence Technology Strategy and the MoD’s initiatives to encourage innovation, such as the Competition of Ideas and the Grand Challenge. We are disappointed that the Strategy did not set out how much the MoD would be investing of its budget in defence research. We will be examining the funding of Defence Research and Technology in our forthcoming report on the work of the Defence Science and Technology Laboratory. (Paragraph 64)

16. The Department notes the Committee’s comments. The Defence Technology Strategy is not a costed balance of investment, and the next steps with our industrial partners will be to assess jointly the resources required to maintain priority national capabilities and ensure that our implementation plan to maintain them is jointly affordable. The Defence Technology Strategy will enable MoD and Industry to cooperatively plan their investment in research and development, rapidly bringing the benefits of advanced technology to the frontline.

The MoD has sought to improve its understanding of Small and Medium-size Enterprises and the supply chain, but its progress has been considered slow by one of the major defence trade associations. The MoD should continue to work closely with the defence trade associations, the Department of Trade and Industry, the Treasury, Regional Development Agencies, and the devolved agencies, to identify approaches to improve its understanding in this area further. This will be vital to the success of the DIS. Prime contractors also need to improve their understanding of supply chains and the key role of Small and Medium-size Enterprises. (Paragraph 68)

Small and Medium-size Enterprises are often the source of highly innovative ideas and products. In understanding supply chains, the MoD must improve its understanding of the contribution made by such companies and the impact if they disappeared from the supply chain. We look to the MoD to improve its understanding of the innovation provided by Small and Medium-size Enterprises and the investment they make in Research and Technology. (Paragraph 69)

17. The Department accepts these recommendations. SMEs have a critical part to play in delivering capability to our front line forces. Initiatives such as the competition of ideas aim to remove barriers to innovative ideas being exploited from both academia and SME. The Defence Suppliers Service provides information and guidance for new defence suppliers, and we organise a range of supplier days organised both directly and under the auspices of the Defence Manufacturers Association. The Department's latest research supplier day organised in conjunction with the RDAs was attended by 120 SMEs.

18. The Department expects all SMEs in the supply chain to be treated fairly and properly by MoD and its primes and is undertaking a review of whether the contracting processes discriminate against SMEs. While prime contracting will continue to play a major part in our commercial arrangements, there is more that the Department needs to do to ensure that the supply chain structures below primes are well structured, open and encourage innovation or competition. The Department welcomes the recent Supply Chain 21 initiative from the Society of British Aerospace Companies (SBAC) which aims to roll-out best practice at all levels in the supply chain.

Long-term partnering arrangements are a new approach for the MoD and require specialist skills in negotiating and letting the contracts for such arrangements, and for monitoring performance once contracts have been let. We look to the MoD to ensure that its staff who deal with long-term partnering arrangements have sufficient training in such arrangements, or recruit staff with the experience required. (Paragraph 73)

19. Although the Department has significant experience of negotiating complex, high value arrangements, the Long-Term Partnering Agreements do offer new challenges. The Department has set up dedicated teams, comprising experienced negotiators and, where appropriate, external specialists, whose sole responsibility is to negotiate and implement these arrangements. Lessons identified as each arrangement is let are passed on to the next teams to ensure best practice is followed and any pitfalls avoided. More importantly, prior to entering into any long term partnering arrangement, MoD and its industry counterparts are following a due diligence process akin to that seen for Private Finance Initiative to ensure that neither party is disadvantaged.

20. For the longer term, the Department is producing more detailed partnering guidance, in consultation with industry, to ensure wider commercial best practice is adopted, to explain to those involved in any partnering related activity, what is required, how best to approach negotiations and manage the relationship. In parallel, the Department will undertake a full review of what skills are required for these arrangements, carry out a skills gap analysis and provide appropriate training.

We consider that there would be real benefit in the MoD producing a document for industry which set out what partnering relationships should look like, and the

principles underpinning long-term partnering agreements. We look to the MoD to take this forward. (Paragraph 74)

21. The Department is producing a Partnering Handbook in consultation with industry that will set out how it will approach Partnering for the future. The Handbook, the first draft of which is currently out for comment with industry, will include sections on how Long-term partnering arrangements should be arranged, how the relationship should be managed and monitored for effectiveness, and recommend joint industry/MoD workshops to ensure that the best benefit for both parties is obtained.

Some long-term partnering arrangements will be let on a non-competitive basis as in some sectors, if the work is to be retained in the UK, there is no other supplier. There is, therefore, a risk that the MoD may not be contracting with the most efficient supplier and achieving best value for money. We consider it vital that the MoD build into such long-term partnering arrangements incentives which drive real efficiency into the supplier's organisation. This will be particularly important where the throughput of work for such arrangements may well reduce in the future. (Paragraph 78)

22. Value for money continues to be the key consideration in delivering the capability our Armed Forces expect. The Department will not enter into Long-Term Partnering Agreements unless they offer value for money to the taxpayer.

23. In headline terms, each long-term partnering arrangement requires the contractor/industry concerned to transform its business with the emphasis on year on year cost reduction. Put bluntly, if industry do not reduce the costs, sanctions involving reducing agreed payments, will be taken. Before each Long-Term Partnering Agreement is entered into, a robust analysis of the costs is undertaken between MoD and industry with incentives introduced to deliver value for money. At regular intervals, a joint analysis of the cost basis will be undertaken and if value for money is not being achieved, action will be taken to address the matter and alternative arrangements considered.

We note that it is possible to have competition for the work underlying long-term partnering arrangements and that the MoD has introduced measures to encourage this. We consider it important that Small and Medium-size Enterprises are provided with an opportunity to compete for such work and look to the MoD to ensure such opportunities are provided. (Paragraph 79)

24. Maintaining and introducing competition below the prime contractor level is a key Departmental policy. Existing contracting processes require industry to demonstrate that it has maximised the opportunities for competition below the prime level by the provision of a Make or Buy Plan. If a contractor seeks to change the Make or Buy plan it must seek Departmental agreement.

25. In parallel, the Department is working with industry to look at ways of increasing the level of and nature of access by SMEs to the Defence Supply Network through better understanding of where SMEs provide added value and widening the scope of advertising Defence procurement opportunities by both the Department—for direct contracts, and by Prime Contracts for sub-contracts. There is also ongoing consideration of how to best actively manage the joint Departmental and Industry Codes of Conduct so as to enable an

accurate assessment of the quality of the management of relationships within the supply network and how these compare to the common principles enshrined in the codes.

We welcome the signature of the Memorandum of Understanding covering production, sustainment and follow-on development on the Joint Strike Fighter programme, and congratulate the Minister for Defence Procurement and his staff on its achievement. Because of the MoD's unwillingness to provide us with the supplement to the Memorandum of Understanding, we can only report that the Minister for Defence Procurement has assured us that the UK will get all the technology transfer it requires to operate the Joint Strike Fighter independently. While we are of course pleased to hear this, we continue to have concerns about how things will work out. In particular, we will wish to probe how robust the Memorandum of Understanding will prove in practice and will seek an early opportunity to take oral evidence on this. UK industry also needs to know to what extent it will have access to the technology transferred under the Memorandum of Understanding agreement and its unpublished supplement. These are matters that we will monitor closely. (Paragraph 86)

26. The Department notes the Committee's concerns about the robustness of the Memorandum of Understanding and their desire to take evidence on this.

27. In regard to the extent that UK industry will have access to technology transferred under the MOU, the Department has received the necessary assurances from US with regards to information access, in order to operate, maintain, upgrade and repair JSF, thus ensuring UK Operational Sovereignty can be achieved. The Department intends to monitor progress with the US very closely before committing to purchase aircraft.

The Minister for Defence Procurement assured us that the US Administration was still committed to the JSF programme and specifically the STOVL variant of the JSF which the UK is procuring. We expect the MoD to keep a close watch on any possible changes to the US JSF programme given the potential impact on the UK JSF programme. (Paragraph 87)

28. The Department will continue to closely monitor the US STOVL requirements and the performance of the STOVL variant.

There is an initiative underway to create an overarching agreement with the US on the issue of technology transfer. We recommend that the UK Government attach the highest priority to achieving this aim, as a concrete embodiment of the relationship which the UK enjoys with the US. This is needed to ensure that separate negotiations do not have to take place for each future equipment programme and it should lead to quicker decision-making on the specific technology transfers for future programmes. We look to the MoD to ensure that the overarching agreement covers industry to industry technology transfer as well as Government to Government technology transfer, and clarifies the position of UK companies with subsidiaries within the USA. (Paragraph 89)

29. An outline agreement has now been signed between the Ministry of Defence and the US Department of Defense to initiate and facilitate discussions on export control and technology sharing which will cover Government and industry-related issues and aim to

increase transparency, timeliness, and predictability through mutually determined business process improvements.

The MoD is finalising new arrangements for the supply of munitions after the former Royal Ordnance Factory sites at Bridgwater and Chorley close. It is confident that these arrangements will provide security of supply in this critical area. (Paragraph 92)

30. Regarding the site rationalisation of the former Royal Ordnance Factory sites at Bridgwater and Chorley, BAES LS remain responsible for successful transition to the new arrangements and continue to implement robust contracts to manage their suppliers. The company maintain their assurance that they will not close their sites until the new supply chain arrangements are sufficiently mature and until we have confirmed that we are content. The Department has formed a joint project team with the company to oversee the transfers and verify that they are taking every reasonable step to guarantee supply to our armed forces

Work on how best to sustain the required access to general munitions is ongoing. We look to the MoD to complete this work and commit the required investment by the end of 2007 as planned. (Paragraph 93)

31. The project (Project MASS) looking at the secure sustainable supply of general munitions is ongoing. It is charged with delivering a value for money solution.

It is important that the MoD, working with the defence industry, ensure that the assumptions and proposals in the DIS remain relevant. We note that the MoD plans to review the DIS at the end of 2007, two years after it was published. As the DIS is the Government's Strategy, we also look to other Government bodies, particularly the Department of Trade and Industry and the Treasury, to review the DIS to ensure it remains relevant. (Paragraph 95)

32. The Department accepts this recommendation.

The Minister for Defence Procurement is confident that the changes being introduced will be permanent, but this remains to be seen. We look to the MoD to ensure that the changes being implemented as a result of the DIS are fully embedded so that they deliver the expected benefits. (Paragraph 98)

33. The Department accepts this recommendation. Implementation of the DIS and the subsequent Defence Acquisition Change Programme (DACP) is proceeding apace throughout the department with many of the recommendations already implemented across the MoD. The most obvious examples of this are the creation of the Defence Commercial Director post and the merger of the DPA and DLO to form the new DE&S from 2 April 2007.

The MoD estimates that the costs of implementing the DIS in 2006–07 and 2007–08 will total just over £50 million. However, these costs only cover the MoD internal costs, and do not include the costs which will be incurred in the move away from competitive procurement in many areas, and from sustaining technological and industrial capabilities in the UK. We look to the MoD to estimate the overall costs of implementing the Defence Industrial Strategy. (Paragraph 103)

The DIS has, in the MoD's own words, the potential for "major pay-off". However, to realise the pay-off, the required funding must be made available to fund the future equipment programme. We would consider it a real missed opportunity if adequate funding for the MoD to realise the full benefits of the DIS were not provided. We plan to take a close interest in the outcome of the Comprehensive Spending Review. (Paragraph 104)

34. The Department has now put in place robust mechanisms to ensure that the costs of retaining critical capabilities in industry are considered during each planning round. This will be reviewed as part of Planning Round 2008, and where necessary will expose and review the premium associated with the maintenance of industrial capabilities which are key to our operational sovereignty. Nevertheless, the DIS is expected to deliver improvements in long term value for money, and this is also expected to be a key element of the Long Term Partnering Arrangements being put in place in each sector to drive industrial efficiency and performance improvement.

The MoD plans to assess whether the DIS is delivering the expected benefits by asking the Armed Forces, the defence industry and MoD staff whether they can see improvements or a changes in the processes. We welcome such an approach and look to the MoD to ensure that this is undertaken on a regular basis and represents a representative cross-section of different ranks, grades and company sizes. However, we also expect the MoD to continue to measure its performance in procuring equipment to cost, time and quality and to develop metrics to measure its success in managing equipment on a through-life basis. (Paragraph 106)

35. The Department accepts this recommendation and is developing measures that will allow this monitoring to take place.

We plan to continue to monitor the progress in implementing the DIS and whether the expected benefits are delivered, and will use the MoD's checklist for 2007 as the basis for doing this. (Paragraph 107)

36. We welcome the Committee's continued involvement and look forward to briefing again in the future.