House of Commons
Committee of Public Accounts

The privatisation of QinetiQ

Twenty–fourth Report of Session 2007–08

Report, together with formal minutes, oral and written evidence

Ordered by The House of Commons to be printed 12 May 2008

HC 151
Published on 10 June 2008
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Committee of Public Accounts

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Mr John Healey MP (*Labour, Wentworth*).

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Summary

QinetiQ was created out of the Defence Evaluation and Research Agency (DERA) in 2001 as a means of addressing the declining defence research budget, which threatened DERA's ability to maintain its capability. As well as carrying out research for the Ministry of Defence (the Department), QinetiQ advises the Department on the procurement of equipment and manages the testing and evaluation of this equipment.

QinetiQ was privatised in two stages: the sale of a minority stake in the business to the private equity firm the Carlyle Group (Carlyle) in 2003; and a flotation on the London Stock Exchange in 2006. The Department conducted the flotation well in a strong market and used the experience and expertise of the Shareholder Executive to good effect. There were however weaknesses in the 2003 sale process, and the National Audit Office have estimated that the taxpayer could have received £90 million more from the privatisation.

The Department began the competition for a strategic partner when market conditions were poor and before the terms of QinetiQ's most significant contract had been agreed. It also eliminated the only trade bidder at a very early stage. These decisions weakened the competitive process for selecting a strategic partner, and Carlyle negotiated a £55 million reduction in the value of the business after they had been appointed preferred bidder. The Department nevertheless agreed to sell Carlyle 2.5% more of QinetiQ than they had specified in their bid.

The Department failed to manage specific risks relating to the management incentive scheme established as part of the privatisation. The Department relied on Carlyle to design the incentive scheme but did not put safeguards in place to protect its interests, nor did it take specific professional advice. QinetiQ's management were consequently able to influence the design of their incentives before Carlyle were appointed preferred bidder. At the date of the flotation the top 10 managers held shares worth £107 million for an investment of just £540,000.

The privatisation of QinetiQ was successful in protecting the viability of a business of strategic importance to UK defence interests. QinetiQ has balanced the decline in the research budget with revenue from other sources and has successfully expanded into the US defence market. There are, however, risks to the long-term value for money of the privatisation arising from the Department's ongoing relationship with QinetiQ. The Department envisaged that the privatisation would deliver reduced prices and improved services and will need to develop robust benchmarks to ensure it realises this aspiration. The firewalls intended to protect the independence of QinetiQ's advice require active monitoring to ensure they are operating effectively.

On the basis of a report by the Comptroller and Auditor General,[1] the Committee examined the Ministry of Defence, Shareholder Executive and the Chairman of QinetiQ on the process by which QinetiQ had been privatised and the lessons that can be learned for future privatisations.

1 C&AG's Report, *The privatisation of QinetiQ*, HC (2007–2008) 52

Conclusions and Recommendations

1. **The budget for defence research fell by 40% in real terms between 1992 and 1998, limiting the ability of the Defence Evaluation and Research Agency to maintain the breadth of its expertise**. QinetiQ has been successful at finding new sources of revenue to balance the decline in research spending and has increased its turnover by 48% since 2003.

2. **The restrictions that prevented QinetiQ from engaging in defence manufacturing contracts were lifted in April 2008**. If QinetiQ is successful in winning more contracts to supply the Department there will be greater scope for conflicts with its important role of advising the Department on the procurement of equipment. The Department needs to actively manage the operation of the Compliance Regime to protect the independence of QinetiQ's advice, which is critical to UK defence interests.

3. **The sale to Carlyle was conducted in 2002, when market conditions were poor and before the future of QinetiQ's most significant long term contract, accounting for about a third of QinetiQ's revenue, had been agreed**. The Treasury had agreed to credit the Department's budget with £250 million if the sale was completed before 31 March 2003. The Treasury should avoid creating incentives to press ahead with privatisations when conditions are unlikely to maximise longer-term value to the taxpayer.

4. **The Department negotiated the terms of QinetiQ's most significant contract, the Long Term Partnering Agreement, at the same time as conducting the sale of part of the business.** Bidders would have been unable to place an accurate value on QinetiQ and Carlyle were subsequently able to negotiate a reduction in the value they ascribed to the business. Departments should settle the terms of significant contracts before entering negotiations to privatise public sector businesses.

5. **The Department weakened the competition by eliminating bidders at an early stage in the process, including the only trade bidder.** It also appointed a preferred bidder with major price sensitive issues outstanding, turning a competitive process into one of negotiation. Departments should maintain competition until significant price sensitive issues have been resolved.

6. **The Department executed the flotation well, assisted by the involvement of the Shareholder Executive.** The Shareholder Executive provided valuable experience and expertise, which helped protect the Department's interests where these were not aligned with those of Carlyle and QinetiQ. Departments should take advantage of the available expertise by involving the Shareholder Executive in future privatisations.

7. **QinetiQ senior management received £200 for each £1 they invested whilst the taxpayer received just £9**. QinetiQ management negotiated their own incentive arrangements before Carlyle were appointed preferred bidder, without making the Department aware of this serious conflict of interest. Such profiteering at the expense of the taxpayer is not something this Committee would expect from former public

servants. In future privatisations Departments should prevent management from having discussions on incentivisation with investors until a preferred bidder has been appointed and the basic structure of the incentive scheme agreed.

8. **Sir John Chisholm, the then chief executive, was allowed to propose the allocation of shares to senior QinetiQ management without the oversight of the remuneration committee**. The Combined Code on Corporate Governance, which QinetiQ committed to follow, prohibits directors from being involved in deciding their own remuneration. Departments should ensure that directors in any company to be privatised are not able to propose their own incentives without independent oversight.

9. **In relying on Carlyle to develop the management incentive scheme the Department failed to protect its interests.** The resulting scheme gave management returns far in excess of what was necessary to incentivise them. Specialist advice could have explored ways of limiting returns to management, for example capping returns or stripping out the impact of favourable market movements on the growth in value of the company. Departments should seek appropriate advice on restricting returns under incentive schemes.

10. **The Department allowed QinetiQ to reimburse Carlyle's bid costs without validating them.** It is well precedented for the acquired company to refund the successful bidder's costs in private equity transactions where the whole business is sold, but in this case the Department retained a majority of the shares, and it had also made clear to all bidders that such costs would not be reimbursed. The Department should require bidders to meet costs which are their responsibility; and where they are not, it should validate costs before meeting them.

11. **The Department could have received £90 million more than it did from the privatisation.** It sold Carlyle 2.5% more of QinetiQ than they had asked for in their bid, allowed management to influence the design of their own incentives to the detriment of the taxpayer and did not consider excluding the impact of the improvement in the general market from the returns management received.

12. **The Department successfully ensured that the taxpayer benefited from the growth in the value of the business by initially selling only a minority of shares, in recognition that it was unlikely to maximise proceeds in the prevailing market conditions.** This approach was in line with earlier recommendations from this Committee. The strategy of bringing in a strategic partner to develop the business in advance of a flotation had some benefits and Department's should consider repeating this in future privatisations.

1 Risks to the Ministry of Defence

1. The Defence Evaluation and Research Agency (DERA) had the role of supporting effective procurement of military equipment by providing the Ministry of Defence (the Department) with independent advice and carrying out research to support the development of advanced technology. It also managed the testing and evaluation of military equipment.[2] The decision to part privatise DERA was taken in 1998 as a means of addressing the impact that declining defence research budgets would have on the business. Over the period 1992 to 1998 the budget for defence research had fallen by 40% in real terms.[3]

2. QinetiQ was created by dividing DERA into two organisations in 2001. The most sensitive aspects of DERA's work were kept in the public sector by transferring them to the Defence Science and Technology Laboratory. The remainder of DERA, including the responsibility for delivering test and evaluation services, was transferred to a Government owned private company, QinetiQ, and privatised in two stages: the sale of a minority stake to a strategic partner in 2002 and the flotation of the business on the London Stock Exchange in 2006.

3. The privatisation has been successful in protecting the viability of the business.[4] Since the privatisation, QinetiQ has found new sources of revenue to balance the fall in the defence research budget, which between 2001 and 2005 fell by 10% in real terms.[5] Revenue has grown by 48% between 2003 and 2007, as shown in **Figure 1,** and operating profit has increased by 197% over the same period. The business has expanded its presence in the US defence market by acquiring a number of US companies,[6] and in the six months to September 2007 it derived over 40% of its revenue from the US.

4. Significant risks to value for money remain over the long term.[7] One of the Department's objectives in part privatising DERA was to deliver reduced contract prices, enhanced flexibility and improved services. It is not yet clear whether these aspirations have been achieved. There is a particular risk associated with the price of the 25 year Long Term Partnering Agreement, which is renegotiated every five years to agree a minimum step down in price. No other suppliers are able to deliver the services under the contract and the Department will need to develop robust benchmarks to ensure it realises the envisaged costs savings.[8]

2 C&AG's Report, para 1.1

3 House of Commons Defence Select Committee, Sixth Report, Session 1997–98, *The Defence Evaluation and Research Agency*, HC 621, 6 July 1998

4 Qq 39–40, 239

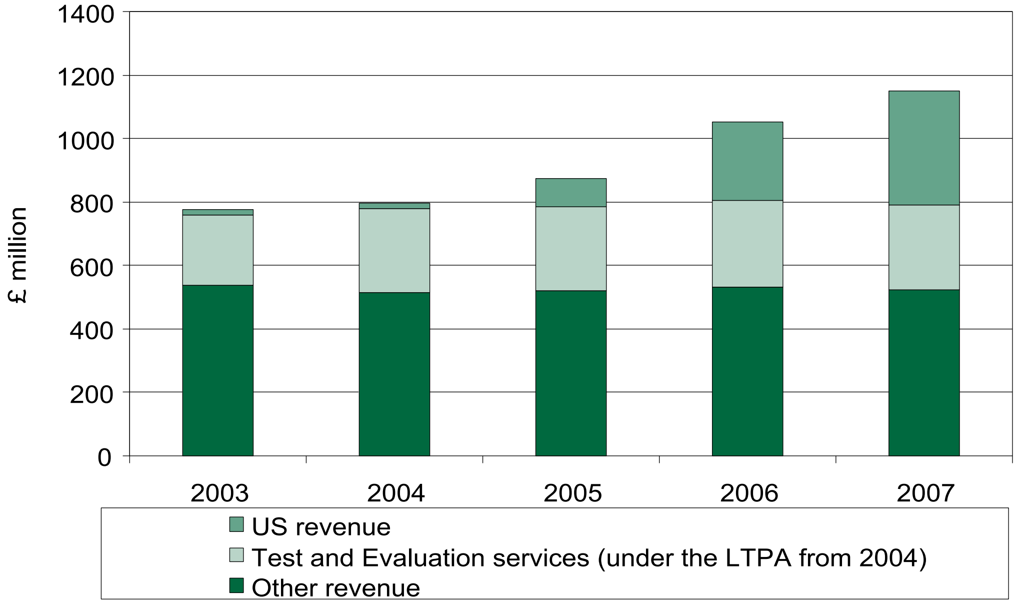
5 Using Retail Prices Index

6 C&AG's Report, para 3.2

7 Q 43

8 Qq 113, 243

Figure 1: Growth in QinetiQ's revenue



Source: QinetiQ Annual Report and Accounts 2003–07 and IPO Prospectus

5. QinetiQ is still responsible for the provision of independent advice to the Department on the effective procurement of equipment. As QinetiQ is increasingly a supplier to the Department, conflicts of interest may arise when QinetiQ is required to give independent advice on equipment that it is also supplying. In creating QinetiQ the Department established the Compliance Regime whereby QinetiQ is required to inform the Department of any potential conflicts of interest and, where necessary, to establish a firewall between the teams that are providing independent advice and those that are directly supplying the Department.[9]

6. At present there are restrictions in place that prevent QinetiQ from engaging in defence manufacturing work. These restrictions will be lifted from April 2008, potentially increasing the number and severity of any conflicts of interest and the number of firewalls in operation.[10] The Department is confident that the Compliance Regime is working effectively but has acknowledged that it will require careful monitoring.[11] It asked its Internal Auditors to audit the effectiveness of the Compliance Regime process and its application in September 2006.

9 C&AG's Report, para 1.24

10 C&AG's Report, para 4.5

11 Qq 114, 245

2 Conduct of the Privatisation

7. In 1997 DERA proposed a range of options for addressing the risks that declining research spending posed to the business. DERA management recommended either franchising DERA's work to academic laboratories or bringing in private investment through part privatising the business. They pointed out that only the part privatisation option would generate significant proceeds[12] but did not highlight the potential for management to receive financial incentives as a consequence of private investment in the business.[13] The Department accepted DERA's recommendation without independent validation despite this potential conflict of interest.[14]

8. The decision to sell a stake in the business to a strategic partner was taken in early 2002 when the market for technology stocks was poor. QinetiQ had only been trading for six months and it was unclear how it would fare in the private sector. Although the Department had decided that QinetiQ would provide test and evaluation services under a long-term contract,[15] the terms of this contract had not been agreed.[16] At that time the test and evaluation work accounted for approximately one third of QinetiQ's revenue.[17] Sir John Egan, the then Chairman, believed that the poor market offered an opportunity to develop QinetiQ in the public sector, thereby realising more value for the taxpayer.[18] By instead deciding to sell a stake in QinetiQ at a difficult time the Department created the potential for Carlyle to profit from the recovery of the market.[19]

9. The 1999–2002 Comprehensive Spending Review assumed that the part privatisation of DERA would be completed by 31 March 2002 and would generate £250 million for the defence budget; any money raised in excess of this would be returned to the exchequer. The Treasury agreed to credit the Department's 2002 budget settlement with the £250 million receipt as long as the sale was completed before 31 March 2003.[20] This arrangement created pressure to complete the sale to a strategic partner.[21] The sale was eventually completed on the same day the Long Term Partnering Agreement was signed, 28 February 2003.[22]

10. The Department began the formal sale process on 8 March 2002. It received 16 expressions of interest from potential strategic partners only one of which came from a trade bidder, SERCO.[23] QinetiQ management strongly objected to trade bidders and the

12 C&AG's Report, para 1.3

13 Qq 16–17, 181

14 C&AG's Report, para 1.4

15 This was to become the Long Term Partnering Agreement

16 Qq 6, 45

17 C&AG's Report, Figure 4

18 C&AG's Report, para 2.2

19 Q 2

20 C&AG's Report, paras 1.6, 1.7

21 Qq 5, 73

22 C&AG's Report, para 2.25

23 C&AG's Report, para 2.6

Department rejected SERCO's expression of interest on the grounds that their proposal was weaker than the other potential partners. The 12 bidders that were taken forward were all private equity firms.[24] The Department weakened the competition by rejecting SERCO's proposal at this early stage when it would have been helpful to keep a different type of bidder in the process.[25]

11. Carlyle were appointed preferred bidder on 4 September 2002 when there were still two major price sensitive issues outstanding. The Long Term Partnering Agreement was still being negotiated and the treatment of QinetiQ's significant pension deficit had not been resolved. The Department did not attempt to negotiate the treatment of the pension deficit during the competition.[26] Appointing Carlyle preferred bidder with these issues outstanding allowed them to negotiate a £55 million reduction in their valuation of QinetiQ.[27]

12. The Department nevertheless conducted the subsequent flotation well[28] and achieved a higher price than QinetiQ's shares have been trading at for most of the time since then.[29] The interests of Carlyle, QinetiQ management and the Department were all aligned in respect of maximising the share price but the Department had additional objectives, such as protecting UK defence interests and guarding against an overdependence on QinetiQ.[30] The Shareholder Executive, established in 2003, supported the Department throughout the flotation and ensured that the Department's interests were protected.[31]

24 C&AG's Report, para 2.7

25 Qq 23, 168

26 Q 103

27 Qq 6–7, 67, 99, 190

28 Qq 170, 240

29 C&AG's Report, Figure 14

30 C&AG's Report, paras 3.5–3.8

31 Q 13

3 Management of Incentive Schemes

13. Share schemes to incentivise senior management are a common feature of private equity deals. They are intended to align the interests of management with those of the investor, which are generally to maximise the growth in the value of equity in the short to medium term. Such incentive schemes are often structured with ratchets that amplify the returns of key individuals when certain performance targets are met.[32] In the case of QinetiQ the Department specified that any incentive scheme should encompass all QinetiQ staff.[33]

14. QinetiQ senior management were heavily involved in the design of the incentive scheme. In their bid Carlyle initially proposed to set aside 10% of QinetiQ's equity for management and staff. In evaluating the bid Sir John Chisholm wrote to the Department setting out his view that the proportion of equity Carlyle were offering to incentivise management was low and that he wanted the scheme to offer higher rewards for exceptional performance. QinetiQ management held discussions on the incentive scheme with Carlyle before they were appointed preferred bidder.[34] The Department failed to put in place any safeguards to manage this serious conflict of interest.[35] Following the discussions between QinetiQ management, Carlyle submitted a revised bid. The revised incentive scheme set aside 20% of QinetiQ's equity to management and staff. It encompassed all QinetiQ staff but offered the prospect of much greater returns to the top 245 managers, and especially to the top 10.[36]

15. If the Department had restricted the proportion of QinetiQ's equity made available to staff to 10% it could have realised additional proceeds of £76 million. This figure assumes that the incentive scheme would have been structured in the same way but that each group of staff would have received half the number of shares that they in fact did. **Figure 2** shows the impact that this change would have had on the value received by each class of shareholder at the flotation.

16. The top 10 and top 245 managers were selected by Sir John Chisholm based on his views on which members of staff were critical to the success of the business.[37] He also proposed the number of shares each of the senior managers would be able to purchase under the scheme, including the level of his own investment. Although the Department did subsequently approve the scheme it did not seek to involve the remuneration committee in the allocation of shares to management and staff.[38] The Combined Code on Corporate Governance[39] prohibits Directors from being involved in deciding their own remuneration.

32 C&AG's Report, para 2.14

33 C&AG's Report, para 2.15

34 Qq 8, 30–33, 82, 139, 248–259

35 Qq 116, 182

36 Qq 19, 139

37 Qq 128–130, 148

38 Q 57

39 *Combined Code - Principles of good governance and code of best practice*, May 2000, Schedule B.2

Figure 2: Shareholder returns at the flotation if management and staff had been allocated 10% of the equity

Shareholder	Total investment (£ million)	Value of shares at flotation (£ million)	Difference in value of shares compared to actual deal (£ million)
Top 10	0.27	53.7	(53.7)
Top 245	0.23	32.6	(32.6)
Co-investment scheme	2.32	20.5	(20.5)
The Department	82.83	765.9	76.0
Carlyle	44.79	417.3	43.1
Share options	Free	12.3	(12.3)

Source: National Audit Office analysis

17. The Department relied on Carlyle to design the management incentive scheme as it believed they were best placed to do so.[40] It did, however, approve the final structure of the scheme based on limited modelling of the potential outcomes. The Department did not seek any specialist advice on the design of the incentive scheme,[41] despite assuring the Defence Select Committee that it would pay close attention to the risk of managers making large amounts of money from the privatisation.[42] It did not consider the possibility of capping returns or of structuring the scheme to ensure management were not rewarded for a general upturn in market conditions.[43]

18. Between the 2003 sale to Carlyle and the 2006 flotation the market improved by 80%.[44] If the Department had structured the incentive scheme so that the returns of management were not influenced by the improvement in the market it could have realised additional proceeds of up to £9 million assuming that the impact of market growth was clawed back from the returns of the top 10 and top 245 managers and redistributed to the other shareholders proportionally to the size of their shareholdings.[45] **Figure 3** shows the value of the shares of all classes of shareholder under these assumptions.

19. The top 10 managers invested £537,000 of their own money in the management incentive scheme. At the flotation these 10 individuals owned shares worth £107 million, 200 times their investment. The top 245 owned shares worth £65 million at the flotation from an investment of £450,000.[46] The scale of these returns was far in excess of those received by the Department, Carlyle and QinetiQ staff who invested in the co-investment scheme: they all owned shares worth only nine times their investment.[47] Although the senior managers stood to lose their investment if the equity value of QinetiQ did not

40 Qq 8–10, 59–60

41 Qq 68, 71, 86–87

42 Q 7, Minutes of evidence, *The Future of DERA*, May 2000

43 Qq 82, 106–108

44 Relevant market indices have been used to calculate the improvement in the market. Indices used are: FTSE Techmark 100, FTSE 350 A&D, SPADE, S&P A&D, S&P 1500 tech hardware, NASDAQ, S&P 500 tech hardware, DJUS technology, DJUS, technology software and S&P systems software.

45 Q 106

46 C&AG's Report, Figure 19

47 Q 19

increase by 1.2 times before a flotation,[48] over 87% of the senior managers opted to take part in the scheme. QinetiQ had talented staff, a strong history and was in the process of negotiating a 25-year contract that was predicted to provide revenue of £5.6 billion over its life.[49]

Figure 3: Shareholder returns at the flotation if market growth had been stripped out of senior management returns

Shareholder	Total investment (£ million)	Value of shares at flotation (£ million)	Difference in value of shares compared to actual deal (£ million)
Top 10	0.54	98.3	(9.2)
Top 245	0.45	59.7	(5.6)
Co-investment scheme	4.63	41.6	0.6
The Department	78.12	699.1	9.2
Carlyle	42.25	379.2	5.0
Share options	Free	24.7	-

Source: National Audit Office analysis

48 Qq 150, 166

49 Qq 12, 20, 41–42

4 Managing the Sale Process

20. Private equity transactions are complex, creating risks for Government Departments to manage. Private equity firms are adept at negotiating and are strongly incentivised to pay the lowest possible price for their investment.[50] Government departments require the right skills to handle these negotiations.[51] The Shareholder Executive was not formed until after the sale to Carlyle had been completed but will be able to advise departments in future deals.

21. Carlyle's final bid placed an enterprise value of £374 million on QinetiQ but contained significant conditionality. In particular it made assumptions about the value of the Long Term Partnering Agreement, which had not been agreed at that time. It was also subject to the amount of debt in the business, including the pension fund deficit. Neither of these price sensitive factors were settled before Carlyle were appointed preferred bidder, which enabled them to negotiate a reduction of £55 million in the value they placed on QinetiQ.[52]

22. QinetiQ had a projected pension fund deficit at the time of the flotation. The Government Actuary's Department had advised that the deficit could be estimated in the range £0–£70 million. Carlyle negotiated an immediate reduction in the value they placed on QinetiQ of £25 million in respect of QinetiQ's pension fund deficit. The Department also committed to pay £45 million into QinetiQ's pension fund if the deficit remained at the time of the flotation.[53] This negotiation took place after Carlyle had been appointed preferred bidder and other bidders were not asked how they would value and treat the pension scheme deficit.[54]

23. In describing the Long Term Partnering Agreement to bidders the Department made clear that it incorporated two strands of revenue: revenue to maintain and improve test and evaluation facilities and revenue for the provision of individual tests.[55] Carlyle negotiated a £30 million reduction in the value they placed on QinetiQ citing a fall in the value of the Long Term Partnering Agreement but did not include the significant value attached to the revenue relating to individual tests in their calculations.[56] At the time of the sale to Carlyle this revenue was predicted to be between £50 million and £60 million a year but in 2007 it amounted to £94 million.[57]

24. The Department had asked potential strategic partners to bid on the basis of purchasing 35% of the business.[58] During negotiations with Carlyle, however, the Department agreed to sell an additional 2.5% of QinetiQ. It received £3 million proceeds

50 Q 98

51 Qq 15, 95

52 C&AG's Report, para 2.25

53 C&AG's Report, para 2.29

54 Qq 99–104

55 C&AG's Report, para 2.27

56 Q 260

57 QinetiQ Annual Report and Accounts 2007

58 C&AG's Report, para 2.11

for this additional equity, which was eventually worth £27 million at the time of the 2006 flotation.[59] The Department could therefore have received £24 million more from the privatisation by adhering to the terms of Carlyle's bid. This calculation assumes that the equity offered to staff under the co-investment scheme comes entirely out of the 35% of equity sold, which is consistent with the deal agreed. **Figure 4** shows the value each shareholder would have received at the flotation if the Department had sold 35% of QinetiQ.

Figure 4: Shareholder returns at the flotation if the Department sold 35% of QinetiQ

Shareholder	Total investment (£ million)	Value of shares at flotation (£ million)	Difference in value of shares compared to actual del (£ million)
Top 10	0.54	107.5	-
Top 245	0.45	65.3	-
Co-investment scheme	4.63	41.0	-
The Department	81.24	717.5	27.6[60]
Carlyle	39.13	346.5	(27.6)
Share options	Free	24.7	-

Source: National Audit Office analysis

25. At the completion of the deal Carlyle's bid costs of £16 million were fully reimbursed by QinetiQ. This practice is common in private equity deals where the private equity firm is buying 100% of the business. In the QinetiQ privatisation the Department retained a majority stake in the business and therefore suffered a fall in the value of its investment when QinetiQ reimbursed Carlyle. The Department had made clear to all bidders that bid costs would not be reimbursed. It did not verify or validate any of these costs.[61]

26. The privatisation has to date generated £576 million in proceeds for the taxpayer, net of costs. The Department still holds a 19.3% shareholding in the business worth £227 million as at 17 December 2007.[62] Although this is a significant amount of money, the Department could have generated more from the privatisation. Carlyle's bid was for the purchase of 35% of the business and originally offered management and staff 10% of the equity. By not selling Carlyle the additional 2.5% of the business, restricting the proportion of equity available to management and staff to 10% and then stripping out the impact of the improvement in the market from the returns of senior management the Department's shares would have been worth £96 million more than under the actual deal. The Department would have received £3 million less from the sale by selling only 35% and would therefore have received £93 million more.[63] The impact of these changes on the value each shareholder received at the flotation is shown in **Figure 5**.

59 Q 81

60 The value of the Department's shares in figure 4 is £27 million higher than under the agreed deal but it would have received £3 million less in proceeds from the sale.

61 Qq 36, 80, 119

62 C&AG's Report, para 1

63 This figure is not the sum of the extra proceeds generated under the three scenarios in figures 2, 3 and 4 due to interactions between the assumptions.

Figure 5: The Department could have received £93 million more from the privatisation

Shareholder	Total investment (£ million)	Value of shares at flotation (£ million)	Difference in value of shares compared to actual deal (£ million)
Top 10	0.27	49.2	(58.3)
Top 245	0.23	29.9	(35.4)
Co-investment scheme	2.32	20.5	(20.5)
The Department	84.34	786.5	96.6
Carlyle	43.28	404.1	29.9
Share options	Free	12.3	(12.3)

Source: National Audit Office analysis

Formal Minutes

Monday 12 May 2008

Members present:

Mr Edward Leigh, in the Chair

Mr David Curry
Dr John Pugh
Mr Don Touhig

Draft Report (*The privatisation of QinetiQ)* proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 26 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Twenty-fourth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 14 May 2008 at 3.30 pm.

Witnesses

List of written evidence

List of Reports from the Committee of Public Accounts 2007–08

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Third Report	Building for the future: Sustainable construction and refurbishment on the government estate	HC 174 (Cm 7323)
Fourth Report	Environment Agency: Building and maintaining river and coastal flood defences in England	HC 175 (Cm 7323)
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Fourteenth Report	The budget for the London 2012 Olympic and Paralympic Games	HC 85
Fifteenth Report	The Pensions Regulator: Progress in establishing its new regulatory arrangements	HC 122
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Twentieth Report	HM Revenue & Customs: Helping individuals understand and complete their tax forms	HC 47
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Twenty-fourth Report	The privatisation of QinetiQ	HC 151

Oral evidence

Taken before the Committee of Public Accounts

on Monday 3 December 2007

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon	Dr John Pugh
Angela Browning	Geraldine Smith
Mr David Curry	Mr Don Touhig
Mr Ian Davidson	Mr Alan Williams
Nigel Griffiths	Phil Wilson
Mr Austin Mitchell	

Sir John Bourn KCB, Comptroller and Auditor General, **Mr Tim Burr**, Deputy Comptroller and Auditor General, and **Ms Patricia Leahy**, Director for Private Finance, National Audit Office, were in attendance and gave evidence.

Ms Paula Diggle, Treasury Officer of Accounts, and **Mr Jeremy Pocklington**, Treasury Official, HM Treasury, were in attendance and gave evidence.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

THE PRIVATISATION OF QINETIQ (HC 52)

Witnesses: **Mr Bill Jeffrey CB**, Permanent Secretary and **Mr Trevor Woolley CB**, Finance Director, Ministry of Defence; **Mr Peter Schofield**, Director, Shareholder Executive; and **Sir John Chisholm**, Chairman, QinetiQ, gave evidence.

Q1 Chairman: Good afternoon. Today we are looking at the Comptroller and Auditor General's Report into *The Privatisation of QinetiQ*. We welcome back to our Committee Mr Bill Jeffrey, who is the Permanent Under Secretary of the Ministry of Defence, and Peter Schofield, who is the Director from the Shareholder Executive, and also Sir John Chisholm from QinetiQ. Perhaps you might introduce your other colleague.
Mr Jeffrey: My other colleague is Trevor Woolley who is the Finance Director at the Ministry of Defence.

Q2 Chairman: Thank you very much. Perhaps we could start, Mr Jeffrey, by looking at paragraph 2.2 of Sir John's Report, which tells us that Sir John Egan, QinetiQ's chairman at the time: "told us that the poor markets presented an opportunity to get the business in shape ahead of privatisation and could not see what value could be added by private equity houses or the trader partners who were likely to bid." That leads me, Mr Jeffrey, to ask why did you not take up Sir John's advice at the time. Why did you not get this business into shape in the public sector first rather than selling a stake in QinetiQ in 2003? If you had got it into shape in the public sector first and then privatised it you might have avoided Carlyle profiteering at the expense of the taxpayer.
Mr Jeffrey: I think it is matter of judgment, Chairman. The judgment the Department reached at the time, which the NAO endorses, was that it was not right to go straight to flotation.

Q3 Chairman: Why not?
Mr Jeffrey: Because at the time the market and the market's knowledge of DERA, as it then was,—

Q4 Chairman: I was not suggesting it should have gone straight to flotation, what I said was why did you not take up Sir John's advice to get the business in shape in the public sector.
Mr Jeffrey: The judgment at the time was that it was unlikely to achieve that within the public sector and the best way to grow the value of the business was to introduce a strategic partner from the private sector. The result in terms of the benefits to the taxpayer a few years later, I would argue, tend to vindicate that judgment.

Q5 Chairman: We can certainly accept for the sake of this hearing that the taxpayer did make a profit. I think the purpose of this hearing is to establish whether the taxpayer could have made much more of a profit. We will go on pursuing this, we have got all afternoon. Let us now look at paragraph 1.7 which tells us that: "The inclusion of a £250 million receipt in the 1999-2002 Comprehensive Spending Review had the potential to create pressure for the PPP to be completed by the end of the financial year in March 2002." How did this Treasury earmarked £250 million affect the timetable? I suspect that this may have pressurised you into rushing the sale.
Mr Jeffrey: I do not believe it did. I have looked at the papers on this to a certain extent and I have found no evidence within the Department that people felt they were being rushed in any way about this. It is also the case that there was a specific

understanding, as the Report brings out, with the Treasury that if the introduction of the public-private partnership did slip into the year 2002-03 then it would still be credited to the Department's budget in 2001-02. I do not think there is evidence there that the Department was operating under that sort of pressure.

Q6 Chairman: Let us look at the heart of this which is summarised in paragraphs five and six. It tells us in paragraph six that: "After Carlyle were appointed preferred bidder they negotiated a reduction in the value of the business of £55 million". So why would did you not settle the terms of this Long Term Partnering Agreement between QinetiQ and the MoD before starting these sales? Would that not have been wise? The fact that you had not settled it meant that you were really in a very weak bargaining position with Carlyle and, indeed, this was precisely what happened.
Mr Jeffrey: The initial Carlyle offer, certainly in terms of the financial advice the Department received at the time, was not such that as we came to settle the Long Term Partnering Agreement it was unreasonable for the company to expect some recognition of the impact of that agreement. I think the position the Department was in at the time was that there was a risk in concluding the agreement more quickly than was sensible. There was a risk also, and that was certainly the view of our financial advisers, in delaying the sale of the minority stake in the business. Those responsible at the time did their best to balance these risks.

Q7 Chairman: You are not surely suggesting to this Committee are you, Mr Jeffrey, that if you had not got into bed so quickly with Carlyle you would not have got a higher price? The fact is you got into bed with them too quickly, your arm was forced and, frankly, you could have got a lot more. You are not denying this, are you? Are you seriously suggesting to this Committee that you got the best price you possibly could have got?
Mr Jeffrey: What I am saying is that there was a properly conducted process. It involved eliciting bids which were properly considered. They were reduced and the ones that were discarded, the NAO accept, were weaker. We then reached a point where there were two and they were invited to bid and the result was the one that was reported in the Report.

Q8 Chairman: I have got to move on, others will come back to that. Let us look at this incentive scheme. Let us look at paragraph 2.15, shall we. Halfway down it says here: "Carlyle should revise their offer to include a three-tier structure to encompass middle managers. The Chief Executive", that is Sir John, "also expressed the view that the 10% of equity offered by Carlyle was low . . ." You allowed Carlyle and QinetiQ to sort out the incentive scheme between them, did you not?
Mr Jeffrey: Chairman, one has to recall the basic strategy that was being pursued. As we have said, it was not to float the whole enterprise immediately, to introduce a strategic partner from the private sector that had the expertise to develop the business and to give that partner only a minority stake so that the taxpayer could share in any growth of the business. Given that we were doing that, the view that was taken was that it was reasonable to leave the design of the share incentive scheme to the strategic partner. That is what firms like Carlyle are expert in.

Q9 Chairman: What was the result of this? "Bidders initially intended making just 10% of shares available to management". Carlyle, because you had such a light touch on this, doubled their proposal from 10% to 20%. Why did you agree to this?
Mr Jeffrey: In the end it was Carlyle's judgment. They are the experts in incentivising—

Q10 Chairman: That is precisely my point.
Mr Jeffrey: They had no incentive to make the scheme more generous than this.

Q11 Chairman: You have obviously read figure 19 on page 38. The top ten managers get a 19,000% increase on their investment and the ordinary workers get £9 back for every £1 they have put in, which I think is a perfectly adequate incentivising scheme. Let me put it this way: you are not suggesting you need a 19,000% return on your investment to incentivise you, are you? You are not going to come to this Committee and defend this. It would be much better just to apologise now and admit that you got it wrong.
Mr Jeffrey: What I am saying to the Committee is, first of all, I think everyone has agreed that the growth in the value of the company exceeded what was expected at the time and that did lead to these very high rewards for the executives in the company, but in the end --- If we had second-guessed Carlyle, who had been brought in order to grow the company, in order to improve its management, first of all, as the Report observes, there might well have been an impact on the price that Carlyle were willing to pay because these incentivisation schemes are a key element of what companies like Carlyle bring to the party. Of course rewards of quite that order were not foreseen. It might have been an option to place some sort of cap on it, but we need to recognise that if a cap had been placed on it, it might not have incentivised—

Q12 Chairman: It did not occur to you that this was the best deal of all time? It did not occur to you that this was a fantastic deal for whoever was buying it?
Mr Jeffrey: What I would say is if one looks at the whole course of events, one looks at the effect of the strategy of selling part of the company to start with and then hoping that the private sector partner would succeed with management in growing it, that strategy has been successful because it has brought very substantial gains to the taxpayer.

Q13 Chairman: But we believe that you should have got much more. Mr Schofield, here we have a conflict of interest within the MoD, both as shareholder and as customer, do you think you could have made a difference? Would you have made a difference?

Mr Schofield: As the Committee knows, we were set up in order to grow shareholder value. If we had been involved I think we would have added the same value that I hope we added in the flotation, which we were involved with. That is setting out very clearly an approach that is based on getting our objectives right, being very clear about what the Government's objectives are and being very clear where objectives compete against each other. We would have brought skills and experience in terms of managing transactions of this kind and we would have brought experience in terms of managing advisers.

Q14 Chairman: Do you not think it was a bit odd that defence manufacturers were barred from bidding, although at the time of flotation QinetiQ, hey presto, was allowed to carry out defence manufacturing work? Do you not think this was rather odd? If you had been involved, would you have done it this way?

Mr Schofield: We would have started by trying to be clear about what the MoD's objectives were in taking the transaction forward. I think it is very clear that the MoD were looking to maintain a source of impartial advice, which is the reason for the—

Q15 Chairman: Mr Jeffrey, I think you were just naïve babies in a sea of sharks.

Mr Jeffrey: I do not accept that, Chairman. I have looked at this myself, and it clearly predates my time at the Department, and I know that is not a relevant consideration for the Committee, but—

Q16 Chairman: Listen to what Lord Gilbert said, former Defence Procurement Minister. I am going to put this to Sir John, he is here to defend himself and his profit margin. One of the things Lord Gilbert said that irritated me, and that is a soft word, was: "Never once in my presence did Sir John Chisholm indicate that he might have a conflict of interest or was going privately to be enriched by what was going on". What do you say to that, Sir John?

Sir John Chisholm: I would say that never once in my presence did Lord Gilbert suggest he was against the policy of the then government.

Q17 Chairman: That is not an answer to the question I put to you. Is Lord Gilbert right in saying that: "Never once in my presence did Sir John Chisholm indicate that he might have a conflict of interest or was going privately to be enriched by what was going on"? Is Lord Gilbert right in saying that or is he making it up?

Sir John Chisholm: At the time that Lord Gilbert was in office there was not in prospect a private equity investor. Indeed, the plan was not private equity at that stage, it was institutional investment, so the whole issue of any management or staff shareholding was simply not discussed by anyone. It was not in the frame at that time.

Q18 Chairman: Yes, because you told the Defence Committee on 28 February 2001: "In regard to people who were already in the organisation, certainly when they have proved themselves successful they can expect to earn a reward but they cannot expect to earn it just because we have been privatised". What the public think is that it is frankly appalling. It goes totally against any concept of ethical capitalism, Sir John, that you can put £100,000 into a business and emerge with £25 million of taxpayer's money. Nobody from outside can understand it. Do you have any sense of shame here before us?

Sir John Chisholm: I have a considerable sense of having led a team to create £1 billion worth of value for the taxpayer. I think that is a great achievement by the team.

Q19 Chairman: Why should your poor staff get £9 for every pound they put in but you get £200 for every pound that you put in? Do you think that is fair?

Sir John Chisholm: I believe in any deal like this there was a contractual agreement put by the investor to the management team that had considerable risk for the management team at the time and they signed up to it.

Q20 Chairman: Why should your poor staff get £9 for every pound they put in but you get £200 for every pound that you put in? Do you think that is fair?

Sir John Chisholm: Can I answer that question?

Q21 Chairman: Yes, please, that is only fair.

Sir John Chisholm: The NAO Report itself says that if the company had not achieved a 20% return at least then the management team would have lost their whole investment.

Q22 Chairman: But was there any doubt that you would achieve this? Surely, not for a second did you doubt that with this secure contract from the MoD you would not achieve this. Are you seriously suggesting that you ever thought your £100,000 was at risk?

Sir John Chisholm: The major document which was produced to support this element of the privatisation was a long form report produced by the reporting accountants and in that Report the top four issues, it says, were: "MoD revenues will go down. QinetiQ trying to penetrate markets in which it has no experience. Revenues will be unpredictable. Risks will increase". There was a considerable sense of risk at the time.

Chairman: That is your point of view, fair enough.

Q23 Mr Touhig: I was a minister for part of the time, although I had no direct responsibility for the Ministry of Defence, and as you point out, Mr Jeffrey, you were not there for most of the time either, you came in almost at the tail end, however you are here to answer for the Department. It is clear from the Report that the MoD did not want defence manufacturers involved in this bidding and the only

trade bidder was SERCO but they were ruled out after opposition by QinetiQ. Do you think you should have allowed that?
Mr Jeffrey: They were ruled out, Mr Touhig, and this was again consistent with the financial advice the Department was receiving, on the basis that their bid was weaker than those of others.

Q24 Mr Touhig: But QinetiQ opposed them, did they not?
Mr Jeffrey: I think they may well have done but that was not the reason they were ruled out. The view that was taken within the Department was that the SERCO bid did not adequately address how potential conflicts would be dealt with.

Q25 Mr Touhig: Here is a company, Mr Jeffrey, about to be privatised and you are allowing it to have the lion's share in the say of who should be the successful bidder. Do you think that is healthy?
Mr Jeffrey: I would question if I may the premise of your question. It is not my impression looking back into this that that was the story of SERCO not having their bid advanced.

Q26 Mr Touhig: Little was done to give them a chance to mount an effective bid because it was opposed by QinetiQ.
Mr Jeffrey: There was a discussion with SERCO at the time about the extent to which the bid might advance but the reason was not that QinetiQ was opposing it, the reason was the one I have given.

Q27 Mr Touhig: It came down to two bids in the end, Permira and Carlyle. Permira would have wanted to appoint a new chairman. Carlyle became the preferred bidder and QinetiQ certainly did not support Permira, did they?
Mr Jeffrey: I cannot recall whether they supported them or not, but, again, the reason for favouring Carlyle over Permira was that it was a more attractive bid, including financially, and when the two companies were given an opportunity to improve their bids Carlyle did and Permira essentially did not.

Q28 Mr Touhig: Out of those two bids, Permira and Carlyle, QinetiQ opposed Permira, yes, and Carlyle became the preferred bidder aided and abetted by QinetiQ's management who then went on to make a substantial fortune as a result.
Mr Jeffrey: First of all, I think it is worth bearing in mind that at an earlier stage what became QinetiQ management were opposed at one point to the involvement of Carlyle in the competition. I think underlying your question, Mr Touhig, is a sense that what became the QinetiQ management were unduly influential within the Department and that is not my sense, I have to say, because there was clearly a good deal of care taken to establish teams that supported—

Q29 Mr Touhig: The Report tells us, Mr Jeffrey, that the QinetiQ board had an active role in evaluating the bids and they played a substantial part in the Department's decision not to involve Permira but to involve Carlyle. The result was that Carlyle were then the successful bidder and they were aided and abetted throughout by QinetiQ.
Mr Jeffrey: They played an active role in the sense that their views were taken and I think it is quite reasonable that as those who would have been working with the private sector partner their views should have been taken. Their contribution was by no means decisive and a good deal of care was taken within the Department to ensure that advice that went to ministers came from a completely separate team reporting to the then finance director.

Q30 Mr Touhig: You see our concern, because one of the first things that Carlyle did when it became the preferred bidder was to change the planned management incentive scheme following representations from the QinetiQ Board. The outcome of this, as the Chairman has pointed out, was that top management got almost a 20,000% increase on the return on their investment. Sir John, that is not so much the unacceptable face of capitalism as the unacceptable face of greed, is it not?
Sir John Chisholm: I do not accept that, no.

Q31 Mr Touhig: You do not?
Sir John Chisholm: As I said before, the taxpayer was by far the biggest beneficiary of the whole episode. Over a billion pounds has been created for the taxpayer and that is a very acceptable outcome. In 2002-03 the business was unrecognisable compared to what it is today. The elements which create the value today did not exist in 2002-03. This is all an achievement by Carlyle and the management team.

Q32 Mr Touhig: It is an achievement, Sir John, by a lot of collaboration between QinetiQ's management and Carlyle, the successful bidder. The point I am making to you is when they became the successful bidder they changed the incentive scheme and, as a result, you and your senior colleagues became very rich indeed.
Sir John Chisholm: Perhaps I could help you with an element of that. Post the agreement for Carlyle and Permira to go forward for the last two, they were both asked to talk to the management. Up to that time there had been no contact other than very formalised management presentations, so it was natural that before their confirming their bids they would want to decide who should be the management in the company into which they were investing.

Q33 Mr Touhig: But we are told in the Report, Sir John, that following the QinetiQ Board's evaluation of the Carlyle bid you argued that the 10% of equity offered to management employees was low.
Sir John Chisholm: I am glad you mention that because that is a letter of five pages with about 50 paragraphs in it. That particular paragraph is just one of those. The issue behind that 10% being low was principally that I suggested to Carlyle that their

idea of incentivising or just bringing the top half a dozen or dozen managers into the share scheme was not right in the context of QinetiQ, it was dependent upon the efforts of far more people than that. I suggested to them that a scheme which allowed up to 300 managers to invest in the company, plus an opportunity for the staff at large to invest in the company, would incentivise and bring along far more people in the company and we needed those people in the company.

Q34 Mr Touhig: You were supportive of Carlyle's bid and when they eventually got the company they improved the lot of the top management. The MoD made it clear to bidders that they could not be reimbursed for the cost of their bids, yet QinetiQ, when they got up and running, allowed Carlyle to take £16 million out of the company to reimburse it for its bid. Sir John, is it not a case of your scratching their back and they scratch yours? You stitched up the MoD.
Sir John Chisholm: I am sorry, I have lost which question I am answering there. Is it the question of the reimbursement for the bids?

Q35 Mr Touhig: Although the MoD said that the bidders should not be reimbursed for their bids, when it got up and running QinetiQ gave Carlyle £16 million to reimburse it for its bid.
Mr Jeffrey: If I might intervene. The extent to which the bid cost could fall to the company is quite well precedented in other acquisitions of this sort and if it had not fallen to the company in the end it would have had a bearing on the price that was paid, so it is swings and roundabouts.

Q36 Mr Touhig: But you made it clear, Mr Jeffrey, that there should be no reimbursement and when QinetiQ got up and running that was one of the first things they did.
Mr Jeffrey: It was made clear in relation to unsuccessful bidders but not, as I understand it, in relation to the successful bidder.

Q37 Mr Touhig: It just seems to me that QinetiQ helped Carlyle win the bid and in turn Carlyle decided to improve the management incentive scheme which overnight created millionaires out of the senior management, and finally QinetiQ handed back £16 million of the company's money to Carlyle to cover its bid costs. Some people would suggest that was tinged with corruption.
Mr Jeffrey: I would not accept that, Mr Touhig, because—

Q38 Mr Touhig: It stinks to high heaven, Mr Jeffrey.
Mr Jeffrey: The sequence of events is as I have described it and the key decisions were taken by the Department. They were taken by the Department in a fashion which, although it admitted discussions with QinetiQ about things that it was reasonable for QinetiQ to be involved in, there was submission of advice to ministers separately from QinetiQ management and it was taken on the basis of fairly serious financial advice at every stage. I do not think the theory that this was a great conspiracy by QinetiQ and Carlyle to stitch up the Department really hangs together.
Mr Touhig: You said decisions were taken by the Department but it seems to me, Mr Jeffrey, that you lot were taken for a ride. That is it, Chairman.

Q39 Dr Pugh: There are two conclusions that leap out from the Report as a whole. One is that you created a successful independent company and the second conclusion which the NAO come to is that they are unable to reach any conclusion on whether you have actually delivered the objectives of the scheme in the first place, that is in terms of contract prices, enhanced flexibility or improved services. Do you agree with both of those conclusions of the NAO Report, one that you created a successful independent company, and I am sure you will agree with that, and, two, that they cannot and nobody can reach any conclusion on whether you actually delivered what you set out to do?
Mr Jeffrey: Is your question addressed to me?

Q40 Dr Pugh: Primarily, yes, the Ministry of Defence.
Mr Jeffrey: I certainly agree that the outcome of all of this was the creation of a successful independent company and it is now flourishing in international markets and is doing so in the context in which our reliance on it is diminishing.

Q41 Dr Pugh: Would you accept that is not altogether a surprising achievement in a way because you had a rising market, you had a 25 year facilities contract involved, a lot of contracts going to QinetiQ which are single supplier contracts, you had a subsidised pension scheme, you had talented British scientists and, by Sir John's own confession, at the time there was a successful trading fund being run. It is not surprising, therefore, that out of that you get a successful independent business, is it?
Mr Jeffrey: If I may say so, it is easy to say that some years later but at the time, for example during the competition of the original 12 bidders, five declined to submit even an indicative offer because once they had seen the detailed information they were worried about the difficulty of achieving cost reductions in the company, the challenge of achieving commercial growth, the time and effort it would take to devote to it preparing the company for flotation. At that point in time this was a business that had never attempted to survive outside government, it was heavily dependent on our business which was a declining asset and I am not sure it was as self-evident as all that that this was going to succeed.

Q42 Dr Pugh: Not even with the pension fund bail-out, not even with the talented British scientists behind you, you still think there was some doubt as to whether it would be a successful independent company?
Mr Jeffrey: The fact that it was a matter of some doubt, at least on the part of markets, is reflected in the valuation of the company that is part of this Report which was very much why our predecessors

decided on the two-stage approach. They decided not to float immediately but to sell a minority stake and on the basis there did turn out to be any undervaluation of the company at that point, and it is hard at this stage to say whether there was or not, then the taxpayer would nevertheless benefit in the growth in value that subsequently occurred.

Q43 Dr Pugh: Okay. Let us look at the second conclusion I mentioned where the NAO say they are not sure whether you have delivered value for money on contract prices. I can see there was a one-off capital growth because of the growth but are services that are being delivered hitherto in the usual way being delivered more cheaply and more effectively given that the Report says there has been no benchmarking of service delivery?
Mr Jeffrey: Our view as a Department is that we are getting value for money from QinetiQ.

Q44 Dr Pugh: That is your view or you have evidence of it?
Mr Jeffrey: I perhaps ought to write to the Committee. It is not something that I have detailed materials on in front of me just now.[1]

Q45 Dr Pugh: Could you give us a note on that. The way I see it is if we take the bits of the Report that you agreed to, on 28—I forget the month—2003, you sold at the bottom of the market over-incentivising management, the NAO say with a lack of agreed terms and genuine uncertainties of a Long Term Partnering Agreement with no benchmarking of services provided and you sold, and they say it, without substantive valuation of the contract. You sold without adequate time to assess intellectual property rights. You failed in the process to satisfy the wider industry about the transparency of the process and you unreasonably reimbursed unvalidated billing costs of Carlyle. It is difficult to think what you could have done worse without putting it on eBay, is it not?
Mr Jeffrey: I do not accept that occurred. On the last point, I am reminded that the bidding cost was included in Carlyle's and, indeed, Permira's bids as something that would fall to the company in the end. What we did sell at was the value the market placed on a minority stake at the time and because we followed the strategy we did it subsequently grew very significantly in value to the taxpayer's ultimate benefit.

Q46 Dr Pugh: You were advised throughout by UBS Warburg, were you not?
Mr Jeffrey: And a number of others, but UBS Warburg, yes.

Q47 Dr Pugh: You paid UBS 2.5 million, is that right, for the advice you got?
Mr Jeffrey: I think so.

[1] Ev 28

Q48 Dr Pugh: Would you take that advice again? Do you think that is a model of good practice that you feel you can export elsewhere?
Mr Jeffrey: UBS Warburg is a company with high professional standards.

Q49 Dr Pugh: I am not talking about UBS Warburg, I am talking about their advice. You have implemented a contract which you are now defending, would you seek to replicate it elsewhere or recommend it to anyone else?
Mr Jeffrey: If you take each stage of this process where, for example, there was a judgment to be made about whether to carry on or abandon the competition and leave it until later, the advice we took from UBS Warburg was that there were greater risks in delay, that we would lose momentum, the company would find it harder to flourish if it did not move into an alliance with a strategic partner. In the end it is advice which the Department did not have to take but if we had failed to take their advice and subsequently it had come to fruition and QinetiQ had not flourished within the Department then in my view we really would have been open to criticism.

Q50 Dr Pugh: On the Carylye bid figures that are given in this Report, it actually says: "excess property excluded". What does that mean?
Mr Jeffrey: I do not immediately have the answer to that question. I am not sure if my colleague does.
Mr Woolley: I do not.
Mr Jeffrey: Where could one find this in the Report?

Q51 Dr Pugh: It is page 24: "All excess properly excluded from the valuation". That seemed to be a distinctive feature of the Carlyle bid. I am simply asking, what does that mean?
Ms Leahy: Perhaps I can help. This was a valuation carried out by consultants we had employed and when comparing their evaluation with other valuations they wanted to do it on a like-for-like basis and part of Carlyle's bid included £60 million for proceeds from a surplus property, so Parthenon excluded that from the valuation when they were doing their work on the valuation.

Q52 Dr Pugh: In terms of QinetiQ's property portfolio, what is the value of that?
Mr Jeffrey: What is the value of the QinetiQ property portfolio?[2]

Q53 Dr Pugh: The property portfolio owned by QinetiQ, the company.
Mr Jeffrey: I could not put a value on that immediately. We may need to write you on this one.

[2] *Note by witness*: QinetiQ's annual 2007 report shows the net-book value of QinetiQ's land and buildings as being £260.7m. As indicated to the Committee, the Department has in place a 'property clawback agreement' with QinetiQ, which enables it to clawback a proportion of the gain on each individual property transaction which is in excess of a 30% gain on the July 2001 professional property valuations. The proportion of the excess gains due to the Department is based on a sliding scale which reduces over time from 50% to 9% and as at 31 March 2007, it stood at 41%.

Q54 Dr Pugh: Can you tell me how much property since the deal has subsequently been sold?
Mr Schofield: Perhaps I can help the Committee on that. There are two points I would make. One is that the value of the key piece of surplus property, which was the Chertsey and Aquila sites, was included as a financing item in the original Carlyle deal, so that was taken into account. The second thing is that for all the other aspects of property, any property released after the PPP, there were full claw back arrangements in place to the benefit of the Department.

Q55 Dr Pugh: Are further property sales anticipated?
Mr Schofield: That is probably a question for Sir John.

Q56 Dr Pugh: Sir John, maybe you can answer that.
Sir John Chisholm: We have no currently anticipated significant property sales.

Q57 Dr Pugh: In deciding on what Sir John and other people were going to gain from the proceeds, it actually says rather amusingly that it was thought inappropriate to refer to the remuneration committee, but it clearly was not thought inappropriate to involve the remunerated. Can you clarify that, please, why it was thought inappropriate to refer to the remuneration committee, which I would have thought would have been a sensible way of dealing with things?
Mr Jeffrey: I think the answer is that it was the remuneration committee of the company within the MoD rather than the future QinetiQ Holdings and, therefore, it was not formally part of their role. As regards the second part of your question, the discussions between Carlyle and QinetiQ management, as has been discussed earlier in this hearing, were not an unusual thing to happen between—

Q58 Dr Pugh: It would seem very odd to the general public that we think it is inappropriate to involve a remuneration committee, presumably set up to decide these sorts of things, but we do not consider it inappropriate to discuss the arrangements at appreciable length with the people who subsequently were remunerated. Can you appreciate the oddity of that?
Mr Jeffrey: I appreciate the oddity of that, but in the end the judgment about the executive gains element of this, subject to the Department's overriding interest in it, as has been said earlier, was a judgment that Carlyle made.

Q59 Dr Pugh: A judgment that Carlyle made?
Mr Jeffrey: Yes.

Q60 Dr Pugh: So they got it their way.
Mr Jeffrey: As the Report brings out. Carlyle, let us not forget, had no interest whatsoever in overgenerous incentivisation arrangements, they stood to lose value to the extent that they got that wrong.

Q61 Mr Curry: Mr Jeffrey, I suppose that if anybody in the press was going to be sympathetic to your case it would probably be the *Financial Times*, would it not?
Mr Jeffrey: I would not care to speculate.

Q62 Mr Curry: I am just looking at the leader of Friday 23 November—I used to work for them a long time ago—which begins: "If this is how the Government manages privatisation perhaps we should be grateful that it has carried out so few. The Report from Parliament's public spending watchdog into how the Ministry of Defence privatised QinetiQ, the defence technology business, shows a department out of its depth". Do you think the *FT* have got that wrong?
Mr Jeffrey: I do. I go back to the point I have been making rather repetitively, I feel, in this hearing, which is that in my view it is important to step back from this and look at the whole strategy and the whole sequence of events. The whole sequence of events is one that has led to the growth in the value of equity in the company from £125 million at the time of the sale to £1.3 billion at the time of the flotation, the Government's share going from £80 million to over £600 million and proceeds to the taxpayer already close to £600 million with a retained stake of over £200 million. I do not think that is as bad a story as the *FT* is making out.

Q63 Mr Curry: One could add to that, could one not, annual internal rate of return for the Carlyle Group 112%, annual rate of return for the British taxpayer 14%?
Mr Jeffrey: One thing I would have liked to have said earlier on, Chairman, was that I very much regret that this is not an agreed Report, and I think the Comptroller and Auditor General does as well, but we do not accept that 14% figure is a valid comparison.

Q64 Mr Curry: If you look at the share price, people might have done quite well out of the dividends but the share price itself has absolutely plateaued, has it not?
Mr Jeffrey: You mean the share price since flotation?

Q65 Mr Curry: Yes.
Mr Jeffrey: I think it has been fairly steady since the flotation.

Q66 Mr Curry: By that you mean it has not gone up, do you not?
Mr Jeffrey: Sir John is probably more familiar with the detail of that.
Mr Woolley: We would certainly have been open to criticism if the share price had rocketed up after we sold our stake in it.

Q67 Mr Curry: You said, Mr Jeffrey, and I accept that you were not there at the time, that you had to go back in the process. My concern is not at the end of the day who made what out of it, it is the point at which those decisions were taken. There are two key things which give me particular concern. The first is that the preferred bidder was identified before the very, very price sensitive issue of the Long Term Partnering Agreement was settled, and the second is that the incentives were discussed before Carlyle became the preferred bidder and, indeed, the incentives led to what turned out to be a remarkably generous ratchet scheme, perhaps even more generous than Carlyle anticipated it might turn out with the over times four figure and no professional advice was taken on those incentives. Do you think even with the benefit of hindsight that I am wrong to be feeling slightly queasy that the preferred bidder was identified with, if you like, the relationship between the Government as procurer and the company to be settled and the incentives were discussed before Carlyle became the preferred bidder leading to the inevitable suggestion that the people who would benefit from the incentive scheme and would be giving the advice on the acceptability of the bid might, whether they intended to or not, be capable of being perceived as having a conflict of interest?

Mr Jeffrey: There are three points on that, if I may, Mr Curry. First of all, when the preferred bidder was identified another bidder was kept in play as reserve, so it is not true to say there was only one. Secondly, it is not unusual as one gets to that stage in a competitive process of this sort for there to be some unresolved issues which have a bearing on the eventual price, and it is not unusual for the preferred bidder to expect to have a chance to negotiate these issues with the seller. As far as the timing of the Carlyle discussions with QinetiQ senior management, I do not think it was an unreasonable or improper thing for Carlyle to be doing given that senior management knew the business and knew who was critical in growing it. There may be a point about timing, and that is one which the NAO has made a recommendation on, and it is a recommendation that we and the Treasury will be looking at because it may have implications for wider government. The final decision on the scheme, as I have said, was for Carlyle. I am sure they took account of what QinetiQ management were saying, but in the end they are hard-headed business people who made a judgment on what incentivisation scheme was likely to work for them and for us.

Q68 Mr Curry: If we look at that incentivisation scheme, we have the business of the ratchets so that if the business was grown by three times then the incentive went from 3.9% to 6.67% of the business and if it was grown by four times it went to 9.18%, so each time it more or less doubles. Did any alarm bells ring in the Ministry of Defence when that was being negotiated in saying, "Does somebody think this business is actually going to do a great deal better than perhaps we think and, therefore, should we be looking at the price? Should we get some external advice on that?" In fact, the times four was triggered which is why 20% of the company is now owned by people who work for the company.

Mr Jeffrey: As I acknowledged earlier, the eventual growth in the company was significantly greater than at this stage I judge anybody was expecting. I acknowledge that without hesitation.

Q69 Mr Curry: If you do a classic PFI then of course there is a preferred bidder and, you are quite right, some details are not finally worked out before the preferred bidder, but this is rather different, is it not? This is a preferred bidder for a business which has got apparently huge potential and clearly there was a huge amount of unrealised capability in that business which the privatisation was intended to realise, but the management must have known that because the incentive scheme appeared to be very optimistic about what could be delivered.

Mr Jeffrey: Sir John can speak for himself, but my sense is at the time no-one expected that the growth of the value of the business would be quite as great as it turned out to be.

Q70 Mr Curry: Even Carlyle, I think, because they lost holdings.

Mr Jeffrey: You might say that should have led us to place a cap on the extent to which executives should—

Q71 Mr Curry: Perhaps to seek some external advice as to whether this was going down a reasonable path or was getting a little bit excessive.

Mr Jeffrey: It comes back to the point I was making earlier, Mr Curry, that in the end this was a decision by Carlyle. As I said, we might have considered capping it, but—

Q72 Mr Curry: It is the process which concerns me. If Sir John does very well out of it, fine, but it is the process which concerns me, the point at which these decisions were taken in this process.

Mr Jeffrey: I would be reluctant at this range to say that the Department should definitely have insisted against Carlyle's wishes on capping the benefits that executives could gain. As I said earlier, one of the consequences if we had told them to do so was that it might have been that the value of the company would reduce and essentially we would have been second-guessing the private sector partner whom we were bringing in in order to apply their expertise to build the business up.

Q73 Mr Curry: Perhaps if the whole private equity controversy had been happening a few years earlier it would not have been possible to operate in that way, would it, the whole public focus would have been much more concerned. When the Chairman suggested that the Treasury pushed through this sale presumably the Treasury had got some money on the books for the receipts, had it not?

Mr Jeffrey: The Spending Review covering the period 1999-2002 had assumed the receipt of £250 million for this PPP but, as I remarked earlier, the Treasury agreed that we should have credit for that in the defence budget in the last year of the Spending Review period even if the eventual sale slipped into the following year, which it did. That rather lays the lie to the view that we were hustled into this by the Treasury.

Q74 Mr Curry: Lord Moonie, who was the Minister at the time, on the *Today* programme about ten days ago said specifically that he had advised the then Chancellor to defer the sale on the grounds that more could be obtained if the sale came later. You were aware of that, were you?
Mr Jeffrey: I am aware of that. Lord Moonie can clearly speak for himself but I have not been able to find within the Department, and we are talking quite a number of years later, any evidence that people were saying, "We don't want to do this but we have to because of the Treasury". It does not feel like that.
The Committee suspended from 5.19pm to 5.25pm for a division in the House.

Q75 Geraldine Smith: I understand there were seven indicative bids for QinetiQ, am I right in assuming that they would all have incurred significant costs in preparing the bids?
Mr Jeffrey: Yes, they would have done.

Q76 Geraldine Smith: Was it made clear to them that they would not get those costs reimbursed?
Mr Jeffrey: Yes, I believe it was.

Q77 Geraldine Smith: So why did Carlyle get their costs reimbursed? What was different about them?
Mr Jeffrey: As I said earlier, it is quite common in transactions of this kind for bid costs to fall to the company. It was certainly part of the Carlyle bid and it was taken into account in assessing the Carlyle bid.

Q78 Geraldine Smith: The costs would fall to whom?
Mr Jeffrey: In the end to the company, as was discussed earlier.
Mr Woolley: To QinetiQ.

Q79 Geraldine Smith: But why? They were going to bid anyway, why just give £16 million away when you do not have to?
Mr Jeffrey: The bid which Carlyle made assumed that the costs of the bid would in the end fall to the company. That is also true of the bid which Permira made. If it had not had that aspect to it then it would have reduced the ultimate price. As I said earlier, it is swings and roundabouts.

Q80 Geraldine Smith: £16 million seems an awful lot of money to prepare a bid. I think most people would think it really is a lot of money. What checks were made to make sure that those costs were validated, that they were incurred? Have you got a breakdown of them and can we see that?
Mr Jeffrey: I imagine that we can provide the Committee with a note on that. I am sure that these costs were properly audited and checked, but in detail I am not familiar with the process that was gone through.[3]

[3] Ev 29

Mr Schofield: I have three points to make. One is that the audit committee of QinetiQ Holdings Limited would have audited all of the costs. The second point to make is that it is a fairly standard process, as paragraph 2.34 says, in a private equity deal for the new company that takes the business forward to pick up the costs of the successful bidder. The third point to make is, as you say, all of the bidders incurred significant costs but those costs increase as the process goes through and at the very end the short-listed bidders are incurring very significant costs in full due diligence of the business, and that is legal due diligence and financial due diligence.

Q81 Geraldine Smith: Carlyle was also given the opportunity to bid for additional shares which they got for £3 million which later went on to be worth £27 million. Why was that?
Mr Jeffrey: This was a judgment made at the end of the process for reasons that the Report explains in relation to the value of the bid having reduced to take account of the deficit in the pension fund and reduction in the value of the Long Term Partnering Agreement. Both of these tended to reduce Carlyle's stake in the business. The view that was taken was that an additional 2.5% of the business should be included in order to maintain the level of their stake. There is no magic in a particular percentage, but the sense at the time was that Carlyle needed to have a reasonable stake in the business to be incentivised to achieve the growth that was achieved.

Q82 Geraldine Smith: Do you appreciate how this looks to any man or woman in the street? It looks like there is a cosy little relationship between Carlyle and the senior managers who were agreeing and working with the bidder before they became the preferred bidder and working on their own incentive scheme which turned them into multimillionaires? It stinks. It looks terrible to anyone and I do not think you can justify it. I do not think you can justify an investment of £100,000 where you end up with £20 million, a civil servant. £20 million would do a lot in my constituency. For that sort of money to go to one individual goes way beyond an incentive scheme. The point was made earlier that there should have been a cap put on it. I would say that you have been completely irresponsible in not putting that cap on it.
Mr Jeffrey: I do see how this looks to members of the public, I understand that very well. Against that I would only put the points that I made earlier about the extent to which in combination this was a strategy that yielded very significant benefits to the taxpayer.

Q83 Geraldine Smith: Yes, but the point is could it have yielded more benefits to the taxpayer? Did your actions disadvantage the taxpayer? Yes, they did make money on it but could they have made a lot more?
Mr Jeffrey: I do not think it is possible to establish that we could.

Q84 Geraldine Smith: I think you could have a pretty good guess.
Mr Jeffrey: With great respect, I would disagree with that. The judgment is about how much this business would have grown if we kept it within the Department and with all the things that entailed and without the invigorating effect that a strategic private sector partner brought into the picture. It may well be that the yield could have been greater but I do not think one can say that with great confidence. I would argue that the overall strategy, starting with the sale of a minority stake and allowing that to build in value and then floated in a way that the NAO praises in a way that I cannot recall seeing in their reports recently was in the end successful.

Q85 Geraldine Smith: You spent £28 million on consultants getting ready for the privatisation. Can you tell me what the taxpayer got for that £28 million?
Mr Jeffrey: It was a range of advice, including the advice of financial advisers who were familiar with business of this kind, legal advice, and I have no reason to suppose that it was not properly incurred and properly audited at the time.

Q86 Geraldine Smith: But you did not bother getting any advice on the incentive scheme. You spent all that money on consultants but you could not spend a little bit more just getting a bit of advice on the incentive scheme for the senior managers and what would be fair and reasonable?
Mr Jeffrey: There was not separate specific advice taken. Our financial advisers helped us to model what the implications of the incentive scheme would be, but in the end, as I said earlier, it was a judgment taken for better or worse that the incentive scheme was something that Carlyle were best placed to assess.

Q87 Geraldine Smith: If your financial advisers helped you model what the incentive scheme should be, should you not be asking for your money back?
Mr Jeffrey: I do not think so. One can always argue about quality of advice but I have no reason to think that this was other than good, professional advice at every stage.

Q88 Geraldine Smith: I guess you can say that because it is other people's money you are spending. It seems there is a blasé approach to taxpayer's money in this Department. It is thrown around at consultants, £28 million. Carlyle must have thought all of their Christmases had come at once, along with the senior management.
Mr Jeffrey: I certainly would contest the proposition that the Department was other than mindful of the fact that it was dealing with public money here. I apologise for keeping coming back to this but one has to look at the proof of the pudding and the proof of the pudding was a very substantial and successful flotation of this company which gained the taxpayer approaching £600 million and we still hold a stake in the company which is worth the best part of a quarter of a billion. That is nowhere near the situation in which Carlyle approached this business and the prospects then were as I have described them: a bit of the MoD that was struggling to find its feet, if Sir John Chisholm would allow me to say so, and it was hard at that stage to say confidently that it was going to have a bright future.
Mr Woolley: I think it is right to say that this was a very complex deal, both at the private partnership stage and subsequently.

Q89 Geraldine Smith: It looks very simple to me, some of the outcomes.
Mr Woolley: There was a very complex need to separate the assets of the company from the assets of the Department. There were some complex contractual arrangements that had to be taken into account and the flotation itself was a complex process. Spending £28 million on consultants in order to generate a return of £850 million does not seem to me to indicate a cavalier way of dealing with the taxpayer's money.
Mr Jeffrey: If you will allow me to add one point. If you care to look at paragraph 1.16 of the Report, the NAO say that their review of the invoices and the correspondence shows that the Department monitored expenditure closely. There is no criticism of our handling of the consultancy side of this in the NAO Report.

Q90 Mr Davidson: I wonder if I could just start by asking you, Sir John, whether or not you are a Labour donor by any chance?
Sir John Chisholm: I am not a donor either in my own name or anyone else's!

Q91 Mr Davidson: Thank you. Excellent. I do not think I have ever been so glad to hear that in my life. While I am quite happy with the strategy that has been adopted here, the two-tiers and so on, like some of my colleagues I have some grave difficulties with the implementation thereof. I have the overwhelming feeling that Carlyle and the others just saw the MoD coming and they have taken advantage of your innocence in these matters and exacted a much better deal than we would have agreed to now when we have much more experience. Can I just ask Mr Schofield if that seems fair, that Carlyle, well experienced in taking sweets off children, found the MoD an inexperienced seller and took full advantage of them in a way that they would not let them do now?
Mr Schofield: I think that is an unfair criticism of the MoD. They were absolutely masterful in only selling a minority stake.

Q92 Mr Davidson: The strategy I accept.
Mr Schofield: In terms of the process, they ran a competitive process against a very difficult backdrop and that is a point that comes out throughout this Report, that the markets were difficult, the business was not as well developed by 2006, its strategy needed developing and at the same time the stock market comparators were falling. I think this was a very difficult backdrop against which to take

forward an ambitious privatisation process and the fact that they only sold a minority stake was a masterful element.

Q93 Mr Davidson: I accept that. So we should be happy with this, should we?
Mr Schofield: I think we should be happy with the overall result. We should be happy with the way that the company was prepared for flotation and we should be happy with the way in which the flotation delivered value for the taxpayer.

Q94 Mr Davidson: You do not think that we could have got a better deal?
Mr Schofield: That is impossible for me to know. The Shareholder Executive first got involved in about 2004, a year after the deal with Carlyle, so I have just been looking back on the papers the way everyone else has. As I say, I was struck in reading the NAO Report as to the difficulty of carrying out a process throughout 2002.

Q95 Mr Davidson: I appreciate the difficulty and I am also supportive of the general structure that was adopted, but when something like that is difficult I was taking the view that was where the experience of Carlyle and the innocence of the MoD were at their most meaningful and it was in the detail where Carlyle then took advantage of these poor unfortunates who perhaps should not have been let out on their own. That is my reservation about that. Can I ask about Carlyle. Does the MoD have a lot of other dealings with Carlyle?
Mr Jeffrey: I do not think we have had other substantial dealings with Carlyle.[4]

Q96 Mr Davidson: Not knowing, perhaps you may give us a note. I am interested in the connections that Carlyle have. Can I just clarify whether or not Carlyle had at that time, or have had subsequently, employed people who had been in defence, military or political worlds in the UK and the same applying to their public relations advisers? Can you tell us that or, if not, give us a note on that?[5]
Mr Jeffrey: I am not aware that they did so but as ever, Mr Davidson, I ought to check and give you a note on the subject.
Mr Woolley: They have a military adviser who they have employed for some years who is an ex-serviceman.

Q97 Mr Davidson: I think it would be helpful if we just see who they have at the moment who was perhaps active at that time, and similarly for the public relations advisers, and who they had at that time who would have been involved actively in either the military, political or defence worlds. You do not know of anybody at all. The name John Major does not spring to your mind, for example?
Mr Jeffrey: Not to my mind, but perhaps I could reflect on that.

Q98 Mr Davidson: Google was able to give me that within two minutes when I was coming down here. Maybe you could check about the others. Mr Schofield, is this normal? One of the things that causes me anxiety is the way in which as soon as Carlyle were given preferred bidder status they managed to negotiate a reduction in the value of some £55 million. That does look as if they took advantage of the position that by then they had been given. Is that normal in these circumstances?
Mr Schofield: Every situation is different and every company is different, every transaction is different. That is an obvious point, I guess. In terms of this case, clearly it would be ideal if you could preserve in aspic a business from the point of going to preferred bidder to the point where you actually get the money in.

Q99 Mr Davidson: £55 million is not loose change though, is it? To be able to get preferred bidder status and then once you have got that foot in the door then to discover that there needs to be more work done on the roof and therefore the price will have to change and so on is standard negotiating practice, is it not, and Carlyle seems to have got away with it?
Mr Schofield: One of the points that comes out of paragraph 2.25 of the Report is the fact that the MoD held Permira as a reserve bidder throughout this process. The other point to make is that around this process, as I understand it, the MoD was receiving its continuing advice from UBS and the assessment was that those two elements that made up the £55 million to which you refer were justified in terms of the pension fund deficit and the changes to the Long Term Partnering Agreement.

Q100 Mr Davidson: So the pension deficit was not known about beforehand?
Mr Schofield: As I understand it, this was something that came out of the—
Mr Woolley: The bid from Carlyle was always subject to a settlement of the pension fund deficit.

Q101 Mr Davidson: Did Permira ever comment on the pension fund deficit or did they not have the right to do so?
Mr Woolley: Their bid would have been subject to the position of the pension fund deficit.

Q102 Mr Davidson: But so was Carlyle's and then Carlyle's changed because of information about the pension fund. Did you not then go back to Permira and say, "Look, here is the same information, what is your view on this?" That could have changed the financial balance.
Mr Woolley: There would be no reason why it would have a different impact between the two bidders, the effect of the pension fund deficit.

Q103 Mr Davidson: But you did not ask the other people?
Mr Woolley: At that stage Carlyle were already the preferred bidder.

[4] Ev 29
[5] Ev 29

Q104 Mr Davidson: So that is a no then, is it? That is a no, you did not?
Mr Woolley: We did not specifically go back to Permira on that point.

Q105 Mr Davidson: That is a no, that is fine. I just wanted to clear that up.
Mr Schofield: Mr Davidson, it is also worth adding that the Government Actuary's Department made their own assessment.

Q106 Mr Davidson: All these people would have made assessments of the position before they made their bids and then Carlyle got their foot in the door and changed their bid, I understand that. Can I just clarify a point that has been made quite strongly on a number of occasions about the rise in value and so on. How much of this has simply been because of a general rise in the market? I notice around about that time there was a general uplift, was there not, both in defence and technology share prices and, therefore, there was a substantial element of simply a windfall gain. I take it there was nothing in the contract that would lead you to have an automatic, as it were, claw back of any windfall gains of that sort. Nor was there any recognition, as I understand it, in terms of the huge amounts of money that Sir John got away with of the simple rise in the market. How was that dealt with?
Mr Jeffrey: It is certainly the case that some of the growth in the value of the company between the sale of the minority stake in early 2003 and the flotation in early 2006 reflected conditions in the market, but it also reflected the success of the company in finding new business.

Q107 Mr Davidson: What was the balance?
Mr Jeffrey: I do not have that figure in my head. I think they were both substantial elements.

Q108 Mr Davidson: Sir John, you are going to tell me.
Sir John Chisholm: I do not have the number but the point I made earlier on was if you look at the things that the analysts now pick out as being valuable in QinetiQ today, they are not the things that were predominantly in the company at the time of the PPP.

Q109 Mr Davidson: I think that is interesting.
Sir John Chisholm: The value has been added since then.

Q110 Mr Davidson: That is interesting but it is not actually an answer to the point I made because I was asking for a balance between the value added by yourselves and your management and the general rise in profits.
Mr Schofield: Mr Davidson, I could give you some numbers. As the Report shows, the rise of the operating profits was something like 260% and there was also an improvement in the contribution in terms of cash generation of today's profits. In terms of the benefit from the performance of the business there is that element. In terms of the market, the aerospace and defence sector in the UK in December 2002 was trading on a PE multiple—price earnings multiple—of 10.8 times and at the time of the flotation in February 2006 was on 17.2 times. What you will see is 260% from the performance of the business and about 70% from the movement in the stock market.

Q111 Mr Davidson: Sorry, what were the relevant percentages there?
Mr Schofield: 10.8 times was the PE multiple on which—

Q112 Mr Davidson: I understand completely that the profits went up but what I am not clear about is what percentage of that was as a result of the innovative management perhaps that was introduced and to what extent it was simply because the market in general terms was rising and, therefore, there was more business going. I am also not clear about the extent to which the value of the shares were reflecting those improvements in the company and to what extent they were just simply the value of the general rise in the market, which is why I wonder what percentage of Sir John's gains was simply due to the work of others or acts of God.
Mr Schofield: To give you some numbers, the business was sold on an enterprise value of £319 million. The impact of the improvement in profitability was 260% on that. The business was more cash generative, so every pound of profit was generating additional cash which was paying down debt, and the business paid down £300 million of debt over the course of the period. In addition, the business benefited from this growth in the market from 10.8 times the PE multiple to 17.2 times. Taking those factors together you will see all of the uplift in value that took you to an enterprise value of—
Mr Jeffrey: What was undoubtedly happening over that period, Mr Davidson, was that the company was outperforming the rest of the market in terms of building markets elsewhere and over time becoming somewhat less dependent on us as customers.

Q113 Angela Browning: Mr Jeffrey, as I have been listening this afternoon I have been reminded of something from Alice in Wonderland, the Caucus race where everybody gets a prize. I am a bit concerned that what we have been really told this afternoon is that this has been such a wonderful success and despite all these disparities between what Sir John and other senior managers got, *et cetera*, in proportion to the return to the taxpayer, the fact that the taxpayer got a good return should be sufficient. But I am concerned, as was my colleague, David Curry, about whether the Department has managed this in such a way that actually they could have got a better deal and return for the taxpayer. I would like to explore that in a minute. I would like to take a look at the future about what lessons are to be learnt. It seems to me, Chairman, that we do not know yet, sufficient time has not passed, to give a clean bill of health to the outcome of what has happened with QinetiQ. Could

I just ask you, Mr Jeffrey, to look at pages nine and ten where the National Audit Office have listed their recommendations. In the first ones at the top of page nine there is a very clear instruction here and it says: "The Department must actively manage the risks that privatising QinetiQ has created if the transaction is to realise value for money" and it goes on further down with some recommendations under one, and one was about benchmarking, and we see the Department should ensure that these are developed in advance of the first price review period in March next year. March next year is not far away. Can I ask you, is your Department geared up to this? Are you on time to do it? Has that lesson been learned?
Mr Jeffrey: I think the lesson has been learned. It is certainly the case, as you say, the eventual outcome of this is not yet known because the company is still building its way in the world. We feel that there is a continuing developing picture in our relationship with the company over, for example, the understandings that we have with them under which they are required to identify potential conflicts of interest for us and ways of mitigating these through Chinese walls, et cetera. As our relationship changes, as they become less able to rely on MoD business and really are in a position where they have got to compete like everybody else then clearly we need to manage that and manage that very carefully.

Q114 Angela Browning: Is there anything in that first section concerning the Department's ongoing relationship with QinetiQ that you do not think you will deliver as recommended by the NAO?
Mr Jeffrey: I do not think so, no.

Q115 Angela Browning: Could we move on then to the lessons learned which follows on on page nine beginning at paragraph three. I will not go through all of them but can I ask you again, from three through to nine, is there anything in those recommendations that you feel you would not implement if such a situation arose again?
Mr Jeffrey: The only reservation I have about them, if I may put it this way, is that they imply shortcomings in the process that the review has been examining and we do not necessarily accept all these that we have been discussing in this hearing, but in themselves they are very sensible observations about how this sort of activity should be managed. Principally, I think it is fair to say they are directed at the Treasury because the indication is about guidance to be given to all government departments about handling privatisation of this sort. Between us, we and the Treasury certainly are examining them that in principle we think they are on the right lines.

Q116 Angela Browning: Could I pick on one as an example, that is in seven on page ten. This has been touched on this afternoon. "Departments should protect their interests by not allowing management to discuss incentive schemes with potential partners until the main principles have been agreed and a preferred bidder chosen". Would you agree that is how your Department will proceed in future?
Mr Jeffrey: As I said earlier, in this case I do not think it was unreasonable for these sorts of discussions to take place. The NAO has made this point and it is a very fair one and one which we and the Treasury will certainly be looking at with a view to reflecting it on the Treasury's part, I would guess, in guidance to departments in the future.

Q117 Angela Browning: You understand why that recommendation is in there specifically in relation to the way the Department dealt with the QinetiQ bid?
Mr Jeffrey: Yes, I do.

Q118 Angela Browning: I am looking for a stronger reassurance from you, Mr Jeffrey. If you are going to reflect and look at it, you have had prior notice of receiving this NAO Report and presumably if you did not agree with anything in it you would have made that known before we all sat down this afternoon.
Mr Jeffrey: As I said earlier, there were regrettably some respects in which the Report was not agreed but this was not one of them. It is a recommendation and I personally think it is along the right lines. What we always do when the NAO make reports of this sort is to take the recommendations on board and in the Treasury Minute, no doubt, there will be a response to it.

Q119 Angela Browning: Could I ask you to turn 2.34 which is on page 26 of the Report. This has been touched on, the question of the reimbursement of Carlyle's bid costs, which were £16 million, which in the grand scheme of things I appreciate was a very small sum of money in relation to the other sums that are being discussed today, but what is very interesting in this section here is that it states: "It would therefore have been reasonable to refund Carlyle's costs" which you defended just now, "only if the Department's costs were also fully reimbursed". Were the Department's costs fully reimbursed?
Mr Jeffrey: They were not. In the end they were something that we netted against the very substantial proceeds of this sale.

Q120 Angela Browning: Why was that? If in this Report it is telling us that would have been a reasonable way to conduct the negotiation, albeit a small amount but still £16 million of taxpayer's money, why was that not negotiated at the time?
Mr Jeffrey: I suspect the answer to that lies in the fact that it would have had to be found somewhere in the sense that if our bid costs had to fall to the company then the receipt we would have received at the time would have been that much less.

Q121 Angela Browning: In the future, just coming back to where I started with the very clear recommendations that the NAO Report gives to your Department, not just with your ongoing relationship with QinetiQ but any future

privatisations of this nature, or government for that matter, would you agree that one would have expected that negotiation to take place?
Mr Jeffrey: I would certainly agree that if we were in the same position again, and I would be very surprised if we were in exactly the same position because, as Mr Schofield said, this was a very complex negotiation, we should be aiming to recoup our own costs from the privatised entity as well.

Q122 Angela Browning: I appreciate the complexity of it but I assume a due diligence exercise was carried out.
Mr Jeffrey: Yes.

Q123 Angela Browning: At what point?
Mr Jeffrey: A due diligence exercise was carried out certainly by the company.

Q124 Angela Browning: As a result of their due diligence exercise were any specific issues raised that the Committee should know about in terms of how these negotiations proceeded?
Mr Jeffrey: I am not quite sure which due diligence exercise you are addressing. It was certainly the case that once Carlyle had been identified as the preferred bidder they undertook due diligence.

Q125 Angela Browning: Of course.
Mr Jeffrey: And it was out of that that came these issues that were referred to in earlier questions to do with the Long Term Partnering Agreement and the pension fund.

Q126 Angela Browning: I thought that might have been the case. Can I ask you then was it the case that when they raised these issues, such as the reimbursement of costs, were these part of the negotiations that took place as a part of issues that were raised more latterly after due diligence?
Mr Jeffrey: The expectation that Carlyle's costs would be recovered from QinetiQ was embedded in the original bid.

Q127 Angela Browning: I would just raise with you, although obviously we are not party to the detail of that negotiation, it just looks like a rather weak negotiating hand, frankly, from where I am sitting. I hope that the lessons will be learned from it.
Mr Jeffrey: There are lessons to be learned from this, I do not deny that, and we will certainly be seeking to learn them.

Q128 Angela Browning: Thank you. My time is just about up but I think, Chairman, I have time for just one for Sir John. The ten senior managers—what was the process followed to identify them? Was it by job title or by individual person?
Sir John Chisholm: When I was asked to go and see Carlyle the main topic of conversation was for Carlyle to get my view of who was most important for the company.

Q129 Angela Browning: By job title or person?
Sir John Chisholm: Obviously, they were interviewing me as well because it was not at all clear that I would be chief executive either, so they wanted to choose their management team and it would be natural to come to me and ask what my views were, and so we went through much more than ten of the top management team and the ten who were most important were identified then.

Q130 Angela Browning: Could you just answer my question? Was it because of their individual experience and skill or was it based on the job title they held within the organisation?
Sir John Chisholm: The two were highly linked together.

Q131 Angela Browning: Yes, of course. Did the 11th one know he was the 11th?
Sir John Chisholm: Not all the people who were offered to be in the scheme agreed to do so because they were concerned about the risk of putting their own money into the company.

Q132 Mr Mitchell: The *Financial Times* has said the department was out of its depth, my colleague Don Touhig has said it has a tinge of corruption and the National Audit Office has been concerned about the excessive enrichment of the executives in the deal. I just wonder, as a question to all of you, the department and the company, whether any of you feel any shame or sense of regret about the deal now.
Mr Jeffrey: I would certainly refute very strongly any suggestion of the tinge of corruption. I have found nothing—

Q133 Mr Mitchell: Okay. That said, do you feel any sense of shame or regret?
Mr Jeffrey: In preparing myself for this hearing I have found nothing that supports that remotely. It is worth saying that just to start with. As for a sense of shame, I would say that the problem I have had with this is first of all that the eventual outcome was, as I have kept saying (and I make no apology for that), I think a satisfactory one and if you view the process as a whole it produced a successful outcome. If you then look at the detailed negotiations around the sale of the minority stake it is, as Mr Schofield said, a very complicated sequence of negotiation with potential bidders.

Q134 Mr Mitchell: I will stop you there because I guess that is a no and you are giving me an E Piaf on that.
Mr Jeffrey: What I am saying, Mr Mitchell, is that these were judgments made at the time in the thick of a commercial negotiation.

Q135 Mr Mitchell: Which in retrospect you might have a sense of regret about.
Mr Jeffrey: I cannot say that because I think the eventual—

Q136 Mr Mitchell: Okay. Sir John, do you have any sense of shame about the enormous amount of money you have made out of this deal?
Sir John Chisholm: Absolutely not. What I have a sense of is that the company was extraordinarily successful and as a consequence those of us who invested in it made an extraordinary gain.

Q137 Mr Mitchell: Okay; I will stop you there again because in the course of the discussions about privatisation your position seems to have varied enormously. You told the NAO that you had raised concerns about the potential risk of management making large returns from the involvement of a private equity investor. Did you say that very quietly? Who did you say it to? Did you whisper it?
Sir John Chisholm: Mr Mitchell, I was simply concerned about the perverse situation whereby, as a chief executive who was employed to create a successful company, I was kind of blamed for doing so.

Q138 Mr Mitchell: In other words you were not being critical of large returns if they came to you; you were critical about large returns that went to other people?
Sir John Chisholm: No, Mr Mitchell. As I said, I was just concerned about exactly the kind of perverse situation that we now have.

Q139 Mr Mitchell: About the potential of them going to other people. Okay; that is paragraph 2.2 Further on, in paragraph 2.15, we find that having expressed that concern you then started arguing that the view that the 10% equity offered by Carlyle was low and wanted the arrangement to offer higher returns based on exceptional performance. You discussed this with Carlyle before the final bids were submitted and Carlyle put up its proposal from 10% to 20% for the enrichment of the executives. You wanted that?
Sir John Chisholm: I touched on that early on, that the principal issue surrounding the 10% was to enfranchise a larger number of people in QinetiQ—

Q140 Mr Mitchell: But it also put money in your own pocket. Did you want that increased from 10% to 20%?
Sir John Chisholm: Indeed I did, in order to bring more people from QinetiQ into the scheme. After all, in that increase from 10% to 20% 5% of that was to do with staff in general being able to purchase shares or get shares through options.

Q141 Mr Mitchell: Okay, so it is purely incidental that you made a lot of money out of it. Let me just turn to the department because, according to paragraph 4.18 the department: "had given assurances to the House of Commons Defence Committee that it did not want to see individuals becoming instantly rich simply by virtue of the privatisation". Well, of course, that might have led them to wait two or three weeks before becoming instantly rich but you did not seriously mean that.
Mr Jeffrey: This relates to some evidence that the then Defence Procurement Minister gave to the Defence Committee in 2001, and what she said was, "I do not want to see anyone become millionaires overnight simply by virtue of DERA being privatised". She went on to say though, "Should people prosper because the organisation prospers, that is a different matter".

Q142 Mr Mitchell: So in fact they did become pretty rich but not instantly?
Mr Jeffrey: Depending on the performance of the company and although the Committee might feel that the chances of failure were slight, as Sir John has said, it was still the case that if they had grown the company by less than 20% they would have lost their money.

Q143 Mr Mitchell: Okay. Let me pursue with you, Mr Jeffrey, the odd way in which the estimated value of the company fluctuated. In March 2002 Pricewaterhouse, an honourable firm, and, of course, accountants always give a true and fair view of assets and obligations, estimated the book value at £534 million. By late 2002 that was down to £312 million. I think KPMG had taken over by that stage, and, of course, both PwC and KPMG are big players in the privatisation game, so they have got an interest in manipulating the price, have they not? That was £312 million excluding debt, but just slightly later we got another estimate, and this is in the minutes, of £312 million including debt, the same but the debts have suddenly been included. That was down in January 2003 to an equity value of £125 million, and then by 2006, after privatisation, it is up to £1.3 billion. How do you account for those insane fluctuations?
Mr Jeffrey: I think the earlier ones that you quote, Mr Mitchell, illustrate how hard it is to value assets of this kind in a vacuum, as it were. There is an interesting quote from the NAO's own consultants in a footnote to the Report when they in a sense give a health warning as regards their own post-hoc valuations when they say, "Value can only be truly determined in an open market. Valuation of companies is a matter of judgment which is impacted by the valuer's interpretation of available information, prevailing market sentiment and other factors, including, but not limited to, the quality of management".

Q144 Mr Mitchell: So the accountants are saying you cannot estimate the value of a company in the public sector?
Mr Jeffrey: I think over that earlier period what was happening was that successive valuations by consultants were varying widely. This was partly to do with the inherent difficulty of valuing something that was still embedded in the public sector and partly to do with changes in market conditions. That was one of the factors, I judged, that led the department to opt for the sale of a minority rather than moving to immediate full privatisation.

Q145 Mr Mitchell: You were relying on these valuations of auditors with an interest in privatisation who, you now tell us, could not accurately estimate the value of a company in the public sector. That is what you are saying, is it not?
Mr Jeffrey: I am saying that they were the best estimates that people had available to them.

Q146 Mr Mitchell: And they kept coming constantly down.
Mr Jeffrey: But the fact that you are able, as you are, to quote such widely varying estimates illustrates that this is by no means an exact science and in the end only the market can value assets of this kind.

Q147 Mr Mitchell: Let us ask Sir John. There has been an astronomical increase since then to £1.3 billion. Mr Davidson was attempting to establish why this has happened. Presumably that is just because the market has changed, largely because of the fact that we have had a series of wars.
Sir John Chisholm: Yes. What has happened is that the company is very different indeed now from what it was then.
Ms Diggle: Yes, but the increase in value is not so much due to your efforts and those of the management who were committed to it as to the fact that we have got bloody wars on.
Sir John Chisholm: The company did not change all by itself. The company changed because the management, together with Carlyle, conceived a very appropriate strategy and pursued it with vigour and great success.

Q148 Mr Mitchell: When it came to enriching the management you proposed the top ten people who were going to get the richest rewards and the top 245 who were going to get slightly less. How did you pick them? Who was left out of this bonanza?
Sir John Chisholm: The issue was how could people contribute to the potential growth of the company. That was the question: what were they able to bring to bear and how could they best be incentivised? Just to be clear, the question of the incentive scheme was wholly a matter for Carlyle. It was their incentive scheme.

Q149 Mr Mitchell: Yes, but you had nominated the people. That gives you a judgment superior in a sense to the Archangel Gabriel because he is admitting people to heaven. You are admitting them to wealth, riches now.
Sir John Chisholm: Mr Mitchell, at the time there was no sense of wealth and riches, frankly. There was a considerable sense of risk.
Ms Diggle: Oh, well, the top management made a return of £107 million out of a fairly small investment.
Sir John Chisholm: Of course, if you had told me that at the time I would have been gobsmacked.

Q150 Mr Mitchell: They were quite enthusiastic about putting their money forward. Did anybody not put it forward?
Sir John Chisholm: Yes.

Q151 Mr Mitchell: How many?
Sir John Chisholm: I cannot give you the exact number.

Q152 Mr Mitchell: Can you remember how many people were excluded from the 245?
Sir John Chisholm: How many people were excluded from the 245?

Q153 Mr Mitchell: Yes, the 245 people who got the lower stratum of rewards.
Sir John Chisholm: Those were the people who were in the broader management team.

Q154 Mr Mitchell: So everybody in that broader management team got it?
Sir John Chisholm: Everybody who—

Q155 Mr Mitchell: Everybody you approved of or what?
Sir John Chisholm: No, everyone in the broader management team—

Q156 Mr Mitchell: Got it?
Sir John Chisholm:— were offered it. Not everybody in that team took it up.

Q157 Mr Mitchell: Mr Jeffrey, Carlyle are private equity people. We are taught not to love private equity in the Labour Party. I do not know what your position on private equity is. Certainly they do not publish accounts so we do not exactly know what is going on. Are there any doubts about Carlyle, as an American firm which does not publish accounts, being involved in this way?
Mr Jeffrey: I do not have a personal view on private equity one way or the other, Mr Mitchell. All I can say is that at the time it was perfectly consistent with the Government's policy for us to involve a private equity firm of that sort as a strategic partner in order to grow the QinetiQ business.

Q158 Mr Mitchell: But the Government felt at the time that it did not want defence producers to take this on and yet Carlyle has other defence interests.
Mr Jeffrey: It may do but it is—

Q159 Mr Mitchell: Do you know what it has?
Mr Jeffrey: Its interest in this particular privatisation was quite specific to QinetiQ and its intention was clearly always to exit when it had achieved the growth in value. The reason that the decision was taken not to favour other defence contractors was that it was thought that there was a risk of conflict and that if it turned out to be in their interests because there were synergies between their business and the QinetiQ business—

Q160 Mr Mitchell: Perhaps you can tell us what defence interests it had at the time of investment. Are you worried that this firm—private equity, no

published accounts, other interests—is getting access to commercially sensitive information about British defence interests?
Mr Jeffrey: There is no reason to suppose that the company behaved other than properly during the period—and in fact, they have now divested themselves of their remaining stake—when they were involved in the company. I do not know whether Sir John wants to add to that.

Q161 Mr Mitchell: Sir John, how do you do it? Do you have Chinese walls? What do you have to stop them getting access to commercially sensitive information about British defence interests?
Sir John Chisholm: Carlyle's involvement with the company is that they put a director on our board. Our board does not routinely discuss operational matters. It discusses strategic matters.

Q162 Mr Mitchell: Surely if Carlyle are interested they can find out, can they not?
Sir John Chisholm: The kind of information that you are referring to there was no need for the Carlyle director to know.

Q163 Phil Wilson: I have one or two general questions first and then I want to move on to something more specific. It says in the Report that there was a problem with the deficit on the pension scheme. Has that been sorted out now? Has that been resolved, around pension issues?
Sir John Chisholm: Is that a question for me, sir?

Q164 Phil Wilson: Yes.
Sir John Chisholm: We, like every other company, or at least most other companies quoted on the London Stock Exchange, still Report a pension deficit and today we still have a pension deficit. At the time of the IPO, which is I guess the relevant time, it was reported as over £200 million. That is £200 million net of the return from the MoD.

Q165 Phil Wilson: And what is the situation now? Is it £200 million now?
Sir John Chisholm: No. We have been since then working on reducing that deficit by all the usual means—putting more money in, increasing rates, all those other things, and so we are improving that deficit. I do not have a figure for you. It is published and I can give it to you.
Mr Jeffrey: In relation to the deficit issue, at the point of sale it was implicit in the Carlyle bid that there would need to be an adjustment to take account of any pension deficit. The Government Actuary's Department assessed that in a range from zero to £70 million and in the final negotiations it was agreed that we would, in relation to the value of the whole business, take £25 million off the original bid in recognition of the fact that the pension deficit issue existed.

Q166 Phil Wilson: The other point is on the shares. I know the rate of return for the senior managers was a lot higher than it was for the employees. Was there a difficulty in convincing staff and managers to take up the share offers at the time?
Sir John Chisholm: Yes, sir, there was, because there was at the time an atmosphere of perceived risk in the business which even our staff found themselves influenced by.

Q167 Phil Wilson: Can I ask a question of Sir John Bourn, please? On page 18 of the Report about SERCO, paragraph 2.8, it says that a bit more effort should have been put in place to ensure that SERCO remained one of the bidding companies because there was not an element of private equity involved in it; it was not a firm that was involved in it. The Report says that more effort should have been put into ensuring that they stayed within the bid process. Could you amplify that, because it says at the end of that paragraph, "We consider that more could have been done to work with SERCO . . . ". What does that mean exactly?
Ms Leahy: In various places in the Report, particularly figure 1, there is a timeline there which talks about the process of appointing a strategic partner. SERCO were not taken forward at a very early stage, so the department began the process for getting a strategic partner on 8 March and before the information memorandum was issued on 23 April after pre-qualification SERCO was out of the competition, and we thought that SERCO, being a different type of bidder than the private equity bidders, if taken forward would have given more insight into the value of the business. We thought that it would have been worth taking them forward.

Q168 Phil Wilson: Could I ask Mr Jeffrey what his view on all that is?
Mr Jeffrey: Other things being equal, it would have been good to have a trade bidder in the field, but the view that was taken at the time was that the SERCO bid was weaker than others and that, as I said earlier, there were some potential conflicts and it did not address how these potential conflicts would be dealt with. The NAO say that we should have worked harder to keep them in the hunt, as it were. I certainly know that there was a meeting with SERCO at one stage to talk through some of these issues but in the end the judgment was made that they were among the weaker bids.

Q169 Phil Wilson: So basically, in the thick of sorting out the bid, and it was a very complicated bid, that was your judgment at the time?
Mr Jeffrey: At the time, as I understand it, that was the judgment.

Q170 Phil Wilson: Going through the Report, some of the statements that are made are that the status quo was not sustainable, that the business was well prepared and was able to demonstrate growth, the department executed the flotation well and received a good price, and £800 million I think is the figure that has been quoted in there, the business is

performing satisfactorily, defence interests are being protected and the rate of return for Carlyle is more or less the same as it is for the MoD, so in essence it is a pretty good news story for the MoD. One thing I would ask is, hindsight being what it is, if there was one thing that you would have done that you did not do, what would it be? What do you think you should have done that you did not do, in hindsight?
Mr Jeffrey: First of all, I am grateful to you, Mr Wilson, for saying what you have said because I hope the Committee knows me well enough to know that I am not gratuitously defensive, but I do feel that this is a story that overall has some very good aspects and the NAO in particular has praised the way we separated the two parts of the old DERA into QinetiQ and the DSTL. It has praised the way we undertook the flotation. My view is that when you get into the events of 2002, of which the NAO is more critical, it is very hard at this range to say in the thick of a commercial negotiation that things were necessarily got wrong. I certainly think, as I was saying in response to Mrs Browning's questions, that we need to learn lessons from this of a general kind, but I cannot point to some specific thing that, if only we had done it differently, would have produced a substantially better outcome.

Q171 Mr Bacon: Mr Pocklington, are there documents --- Mr Pocklington? Are there documents in the Treasury that show that £250 million of the MoD budget for that year was expected to come from this sale?
Mr Pocklington: I was not aware at the time—

Q172 Mr Bacon: Mr Pocklington, my question was not were you around at the time. I am not interested in whether you were around at the time or not. I hoped you had come to this meeting prepared.
Mr Pocklington: My understanding, and the NAO may be able to provide more detail than this, is that it is, of course, an NAO audited assumption that relates to the fiscal projections.

Q173 Mr Bacon: Hang on, hang on. I am not asking about the NAO. I am asking about the Treasury. You are an HM Treasury official, are you not?
Mr Pocklington: Yes.

Q174 Mr Bacon: I am not asking about the National Audit Office; I am asking about the Treasury. Are there documents around --- I will just repeat the question for clarity.
Mr Pocklington: I am not aware of any documents. Indeed, the fiscal projections which the Treasury uses are based on assumptions audited by the NAO and those assumptions include --

Q175 Mr Bacon: Hang on, hang on. Fiscal projections: I did not ask about fiscal projections. NAO: I did not ask about NAO. I am asking about whether the Treasury was assuming that £250 million of the MoD budget for the year involved would come from this sale, yes or no?
Mr Pocklington: I am not aware of any documents.

Q176 Mr Bacon: If you find any when you get back to the ranch will you send a copy of them to us?
Mr Pocklington: Of course, but I think it is important—

Q177 Mr Bacon: Thank you very much. That is great. That is all I wanted to know. Sir John, could you go to paragraph 2.17 of the Report please? This is on page 20, paragraph 2.17. Would you mind reading out the first sentence please?
Sir John Chisholm: "On the basis of the scheme agreed, following input from the chief financial officer, the then chief executive officer proposed the specific allocation of shares to management and staff."

Q178 Mr Bacon: "The then chief executive officer proposed the specific allocation of shares to management and staff". Who was "the then chief executive officer"?
Sir John Chisholm: I was.

Q179 Mr Bacon: I thought so; yes, I thought you were. A separate question: have you had any discussions with anyone about leaving QinetiQ?
Sir John Chisholm: No, sir.

Q180 Mr Bacon: You have not?
Sir John Chisholm: No, sir.

Q181 Mr Bacon: I would like to pursue the question which the Chairman asked you earlier, Sir John, when he quoted Lord Gilbert, former Defence Minister, who said on the radio the other day that he was very annoyed with you because: "never once in my presence did Sir John Chisholm indicate that he might have a conflict of interest or he was going privately to be enriched by what was going on". You replied to the Chairman that private equity was not in prospect. Your exact words elude me but it was along those lines, that private equity was not in prospect. You also mentioned that it was to have been an institutional investor; this was the assumption. It is a long time since I have worked in an investment bank or a finance department, but when I did private equity was not anything like the industry it is now, but even then, when there was institutional investment, it was normal to have management equity, absolutely normal. The Chairman's question was about whether you were wrong not to draw Lord Gilbert's attention to the fact that you would privately benefit. You chose to answer by saying that private equity was not in prospect, although institutional investment was, even though it was quite possible, even with institutional investment, that you would benefit. Now I look at the transcript of the Defence Select Committee on 28 February 2001, to which you gave evidence, and Laura Moffatt asked you, and she had obviously asked you for a while because it starts at paragraph 54 but she says: "I ask you one more time: is there to be any financial benefit to you or to anyone else involved in this process?", to which you

replied, "I draw a salary from the Ministry of Defence at the moment". Her next question was, "What about shares?", and you replied, "I hope that I shall draw a salary from New DERA plc", that is the new co, "in due course", and so when she asked, "What about shares?", your answer was, "I hope that I shall draw a salary . . . ". She went on, "There will not be any stock involved at all, will there?", and you said, "The issue of share schemes for employees is an issue for the vendor to decide.", although we have just established from the way you read out paragraph 2.17 that you were the one establishing who got which shares. We then go on in the Defence Committee over the page where Baroness Symons said, in answer to Bruce George, the Chairman of the Committee, "You say you do not expect anyone to be out of pocket . . . but we expect those appointed to earn reasonable salaries for what they do, which will be different from what they are doing now." Bruce George replied, "You know what I am getting at. I do not want to see people leaving the Ministry of Defence who have been part of the negotiation for New DERA and within 6 months, 12 months or two years ending up on a tripled salary . . . ", and he goes on, "I would be reluctant to acquiesce to any system which would allow people who were part of the negotiations to profit significantly from their work", and Baroness Symons replied, "The important point to remember is that there is already a very robust monitoring of how civil servants move from the public to the private sector . . . ", and then we go to Lord Moonie on the radio the other day, again in the same package with Lord Gilbert on the *Today* programme, who said, and I quote, "We moved heaven and earth to put into position safeguards to ensure that the senior officials who were taking a stake in the company were not able to enrich themselves". Mr Jeffrey, what were those safeguards where you moved heaven and earth? What were they?
Mr Jeffrey: As I said earlier, the executive returns arrangements were set by Carlyle.

Q182 Mr Bacon: Sorry, Mr Jeffrey. I was not asking who set the arrangements. My question was, what were the safeguards?
Mr Jeffrey: In the sense that you are asking the question there were not safeguards.

Q183 Mr Bacon: There were not any safeguards, so Lord Moonie was actually wrong when he said, "We moved heaven and earth to put safeguards in place"? You have just said on the record there were no safeguards. That is correct, is it not?
Mr Jeffrey: What I have said is what I have been saying throughout this hearing, which is that—

Q184 Mr Bacon: I am just asking you, because you are not speaking that loudly, to confirm what you said a minute ago: there were no safeguards.
Mr Jeffrey: The arrangements for executive returns—

Q185 Mr Bacon: Did you say a minute ago there were no safeguards?
Mr Jeffrey: In the sense that you asked the question, I mean,—

Q186 Mr Bacon: Did you say a moment ago—I do not want to have to wait till I read the transcript—there were no safeguards? Yes or no?
Mr Jeffrey: There was nothing in the arrangement that SERCO[6] set that prevented the kind of additions to the value that senior executives had—

Q187 Mr Bacon: I am asking about your statement a moment ago, which I did not quite hear. I think I heard you say there were no safeguards. Is that what you said?
Mr Jeffrey: What I said was that there were no safeguards in the sense that the arrangements that SERCO[7] settled on were ones that were capable of producing the result.

Q188 Mr Bacon: It seems to me the best safeguard was your statement much earlier where you said, "It might have been an option to place a cap on it". "It might have been an option to place a cap on it"—that was the extent of the safeguards, was it not, Mr Jeffrey?
Mr Jeffrey: Which I followed up by saying if our predecessors had chosen to place a cap on it, and, as I say, that might have been an option, they would have had to reckon on the fact that by doing so they were reducing the value of the company and they would be second-guessing the judgment of Carlyle whose business is exactly this, to find ways of incentivising senior managers to deliver for the companies that they are working in.

Q189 Mr Bacon: The Report makes it clear in paragraph 2.30 that: "to achieve market value the competitive process needs to be strong". I know you do not agree with all of this Report, but do you agree with that?
Mr Jeffrey: Yes, I do.

Q190 Mr Bacon: You do? And yet for six months, from 3 September until the thing closed on 28 February 2003, there was no competitive process. It was just Carlyle.
Mr Jeffrey: It was Carlyle but with Permira there as reserve in the background if a satisfactory deal was not done with Carlyle.

Q191 Mr Bacon: Yes, sure, plus your safeguards that it might have been an option to place a cap on it. I wanted to ask you, just for the avoidance of doubt: you are not planning to sell off any MoD assets at the moment which will make you a multi-millionaire, are you?
Mr Jeffrey: Certainly not.

Q192 Mr Bacon: And if you were do you think it is something we ought to know about?

[6] Correction by witness: Mr Jeffrey should have referred to "Carlyle" not "SERCO".

[7] Correction by witness: Mr Jeffrey should have referred to "Carlyle" not "SERCO".

Mr Jeffrey: Of course it is.

Q193 Mr Bacon: Yes, I would have thought so too. Mr Woolley, are you a chartered accountant?
Mr Woolley: I am not.

Q194 Mr Bacon: Are you a qualified financial person of any kind? Do you have any financial qualifications?
Mr Woolley: I do not have financial qualifications.

Q195 Mr Bacon: What is your job?
Mr Woolley: I am the Finance Director of the Ministry of Defence.

Q196 Mr Bacon: Yes, that is what I thought. It is what it says here. Sir John, we have discussed this before when finance directors were called principal finance officers, and I think when I first asked the question some years ago only 23% of principal finance officers had a financial qualification. I think it has gone up significantly in the last little while. The number that sticks in my mind is 60%. Do you have any idea what the current level is?
Sir John Bourn: I think by now it is more than 60%, but there are, of course, exceptions, as in the case of Mr Woolley.

Q197 Mr Bacon: Yes, it would appear the MoD is an exception.
Ms Diggle: I believe it is well over 90%.

Q198 Mr Bacon: It is well over 90%, so Mr Woolley is in a very small category?
Ms Diggle: He is.

Q199 Mr Bacon: And yet he is responsible for a £32 billion budget.
Ms Diggle: He is.

Q200 Mr Bacon: Is this not a bit of an omission on the part of the Treasury in its zeal to encourage qualifications by—
Ms Diggle: We are trying to make it a blanket requirement. We have not quite got there yet.

Q201 Mr Bacon: Does trying to make it a blanket qualification include Mr Woolley?
Ms Diggle: We are trying to get to 100%.
Mr Jeffrey: If I may make a comment, Mr Bacon, Mr Woolley in my view does a very good job as Finance Director.

Q202 Mr Bacon: I was not asking about the quality of the job he does.
Mr Jeffrey: But it is my intention that his successor should be financially qualified, as the policy requires.
Mr Bacon: Good; I am glad to hear it.

Q203 Chairman: I am grateful for those questions, Mr Bacon. Sir John, when I asked you that originally were you just trying to be deliberately disingenuous in answer to my question and pull the wool over my eyes?
Sir John Chisholm: I am sorry, Chairman. I am afraid I have not followed your point there. Which question were you referring to?

Q204 Chairman: I was asking you about your conversation with Lord Gilbert, and I asked you a direct question. We can read out the whole transcript again. I read it to you and Mr Bacon has read it to you. Lord Gilbert, the then Minister, said that you were not honest with him about your possible financial gain. I want to ask you the question again. What was the exact nature of your conversation with Lord Gilbert? Can I have the transcript? "One of the things that irritated me in was that never once in my presence did Sir John Chisholm indicate that he might have a conflict of interest or he was going privately to be enriched by what was going on". I have to ask you, and I do not want any answers about equity or investment; I just want a direct answer, is Lord Gilbert right in saying that on the *Today* programme? Yes or no?
Sir John Chisholm: He is not right, no.

Q205 Chairman: Why is he not right? He is lying, is he? He has made it up, has he?
Sir John Chisholm: Because at that stage there was no scheme or anything to discuss in terms of any kind of management equity.

Q206 Chairman: Are you telling us that when you were having these conversations with Lord Gilbert, and he might well have been naïve about this, it had not crossed your mind that there might be a conflict of interest or that you were going to be privately enriched? Are you really suggesting that to us, that you discussed this with a responsible minister and it never crossed your mind?
Sir John Chisholm: Perhaps it would help, Chairman, if I just said a word or two about what the PPP proposal was then. Would that help?

Q207 Chairman: Yes, of course.
Sir John Chisholm: Okay, thanks. That came out of our 1997 Corporate Plan. At that stage the Agency, having done a reasonable job of getting itself into an efficient position, was suffering from the fact that, being a fully owned government entity, as it tried to deal with the decreasing business from the Ministry of Defence, the 40% downturn that the Report indicates, and as it tried to move into other businesses, its competitors complained about that and went to ministers because it was, obviously, differently financed and had a lot of non-competitive business, and that was clearly a problem, a very significant problem. The ways forward were either to continue the way we were, in which case it would be just a gentle downward slope and a waste of assets, or the other four options. One was to go all-out into the commercial, non-defence world. That looked like high risk. Another was to do what the DIC, the Defence Industrial Council, then recommended, which was essentially that the work should go to the defence industry and DERA should be downsized significantly to stay out of the defence industry's way. That would be enormously expensive for the

Government, and of the two remaining options (this is 1997 we are talking about) one was what we call federated labs, where essentially our labs would be attached to universities rather like the Lincoln Labs in the United States. That was one option and we were quite attracted by that option and so that was one of our recommended options. The other was to pick up an idea—this was 1997, the new Labour Government had just arrived and there was something in their manifesto called "the third way". This is somewhere between public and private; that was the idea.

Q208 Chairman: So this is a triumph for the third way, is it?
Sir John Chisholm: And that is where the phrase "public private partnership" came from, and the notion at that time was that institutional equity would be injected into exactly the same organisation that we have at the moment.

Q209 Chairman: Yes, I understand that.
Sir John Chisholm: As you can see, there was no sense at that stage of the kind of privatisation which subsequently emerged in 2002/2003.

Q210 Chairman: Just because it is not a classic privatisation that had happened before, it was a new form, a third way, if you like, an injection of private equity money, you are the responsible official so when you go and advise ministers it is your duty surely to say to them, "I would rather somebody else was involved in negotiating all this because there is a real possibility that I might be involved in some sort of management buyout", or whatever else you want to call it. This would be the right way of doing it, would it not? You would stand back from it, would you not? That is what we cannot understand, I think.
Sir John Chisholm: Sir, if there had been the proposition of a management buyout—

Q211 Chairman: No, I expressed myself badly. I knew that you would immediately come back on me. I know it was not a management buyout, but what I am trying to get over to you is that here you had a minister you presumed was coming to this new. You should have stood back from it at that stage because it must have occurred to you that whatever you call it, whether you call it an injection of private equity or anything else, there was a real possibility there would be a conflict of interest and that you would benefit from this financially. Surely, in the traditions of our Civil Service, and we are about to celebrate 1,500 years in this Committee, and we celebrate the fact that we have an incorruptible Civil Service, is there no smidgeon of doubt in your mind that perhaps you acted wrongly at that stage?
Sir John Chisholm: There is not.

Q212 Chairman: That you did not act in the traditions of the traditional British Civil Service? There is no smidgeon of doubt in your mind?
Sir John Chisholm: No, there is not, sir. We were at far too early a stage and the proposition did not encompass that at that stage as a possibility.

Q213 Chairman: What about later ministers of defence procurement? When did Lord Gilbert leave?
Mr Woolley: 1998, I believe.

Q214 Chairman: This stage was carrying right on through 2002. At no stage did you say to ministers, "I am going to back out of this now because I might stand to be enriched personally"?
Mr Jeffrey: As I said earlier, Chairman, by that stage we had moved into the period that I described, where the advice to ministers was coming principally—

Q215 Chairman: At what stage did Sir John then stop giving any advice to ministers? What year was it, what month?
Mr Jeffrey: The principal advice to ministers on this issue throughout 2001–02 was coming from Mr Woolley's predecessor as Finance Director.

Q216 Chairman: At what stage did Sir John stop giving advice to ministers?
Mr Jeffrey: He remained involved in the process in the sense of contributing his views but the principal advice to ministers was—

Q217 Chairman: All right, so he was giving his advice to ministers? You have just said that. Till what date was he giving his advice to ministers?
Mr Jeffrey: Sir John?

Q218 Chairman: Mr Jeffrey, I asked you. Why can you not answer?
Mr Jeffrey: If what you wish is a date, Chairman, then I had better—

Q219 Chairman: I do not understand what you are saying because it is now clear to me that you first of all a couple of minutes ago suggested to me that at an early stage he withdrew from all this. You are now saying that he was giving advice to ministers throughout this process.
Mr Jeffrey: What I am saying is that the thing was set up in such a way that the principal advice to ministers and the submissions to ministers about the sale to Carlyle were coming from the Finance Director and the team that reported to ministers.

Q220 Chairman: Maybe the principal advice, but he was still continuing to give advice throughout this process?
Mr Jeffrey: He was still—

Q221 Chairman: The chief executive.
Mr Jeffrey: The chief executive and—

Q222 Chairman: And he was seeing ministers, was he, advising them?
Mr Jeffrey: I was not there at the time but I imagine Sir John was. I was making a point about the way in which the department managed the fact that—

Q223 Chairman: In all fairness, Sir John, I have to give you a chance to reply to this.
Sir John Chisholm: From the time the corporate plan 1997, called the CP98, was published, the Ministry of Defence appointed a separate official to take the lead on policy, so from that time onwards, quite appropriately, the lead was taken by someone else other than me.

Q224 Chairman: The lead, but did you give any advice to ministers after 1998 on this?
Sir John Chisholm: I met with ministers remarkably seldom.

Q225 Chairman: I did not ask you that. Did you give any advice to ministers after 1998 on this project?
Sir John Chisholm: I do not remember, I have to say, discussing this with Lord Gilbert. We had a council.

Q226 Chairman: I did not ask you that. Did you give any advice to ministers after 1998 on this project?
Sir John Chisholm: I presented our Corporate Plan. That I do remember doing.

Q227 Chairman: You presented your—
Sir John Chisholm: Corporate Plan.

Q228 Chairman: Did you give any advice on the implications of the sale or the relationship with Carlyle or anything else? Were there any conversations after 1998?
Sir John Chisholm: Carlyle was absolutely not in it at that stage.

Q229 Chairman: All right. You are deliberately trying to avoid answering the question. Did you have any discussions with ministers appertaining to this privatisation that we are discussing this afternoon after 1998 of any nature?
Sir John Chisholm: I supported from time to time the Ministry of Defence team.

Q230 Chairman: So you did advise ministers?
Sir John Chisholm: I supported the Ministry of Defence team.

Q231 Chairman: What does that mean, "I supported the Ministry of Defence team"?
Sir John Chisholm: Exactly that.

Q232 Chairman: What does it mean?
Sir John Chisholm: That the Ministry of Defence had a team.

Q233 Chairman: Yes.
Sir John Chisholm: And so far as the team—

Q234 Chairman: You advised them?
Sir John Chisholm: So far as that team needed technical advice I advised them.

Q235 Chairman: And you were in a position, of course, as the leading authority on this, to give advice, which presumably was heeded? You were not just some clerk, were you? You were not some junior researcher, or junior official, think, in the parlance, were you?
Sir John Chisholm: The thrust of the advice that I was engaged in was first of all in helping with the formulation of a model and the first model was that early PPP model that I have just described, which involved the whole of DERA.

Q236 Chairman: But you were active right through. What about this advice that the percentage going to management should rise from 10% to 20%? You were not involved in that either, were you?
Sir John Chisholm: I said earlier on, I think, that one of the contributions I made --- let us just remember that up to the moment of down- selecting two the interaction with management was rigorously controlled; indeed, it was rigorously controlled throughout but we had no one-to-one interaction. The interaction we had at that time was primarily orientated around Carlyle, and indeed Permira, getting advice as to what the strength of the team was. They also, both of them, wanted to have input on how the management team would respond to a share scheme. I gave them my advice. Carlyle took that away and later, post-September, came back with their scheme. It was their scheme that they came back with.
Chairman: All right. We must press on. I apologise to Mr Griffiths.

Q237 Nigel Griffiths: I have been a Member of this Committee, Mr Leigh, for a number of years over the past decade and I have seen some damning reports on MoD projects and separately damning reports on privatisation. This is not one of them. I think Sir John might agree.
Sir John Bourn: Certainly the Report testifies to the success of the business. It does, of course, make points that we believe a better price could have been got for it.

Q238 Nigel Griffiths: What it also does not seem to do is criticise Sir John at any stage for his participation. I do not know if you picked that up, Mr Jeffrey, or not.
Mr Jeffrey: You are right to say that. There was no criticism of that sort in the Report.

Q239 Nigel Griffiths: Indeed, paragraph 2.20 on page 21 would imply that if this was such a surefire profitable scheme then senior managers who did not invest in it must have been mugs at the time not to invest, which implies that it was not a surefire thing and that indeed if the *Financial Times* and *Financial Times* journalists thought that so many schemes were surefire or not they would probably be multi-millionaires instead of becoming Members of Parliament. I notice that in paragraph 1.2, and that is perhaps an explanation; perhaps you can help me, Mr Jeffrey, it implies that in the six years leading up to 1998 the budget had plummeted by 40%, I cannot remember, and therefore people involved in this organisation perhaps did have some doubts about the future viability of it.

Mr Jeffrey: They did, and one of the reasons for the course the department took was that there had been this fall in the amount of business that we could expect to bring to DERA and it was becoming questionably viable, but I certainly take your point, Mr Griffiths, and it was one I was trying to make earlier, that it is easier now than it might have been then to say that this was a surefire winner.

Q240 Nigel Griffiths: And usually with such NAO Reports on the MoD I am spoiled for choice for critical comments. What I see here is, chapter after chapter, "The restructuring was completed in a challenging timetable and largely well managed", page 14, and page 15, "The department put in place measures to safeguard UK defence interests", Part Three, "The department executed the flotation and achieved a good price". These are pretty flattering statements from the NAO. "The business appears to be performing satisfactorily in the private sector". Were you surprised at the level of hostility that was reported when this Report was published a week or so ago?
Mr Jeffrey: The points that have been made by other Members of the Committee, that this issue strikes a raw nerve with the public and can be seen in the light that it has been portrayed in in this hearing, I think are very valid ones, so in a sense I was not surprised that those comments in the Report which suggest that we could have done better, for example, were seized on in the media, but I do myself feel, and I imagine this has come through in my evidence, that this is mostly a good story for the reasons that you give, Mr Griffiths.

Q241 Nigel Griffiths: When Lord Moonie reminded the public that the Government had indeed shared in the rising value of the company was he referring to number 15, page 8, that 112% on the investment was the internal rate of return to QinetiQ and that 99% (not far short of 112%) was achieved by the department?
Mr Jeffrey: He may have been. The only reason for the difference between the 112% and the 99% goes back to the slightly contentious point about departmental costs that we were discussing earlier. He may also have been referring to the fact that, as this stands at the moment, as I said earlier, the proceeds from the various sales have already amounted to £578 million and we retain a share which is currently estimated as being worth around £235 million, so there is potentially a very substantial benefit for the taxpayer in this whole episode.

Q242 Nigel Griffiths: When the Report says in Part Three, "The Department executed the flotation well and achieved a good price", do you believe that a better price might have been achieved if this were to be, with hindsight, done in 2007?
Mr Jeffrey: I do not believe so. I, as it happens, was around at the time, although only just, and I think those who made the judgment to go to market early in 2006 got the market about right and got a very good price for the shares, which has since then been sustained. It has neither, as Mr Williams remarked earlier, shot up, which suggested we sold cheap, nor is it depressed.

Q243 Nigel Griffiths: When it says in Part Four, "It is too early to be able to assess authoritatively if some of the objectives have been met", what have you got in place with the company to measure objectives? When do you think we will be able to see a report that shows whether objectives have been met or not?
Mr Jeffrey: I think what has been happening in recent times is the gradual, if you like, normalisation of the relationship so that our relationship with QinetiQ is closer to the kind of relationship that we have with all suppliers in this sector. We have certainly been discussing with them the nature of the safeguards that need to be there to protect against any question of conflict of interest where they are giving us independent advice as well, and we have recently been auditing internally exactly how these arrangements work, so it is a developing relationship and the way I would characterise it is that from a starting point where this was just any old part of the department we are going into a mature relationship with a company that is playing a significant part in the British defence sector.

Q244 Nigel Griffiths: In paragraph 3.9 it says: "The process for appointing advisors for the flotation was robust". You must take some pride in that.
Mr Jeffrey: I think it is a fair reflection of what happened.

Q245 Nigel Griffiths: And, more importantly to all of us, when the department put in place measures to safeguard the UK defence interests, again, do we have to await the verdict of history on that or do you have evidence that UK defence interests have been effectively safeguarded?
Mr Jeffrey: I think the relationship at the moment is working in such a way as to safeguard defence interests, although, for the kind of reason that Mrs Browning was hinting at earlier, we need to keep an eye on this very carefully.

Q246 Nigel Griffiths: Sir John, I mentioned earlier paragraph 2.1 which was the cut in the budget for research which fell by over 40%. What is the present figure? Do you have one?[8]
Sir John Chisholm: I do not have a figure for the Ministry of Defence research budget today because I am no longer involved at that level.
Mr Jeffrey: We can provide one. It is one of the issues that I have been looking at in the context of our overall judgments about financial plans over the next few years. I certainly think that maintaining the level of MoD investment in science and technology

[8] *Note by witness*: The Department's spending on research for 2007–08 is approximately £630m. This figure includes the Science, Innovation and Technology (SIT) budget as well as some of the other research activities carried out in the MOD as defined by the OECD Frascati guidelines (the Frascati guidelines provide a point of reference for the definition of research and development and its outputs).

generally and research in particular is very important. As a matter of fact, over the years when this was happening it was declining. My recollection is that in real terms it flattened out after that period of decline.[9]

Mr Woolley: I think the challenge for QinetiQ has not simply been the decline in the overall value of the research budget but also the fact that it has been progressively open to competition where previously it was virtually assigned to the old DERA.

Q247 Nigel Griffiths: Do you think it is a fair summary of this Report that greater proceeds might have been achievable from the sale to a strategic partner, page 35?

Mr Jeffrey: I think it is very hard to judge. That is why I have been a little non-compliant in this session. I think four or five years after the event there is an argument, and the NAO Report expounds it, to the effect that we could have got more from this. It was a complicated sequence of negotiations in which properly equipped financial advice was taken at each stage, and I am very reluctant myself to conclude that it produced a sub-optimal result, but clearly it is a matter of opinion.

Q248 Mr Williams: Sir John, may I make it clear I am not in any way suggesting that you are a dishonourable man. What I do think is that you may be someone who is out of his depth in the rather cynical world of private equity. Can you tell me, when was the issue of equity for executives first raised? Was it raised early on? Was it raised by your side or was it raised by the bidders?

Sir John Chisholm: All the bids had a section of their bid which talked about equity for staff and managers.

Q249 Mr Williams: So that was envisaged as being something that was to come?

Sir John Chisholm: Yes.

Q250 Mr Williams: Following on what Richard and Austin have referred to, paragraph 2.2, you told the NAO that you were concerned about the potential risk of management making large returns from the involvement of private equity investors. What at that stage did you envisage to be large returns? What did you have in mind? What led you to issue that warning?

Sir John Chisholm: That warning was in the context of the debate over whether the route to market should be through private equity or through a direct flotation. That was the context of that debate and I would not have had a number at all in my mind. I would merely be relating to the perverse issue I discussed early on, that the management team would be employed to create as much value as they possibly could and eventually, if they were successful, that would raise exactly the debate we have been having today.

The Committee suspended from 6.54 pm to 7.00 pm for a division in the House

Q251 Mr Williams: I was asking what sum of money you thought a large return would be. Succinctly, what at that stage would you envisage as a large return?

Sir John Chisholm: I did not have in mind a specific number.

Q252 Mr Williams: Then how did you know to go and ask for more?

Sir John Chisholm: Sorry?

Q253 Mr Williams: How did you know then to go and ask for more?

Sir John Chisholm: As I explained earlier on, the principal thrust in terms of the discussion with Carlyle was that more people should be engaged in it, and in order to bring more people into it we needed more flexibility in the equity scheme.

Q254 Mr Williams: So did you at that stage envisage a possible doubling of it?

Sir John Chisholm: I would have to say that that was not a specific number because I was not proposing any specific scheme at that time. I was merely addressing the issue that this was a different company from many of the other companies that they had done business with.

Q255 Mr Williams: But, you see, approaches were now made as a result of the wish to enlarge the sum and they were made before the decision on the final bid was being made. You are in a pretty cynical, hard-headed world when you are dealing with private equity firms. It looked very much like a nod and a wink to them, and they would just think, "Oh, well, this is it. This is how we get it". Did that thought not occur to you? Did it not occur to you that it might be unwise for yourself as a potential beneficiary to be helping to promote this line of approach?

Sir John Chisholm: Let me make two points. The first point is that at no stage after we had been asked to talk to Carlyle and Permira did we provide any advice to the Ministry of Defence as to the selection of a final preferred bidder, so there was no opportunity in those discussions they had with me for me to influence the final choice of a preferred bidder. That is just a matter of the schedule, the way the schedule worked.

Q256 Mr Williams: Did Carlyle in any way seek advice from yourself or your colleagues, since the first offer had been turned down or indicated as being inadequate, as to what you would have in mind?

Sir John Chisholm: They certainly asked us about the willingness of our management group to invest and they certainly asked us what type of scheme would be readily accepted.

[9] *Note by witness*: The Department's spending on research for 2007–08 is approximately £630m. This figure includes the Science, Innovation and Technology (SIT) budget as well as some of the other research activities carried out in the MOD as defined by the OECD Frascati guidelines (the Frascati guidelines provide a point of reference for the definition of research and development and its outputs).

Q257 Mr Williams: Yes, but we are talking about scale here. Did you give advice on what would be the level of equity that you would expect to have available to distribute?
Sir John Chisholm: They certainly asked us for that, yes.

Q258 Mr Williams: And what was your advice to them?
Sir John Chisholm: They asked for advice as to who were the key people and I provided at least an outline list at that stage as to who they might be, because the key discussion was around my feeling about who the key people were.
Sir John Bourn: So what you are saying is that they wanted to know how many people were going to be participating before they decided how much they would offer? Is that how it happened, or were the two running together?
Sir John Chisholm: It is clear that in order to make a final bid the bidder needs to know what he is bidding for.

Q259 Mr Williams: Yes, and that is exactly where I come back to the nod and the wink again. How did they eventually arrive at the figure they offered or were they told that would be acceptable to QinetiQ?
Sir John Chisholm: No, no. It was not a question of being acceptable to QinetiQ because QinetiQ, as I have just explained, did not have a further voice in that selection. What they were doing was a professional job of designing their principal tool for the achievement of their end, and indeed the other shareholders' end, of increasing the shareholder value. Private equity companies do not manage the business themselves. They (a) select a management team and, as I have said, they were engaged in that process by talking to me, and (b) they design an equity scheme which in their experience achieves the best result in creating value for the shareholders.

Q260 Mr Williams: I do not want to go over ground that has been covered before so I am going to leave you alone for a moment now and switch to Warburg, because Warburg, I think, cost the Government a lot more than you and your colleagues did. First of all, when they came back asking for the £13 million reduction it turned out they had not taken into account the tasking cash flow. That was not taken into account at all, which was rather remiss of them, and the NAO comments that it could have made a significant difference in value, and similarly they seemed to do the same in relation to capital expenditure where they assumed that the capital expenditure was going to be met out of contractual cash flows; they did not take into account the option of the much cheaper and more widely spread option of debt which was available. These two cost a great deal of money, more than, as I say, the executives cost the department. Why were Warburg so remiss in two areas, both of which the National Audit Office said were errors that could have made a significant difference?
Mr Jeffrey: I do not think the NAO's conclusion is that these were errors. What happened was that the Carlyle bid assumed that the long term partnering agreement would generate £30 million profit a year by a predictable income stream. They argued that because that assumption was not, as the LTPA was coming out, going to be well founded. It reduced the contract value by between £43 million and £76 million. UBS/Warburg agreed that there was a material reduction which could be expected to result in a reduction of proceeds to the MoD and there was then a negotiation in which we reduced that reduction to £30 million, of which £11 million impacted on the proceeds of the sale of the minority stake. It was a rational part of the process and it is not so very unusual for these final stages to involve negotiations of that sort.
Mr Williams: But there were two oversights, and I am not asking a further question, and the National Audit Office observed in both cases that it made a considerable difference to the sum and that that comes to vastly more than the £30 million which is already admitted from the one cause alone. I will leave it at that now.
Chairman: That concludes our hearing, but obviously the National Audit Office will have to work on this further in preparing our draft Report for us. For a key part of this hearing, of course, Sir John is going to rely on just how much more the Government could have got for this business in light of the fact that an extra 2.5% was sold for £3 million and this was worth £27 million to the flotation. I do not normally ask the National Audit Office to do further work again, period, but there is no time now to ask questions and I think this could be reflected in our draft report. Thank you very much, gentlemen.

Memorandum submitted by David Kirkpatrick Esq

Key Issues

The key issues considered by the NAO Report is whether the MoD obtained a fair price for the sale of part of Qinetiq in February 2003 to the Carlyle Group and to Qinetiq's senior management, and whether the privatisation process was conducted in accordance with proper standards of corporate governance.

The NAO Report focuses exclusively on how the privatisation of Qinetiq was implemented, so its scope is much narrower than earlier HCDC enquiries which considered whether the MoD's policy decision to adopt a PPP for DERA was in the public interest.

In my notes below I have included references to the relevant paragraphs in the NAO Report.

Review of NAO Report

The NAO Report draws three key conclusions:

1. The MoD did not receive an equitable share of the proceeds of privatisation, because Qinetiq was undervalued when part of it was sold to the Carlyle Group in 2003 [4.12] and because of the generous share incentive scheme adopted for the senior management of Qinetiq which "exceeded what was necessary" [Summary 9],
2. The huge £5.6B Long Term Partnering Agreement (LTPA) between the MoD and Qinetiq, by which Qinetiq was without competition given a contract to provide test and evaluation services to MoD for the next 25 years, incorporates major price risks to MoD [4.23],
3. The Chief Executive of Qinetiq proposed to the Carlyle Group, before it was chosen as the preferred bidder, an incentive scheme for senior management and the allocation of shares to senior managers (including some to himself) without involvement of the remuneration committee established by the MoD [2.15-2.17].

A Note on Qinetiq

Qinetiq was at its inception a highly-unusual company, in that the MoD was both its owner and its principal customer. Most (about 80%) of Qinetiq's revenue then came from MoD contracts, and almost all of those contracts were awarded without competition [Fig. 11]. It follows that Qinetiq's profitability was largely determined by the prices which it charged to MoD for defence research and other services. It also follows that the distinction in Qinetiq's accounts between its share capital and loans is less significant than it would be for most commercial companies; in such companies the capital comes from shareholders and the loans come from banks, whereas for Qinetiq both were provided from public funds by the MoD. However the chosen equity/debt ratio was very significant in determining the financial rewards which were obtained by Qinetiq's senior managers.

Since 2002 Qinetiq has used the cash generated from its operations (still largely with MoD and still largely awarded without competition) to acquire companies in the US and to take advantage of the substantial growth in DoD research funding since the terrorist attack on 11th September 2001. It is unclear how this move into the US market has affected the quality and cost of the research and other services now being provided by Qinetiq to the MoD, but that issue is beyond the scope of this NAO Report.

Personal Comments

A. The genesis of the PPP policy arose from the dramatic fall in MoD funding for defence research (down 40% between 1992 and 1998) after the end of the Cold War which threatened the future viability of DERA. In DERA's corporate plan 1998-2003, the Agency presented five options to address this situation, and identified a PPP as likely to provide the greatest returns to HM Treasury. It is not clear whether MoD consider the sixth option of restoring the defence research budget—which is a very small fraction (2%) of the total defence budget—to its former level, though MoD has since admitted in its 2006 Defence Technology Strategy that the current level of UK defence research is too low. The MoD's decision to adopt a PPP for DERA was included in its Strategic Defence Review published in July 1998; its Comprehensive Spending Review for 1999-2002 planned that the PPP would be complete by April 2002, and would yield £250M for MoD with any excess going to the Treasury. This plan created a tight schedule for implementing the PPP, but simultaneously gave the MoD little direct incentive to maximise the financial proceeds [1.6].

B. It is astonishing that the MoD did not judge it necessary to consult the British defence industry [1.4] prior to its decision to adopt a PPP for DERA. That industry's ability to supply first-class equipment to the UK armed forces, and to succeed in export markets, has traditionally relied on new technology which was created by DERA and its predecessor establishments and was transferred gratis to industrial companies working on MoD equipment projects.

C. It is equally astonishing that, despite acknowledging the divergence of interest between the MoD and DERA management, the MoD neglected to validate the DERA analysis supporting PPP [1.4]. Treasury rules stipulate that any such policy decision should be supported by an investment appraisal covering all of the consequential costs and benefits (including for example likely future revenue from intellectual property [1.21]).

D. It must be presumed that the management of DERA, when it originally recommended a PPP to Ministers, explicitly advised that adoption of this policy might yield rich financial rewards for DERA's top managers. At that stage the managers were civil servants and subject to the civil service code of conduct. (Sir John Chisholm's evidence to the NAO says [2.2] that he advised MoD in early 2002 of potentially large returns to senior managers, but his evidence to successive HCDC enquiries was less explicit).

E. Later, during the PPP process, the senior management of Qinetiq had to strike an appropriate balance between generous remuneration for themselves, low prices for their customers and good returns on their shareholder's capital employed. Most of Qinetiq's customers at that time were in the MoD, which also held all of the shares. This apparent divergence of interest was exacerbated by the MoD which chose to involve Qinetiq closely in the privatisation process. In particular, Qinetiq was involved in

— evaluation of applications from potential bidders [2.7, 2.10];

— management of the data submitted by those bidders [2.10];

— comparison of the final two competing bids [2.12];

— negotiation of the Board's own incentive package with at least one of the bidders before it was selected as the preferred bidder [2.15]; and

— valuation of the LTPA, following which the Carlyle Group negotiated a reduction (which the NAO considers was not sufficiently justified) in the price it paid for shares in 2003 [Annex 5].

These were the circumstances in which Qinetiq's 10 senior managers were in February 2003 able to invest £0.54M in shares which were worth £107M at flotation in January 2006 [Fig.19]. It is more surprising that the responsible MoD Ministers and civil servants allowed those managers a 19,900% return on their investment. The MoD appears to have pursued the policy objective of PPP without much regard for economy with public funds (despite the example of Comax in 1997 and the warnings of potential fat-cattery from HCDC and others).

F. The MoD claim that the remuneration committee need not have been involved in decisions on the incentive scheme for Qinetiq's senior management should be compared with the 2000 edition of "The Combined Code on Corporate Governance" produced by the Institute of Chartered Accountants; MoD itself approved the allocation of shares without independent scrutiny because it considered its interests to be aligned with those of the Carlyle Group [2.16, 2.17]. Perhaps their short-term financial interests overlap to some extent, but the MoD does have some additional responsibilities (such as the UK's national security).

G. The NAO Report [4.7] concludes that the MoD has received net proceeds of £576 from the privatisation, taking account of its costs of £76M incurred during the privatisation process. However before the privatisation, during the division of DERA into two parts (each with independent computers, communications documentation security and administration), the MoD incurred costs of £19M while DERA, DSTL and Qinetiq incurred additional costs of £68M between them [4.9]. Furthermore DSTL now plans to relocate some of its divisions, to achieve a greater physical detachment from Qinetiq, and expects that relocation to cost some £92M. Since most of the revenue of all of these organisations comes from the MoD, and all of these expenditures arose from the PPP policy, it would be reasonable to reduce MoD's net proceeds by the total of 19 + 68 + 92 = £179M plus some fraction of the (unspecified) costs incurred by Qinetiq during privatisation [4.9]. A proper investment appraisal of the privatisation of Qinetiq should also include any differential between the future prices likely to be paid by the MoD for Qinetiq's services (in research, project support, and test & evaluation) and the cost of the same services delivered by a government establishment.

H. It was only several months after the MoD had decided to adopt a PPP for DERA that the Department set up the DERA Partnering Team to consider how the PPP might be implemented, and also consulted UK industry, trade unions, academia and allied nations (notably the US) on the likely consequences [1.8]. These consultations lasted some 2 years and reduced the period available for meaningful negotiation before the April 2002 deadline. This may partly explain why MoD allowed the Carlyle Group to negotiate down the price it paid in 2003, and why MoD agreed to reimburse Carlyle's bid costs of £16M without verification or validation (despite an earlier statement that it would not do this [2.34]).

I. The NAO's advisors have valued Qinetiq as it stood in 2003 at about £100M more than the PPP valuation. Between PPP and flotation Carlyle shares increased in value be £332M, and the Qinetiq managers" shares increased in value by £172M [Fig.19]. Both of these sums are small beer compared with the Northern Rock deficit but if the MoD had, by better judgement, retained even a fraction of them for its own use it could have afforded a lot more body armour for its soldiers.

J. The NAO's study was inevitably focussed on identifying the lessons to be learned from the privatisation of Qinetiq, so that future privatisations might yield better value for money to the taxpayer, rather than with allocating blame to individuals for any of the faults in that process. Its recommendations include:

— the public sector should have a full understanding of the business to be sold;

— the management should not arrange their own incentive scheme; and

— that non-executive directors appointed to protect the interests of shareholders should not participate in employee share schemes

Hardly rocket science!

My Credentials

I undertook front-line research at the Royal Aircraft Establishment, Farnborough for fourteen years (1962–76) and later managed Aerodynamics Department for four years (1988 – 92). In other phases of my MoD career spanning 33 years, I interacted with the various government defence research establishments which were later combined into DERA. Subsequently I submitted evidence (on behalf of the Defence Engineering Group at University College London) to successive HCDC enquiries on the MoD's decision to adopt a PPP for DERA, and acted as a specialist advisor to the Committee through that period. I therefore feel reasonably well placed to offer some comments on this NAO Report.

David Kirkpatrick

26th November 2007

Supplementary memorandum submitted by the Ministry of Defence

Question 44 (Dr John Pugh): *Have you evidence to show services are being delivered more cheaply and more effectively given that the Report says there has been no benchmarking of service delivery*

The Department's objectives, as set out in Appendix 2 of the NAO's Report into the privatisation of QinetiQ, included the introduction of commercial disciplines, to achieve reduced contract prices for the Department and other customers as a result of increased competition, economies and productivity. The NAO have concluded that, even six years after QinetiQ was created, it is challenging to measure the success of some of the Department's wider objectives. Given the very wide range of services (including research, project support, and test and evaluation) which QinetiQ provides to a diverse set of MOD customers, we do not believe there is any single metric which can be used to measure overall value for money. However, there are a number of pieces of evidence which support the view that the privatisation process has delivered good value to the Department as customer, as well as owner, of QinetiQ. These are set out below.

Overall Health of the Research Programme

The extensive audit of the Research Programme by the Department's Chief Scientific Advisor during 2006, and Reported in "Maximising Benefit from Defence Research", placed projects under the scrutiny of independent subject matter experts from the Defence Scientific Advisory Council (an NDPB). Of the more than 130 QinetiQ projects assessed, the average quality was found to be comparable with that found in top-tier research journals and in some cases providing MOD with internationally competitive research.

Incremental Introduction of Competition

The privatisation was not just about ensuring the best prices from QinetiQ, but also reflected an intention to provide customers with access to a wider range of suppliers than would have been possible when the Department had to sustain the Defence Evaluation and Research Agency (DERA) as its in-house provider of science and technology capability. It is generally accepted that the introduction of competition creates incentives for suppliers to increase value for money. In this instance, it also provided an opportunity for new suppliers to enter the market, in a way which was not possible when almost all of the Department's research funding was spent through its in-house provider. In 2002–03 around 90% of the Department's applied and corporate research was carried out within DSTL or by the newly created QinetiQ. By 2009/10, the Department estimates that 60% of the research programme will be competed with industry and academia with the bulk of the remainder going to DSTL. In cash terms, the total annual value of contracts awarded without competition to QinetiQ has declined from approximately £208m in FY04/05 to approximately £80m FY07/08.

Assessment of Key Suppliers

In 2003, the MOD's Supplier Relations Group introduced benchmarking for its key suppliers, including QinetiQ. This assessment covers a range of criteria including but not limited to: approach to project management, responsiveness, management of risk, quality of output, commercial management and innovation. QinetiQ's performance has been measured over the last three years and the results indicate that the company has consistently exceeded the average benchmark level, and has shown an overall performance improvement over the past 12 months.

Documented Contractual Savings

The Department's largest current contract with QinetiQ is the Long Term Partnering Agreement for test and evaluation. Over the first 5 years of this contract, customers have identified that that the contract will deliver savings of around £22m. These savings exceed the target which was originally set when the contract was first awarded.

Question 80 (Geraldine Smith): *Have you a breakdown of the £16million bid costs*

Carlyle's bid, which was submitted in August 2002, identified that, if they were appointed as Strategic Partner, then their bid costs would be reimbursed by QinetiQ Holdings Ltd (the new company that was created as part of the sale process). This is not unusual in transactions of this sort, and in accepting the Carlyle bid, the Department agreed that this should occur. This was further documented in the Shareholder's Agreement signed by the Department and Carlyle, which stated that QinetiQ would be responsible for: "the payment of reasonable professional costs and expenses properly incurred. . . in connection with the transaction". Under the agreement, costs were capped at a maximum of £22m and the actual figure reimbursed was £16m. Before the costs were submitted to the company for reimbursement the invoices were seen by MOD officials to ensure that they were consistent with the shareholder's agreement. However, because the costs were for QinetiQ to reimburse, it was the responsibility of the company, as with any other bill payment, to ensure they were properly incurred. As a limited company any such payments by QinetiQ would have been open to examination by external auditors.

Questions 95 – 97 (Mr Ian Davidson): *The Carlyle Group*

We do not currently have any substantial engagement with The Carlyle Group. Aerospace & defence is one of the sectors in which Carlyle does invest and, accordingly, the Department does from time to time have discussions with them. Such discussions are carried out on the same basis as those with other companies that invest in the defence industry. We were aware at the time of the sale that many of the potential bidders employed individuals who had been active in the political or military arena. However, this was not a factor which in any way influenced the selection process.

We have no comprehensive information on those employed by Carlyle or their advisors, either at the time or subsequently. This is a matter for the company.

Letter from the Treasury Officer of Accounts to the Committee Clerk

I am writing to follow up a couple of points raised by Mr Bacon on 3 December.

Mr Bacon asked a couple of questions about the status of the £250m of Qinetiq proceeds which MoD kept. He subsequently clarified them as:

- Where within the Treasury—MoD budgeting process was there a reference to the expected proceeds of the Qinetiq sale?
- What were these proceeds expected to be?

The NAO Report notes (at paragraph 1.7) an agreement between the Treasury and MoD that allowed MoD to retain up to £250m of proceeds from the sale of DERA. This agreement reflected advice from MoD's advisers that proceeds of £500m could be expected. The following extract from correspondence between the Chancellor and the Secretary of State for Defence in July 1998 makes this clear:

> "On DERA, I had in mind when we spoke an arrangement which would allow you (MoD) to use up to £250m of the proceeds, depending on the amount raised. Since your advisers had estimated that the proceeds were likely to be over £500m, allowing you to keep 50% seemed fair. However, on the basis that you will do all that you can to maximise the receipt for the taxpayer, consistent with best value for money, I would be prepared to agree that you should receive 100% of the proceeds, up to a maximum of £250m".

At that stage in the process, no decision had been taken on how DERA would be split, or on how the sale process would be structured. The £500m would therefore have been an estimate of total proceeds from the whole privatisation process. As the NAO Report shows, the actual proceeds raised were £576m in cash plus the value of MoD's retained shareholding.

After the agreement of July 1988, the timetable for the DERA PPP changed. The Treasury agreed in the 2000 Spending Review to allow MoD a further £250m of capital provision. This was set out in the following extract from correspondence between the Chief Secretary to the Treasury and the Secretary of State for Defence in July 2000:

> "We have agreed that a further £250m of capital provision will be added to 2001–02 from the Reserve, providing the DERA PPP is undertaken in that year, or we collectively agree that value for money considerations clearly suggest a delay until 2002–03".

As noted by the NAO, the Treasury agreed to credit the MoD's budget when the sale of the minority stake was delayed until 2003.

Mr Bacon also asked about the extent of penetration of qualified finance directors in central government. The present position is that 96% of departments have qualified finance directors, while 91% of total resource spending is in departments with qualified finance directors. Of the two departments (out of 46) without qualified finance directors, the finance director of the Crown Prosecution Service is in fast track training qualification; and MoD plans that its next finance director should be financially qualified, as the policy requires.

This is a significant improvement on February 2004, when only 39% of departments had qualified finance directors. And of course most department now have better strength in depth in their finance departments too. There is a variety of initiatives afoot, eg to attract qualified people, to equip civil servants at senior management grades with financial management skills, and to establish professional expertise among bright young recruits. The Treasury believes that these initiatives and others will help to improvement financial capability in departments.

Paula Diggle
Treasury Officer of Accounts

18 December 2007

Printed in the United Kingdom by The Stationery Office Limited
6/2008 395524 19585