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Ministry of Defence: Acquisition and support of defence equipment

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to the report*

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Summary

Our review of three aspects of the Ministry of Defence's acquisition and support arrangements highlights the need for the Department to get to grips with three key areas of its business with better oversight and scrutiny. First, we cover what more can be done to reduce levels of non-competitive defence procurement. Second, we consider the increase in 'cannibalisation' in the Royal Navy, where parts are being taken from one vessel to keep another going. And third we report on weaknesses in the Department identifying contingent liabilities in its contracts, denying Parliament and the Treasury the opportunity for appropriate scrutiny.

Non-competitive procurement

Around 50% of the Department's procurement of equipment is not subject to competition. We recognise that there are sometimes valid reasons why procurement cannot be done competitively and the Department must use a single supplier. Nevertheless, while the Department should not introduce competition for the sake of it, there is scope to do more to reduce levels of non-competitive procurement in line with stated government policy. The Single Source Contract Regulations, introduced in 2014, have led to some improvements in transparency around contract costs. However, there are still too many contracts which the Department has not brought within the scope of the regulations, with some suppliers still refusing to be subject to the regulations or provide all the required information. So far, the financial savings arising from application of the Regulations are very limited, and the Department will need to ramp up progress and have a clear strategy on increasing competition if it is to achieve its 10-year savings target of £1.7 billion. We would also like to see stronger powers for the Single Source Regulations Office.

Cannibalisation

The Department invests heavily in supporting its vessels, but experienced problems when bringing into service the Type 45 destroyers and Astute-class submarines. In the Navy, the levels of 'cannibalisation' (taking parts from one vessel to keep another going) have increased 49% in five years overall, and there has been a particular issue with the Type 45s and the Astutes. The Department does not have the data, controls and processes to routinely monitor cannibalisation and its costs across the Navy. The reasons behind the increase need to be better understood and managed so as not to adversely affect operations and increase costs.

Contingent liabilities

The Department has repeatedly failed to comply with long-established procedures when identifying a contingent liability in a contract, denying both Parliament and the Treasury the means to scrutinise the extent to which the taxpayer might be exposed to potentially huge liabilities in the future. Four cases were identified in 2016 and 2017 before a review was undertaken, which identified 12 more cases within Defence Equipment and Support.

Conclusions and recommendations

Non-competitive procurement of defence equipment

There can be valid reasons for the Department using a non-competitive approach to procurement, including national security considerations and because there is only one suitable supplier. However, in the absence of competition it is more difficult for the Department to be sure that it is paying the best possible price. In 2014, the Single Source Contract Regulations were introduced to increase transparency around contract costs. The Single Source Regulations Office was also established to make recommendations to the Secretary of State on the contract profit rates and to issue guidance on costs that can be claimed by suppliers.

1. **The Department lacks a coherent approach to increasing competition in its equipment procurement and, as a consequence, is struggling to make progress in reducing the level of single source procurement.** The proportion of contracts let competitively has remained unchanged for five years at around 50%, despite the Department's commitment to competition as the default option. We accept that 100% competitive tendering is unlikely; circumstances can arise where only one supplier has the ability to meet demands for particular equipment, or security considerations mean the Department has to contract with a trusted national supplier. But there is little evidence yet of a coherent strategy to increase competition, despite the Department's claims that it is changing practices and the mind-set amongst staff. We are concerned that Commands may still be specifying requirements to dictate single source procurements with a preferred supplier. They may also change the requirements for an existing procurement fundamentally, but place the additional work with the existing supplier instead of re-competing it.

Recommendation: *The Department needs to have a clear strategy for increasing competition which will see real savings materialise. We are not pushing for competitive procurement on every occasion as we recognise that there can be valid reasons sometimes for why single source procurement may be appropriate. Nevertheless, we look to the Department, frontline Commands and project teams to take a competitive approach where it is best, and to seek strategic opportunities to stimulate the market in order to reduce the number of occasions when it uses single source procurement.*

2. **There are still too many contracts outside the Single Source Contract Regulations and some suppliers are still failing to cooperate.** The Regulations are leading to increased transparency and improved information for contract managers, and are strengthening the hand of commercial staff in contract negotiations. However, not all contracts are being brought into the regulations. The Department has particular difficulties with contracts that pre-date the Regulations that may be brought into the regime 'on amendment', although this requires contractors to agree. Only eight such contracts have been included since the Regulations were introduced in 2014. There is also uncertainty about whether particular sub-contracts qualify for the Regulations. With the Regulations giving the Department the power to disallow whole categories of cost, some suppliers are still refusing to be subject to the Regulations or provide all the required information.

Recommendation: *We expect to see the Department meet its target of 100% of all eligible contracts brought within the regulations by 2019–20. Where suppliers refuse to comply with the regime, the Department should develop and apply appropriate sanctions. In defence procurement, where public scrutiny is often limited because of security concerns, it is particularly important that the Single Source Regulations Office has effective oversight.*

3. **The Department has made promises of significant savings arising from application of the Single Source Contract Regulations, but actual savings achieved so far are very limited.** The Department has a target of securing £1.7 billion in savings from the application of the regulations over 10 years, which is an important contribution to managing its wider affordability challenges. It claims to have made £313 million in potential savings so far, shared between cost avoidance and cashable savings, although it is unable to be precise about the balance between the two. Money has already been taken out of the budgets and the Department believes it is on track to meet the overall target. However, it has made a slow start. Actual savings achieved to date are only £3 million, and realisation of further savings will depend on effective management of the contracts over their lifetimes. This in turn will depend on the success of efforts to transform DE&S, and the successful recruitment of staff with commercial skills. When we next examine the Department's Equipment Plan, we will check on progress with savings arising from the Regulations. We are sceptical about the robustness of the £1.7 billion savings target.

Recommendation: *The Department must improve its information and performance monitoring systems so it can effectively track progress against its savings targets and intervene in a timely way to increase momentum. The Department should demonstrate to the Committee at the earliest opportunity that actual savings are being achieved.*

4. **The Secretary of State's review of the regulatory regime provides an opportunity to strengthen the Regulations and the powers of the Single Source Regulations Office (SSRO).** SSRO does not have many of the powers of a typical regulator. We are concerned, for example, that it does not have timely access to all the contractual information it needs to carry out its role and that suppliers' data submissions can be made without senior executive confirmation that data are accurate. We are also concerned to hear of the Department's inability to require the inclusion of eligible amended contracts within the Regulations without the supplier's agreement. The Secretary of State has now completed his review of the Regulations and is due to announce the results in due course.

Recommendation: *The SSRO needs appropriate powers and access to information to do a rigorous and independent job. We expect the Department to set out:*

how the SSRO's powers will be strengthened; and whether, and if so, how contracts will include a requirement on contractors to provide the SSRO with appropriate, reliable data and contractual information.

5. **It will be particularly important that the Department does all it can to ensure that UK suppliers, including smaller companies, are not disadvantaged as a result of Brexit.** The Department realises that it needs to be vigilant as the country leaves the

European Union that UK defence contractors are not disadvantaged in selling their products or entering into international alliances, with part of the Department's role being to encourage and help British industry to be successful. There is the risk that exit from the European Union may further limit choice if it affects UK industry's ability to participate in collaborations. The Department accepts that "we [the UK] do not have the ability indigenously to supply all of the equipment that our armed forces need". The Department also says it wants to avoid falling into the traps it has in the past of bigger companies in the UK supply chain absorbing smaller companies, with the result that its ability to procure competitively is reduced.

Recommendation: *The Department needs to do more to maintain diversity amongst smaller suppliers, and to safeguard the interests of British industry after we have left the European Union.*

Support arrangements and cannibalisation of navy equipment

The Royal Navy operates ships, submarines and helicopters to meet the United Kingdom's defence requirements. They are complex systems with many parts, requiring the Navy to have spares to be used either during scheduled maintenance or if the original parts break unexpectedly. DE&S puts in place support arrangements for equipment, but when parts are unavailable, the Department can authorise that parts are taken from other vessels, a longstanding process known as 'cannibalisation'.

6. **The Department's arrangements to support in-service Type 45 destroyers and Astute-class submarines have not been adequate.** The Department admits that there have been issues with the support of both these vessel types since they were brought into service. To address the recognised shortcomings, the Department said it had recently spent £8 million on Astute-class parts and, in 2016–17, further invested in the Type 45 support arrangements. The lack of operational experience and performance data for these new vessels has made it harder to predict their support requirements. Ineffective support contributed to increased 'cannibalisation', where parts are taken from one vessel to keep another one in service. Over the last five years, there has been a 217% increase in cannibalisation of Type 45s and a 107% increase for the Astute-class submarines. Each instance can increase costs, divert resources and create additional risks, particularly if parts are taken from the production line. Despite the need to make future efficiencies across defence, the Department tells us that the Navy will be adequately resourced to provide its future objectives.

Recommendation: *The Department must make sure it adequately funds the provision of spares for its future new ships—the aircraft carriers and the Type 26 and Type 31 frigates—in order not to repeat the same mistakes made with the Type 45 destroyers and Astute class submarines. It should provide an assessment of what it sees as an acceptable cost envelope for spares that balances competing risks, including the costs of oversupply, risks to effective deployment, and delays in receipt of spare parts.*

7. **The Navy and DE&S have not always ensured that spare parts are available when required for ship and submarine maintenance.** The Department acknowledged it could improve its planning of maintenance by considering its requirements further

in advance and ordering parts from contractors earlier. In September 2017, only 67% of parts ordered by the Ships team in DE&S, and 58% by the Submarine team, were delivered on time (against targets of 95%). The maritime supply chain improvement programme aims to improve planning, alongside addressing the 21% shortfall in staff who are qualified in commercial and inventory management. Inadequate maintenance planning increases cannibalisation risks; in the last five years 60% of ships and submarines requiring cannibalised parts were in maintenance, an increase from 27% to 89% over the period.

Recommendation: *The Navy and DE&S should work with contractors to better plan for scheduled maintenance and ensure that parts are available when required so that the now smaller Royal Navy can fulfil its operational commitments.*

8. **The Navy has become more reliant on equipment cannibalisation, with some pieces of equipment being repeatedly cannibalised.** The Department has previously agreed with this Committee's findings that, although cannibalisation may be necessary in some circumstances, it should not be used routinely. However, over the last five years ship and submarine cannibalisation has increased 49% across the Navy. It has become routine for some pieces of equipment, with 26% of all cannibalisations involving the same specific type of equipment on three or more occasions. During 2016–17, the Department also relied on cannibalised parts to resolve 28% of Astute-class defects. The Permanent Secretary told us he is not uncomfortable with the overall level of cannibalisation across the Navy, although he is concerned that it is happening with great frequency with certain items. He has asked the Department to address this as a matter of urgency.

Recommendation: *The Department must deliver on its undertaking that cannibalisation should not be routine, particularly in relation to repeatedly cyclical cannibalisation of parts. To this end, the Department should, by the end of September, write to the Committee identifying revised targets for acceptable, safe levels of cannibalisation, and what additional actions could be undertaken to reduce it.*

9. **The Department expects vessel cannibalisation to decline but cannot say to what extent, or by when, and has no upper limit on what level it would tolerate.** The Department expects the cannibalisation of Type 45 Destroyers and Astute-class submarines to fall. It does not have a threshold for an acceptable level of cannibalisation, although it does have an equivalent threshold for Merlin helicopters. It does not have the data, controls and processes to routinely monitor cannibalisation and its costs across the Navy. The Department acknowledges that the National Audit Office report has provided it with valuable new insights, and says that applying new data analysis techniques should improve its ability to predict and manage the demand for spare parts. The Department acknowledges that cannibalisation also takes place across the Army and Royal Air Force, but cannot quantify to what extent.

Recommendation: *The Department needs to ensure it has adequate data to better understand and respond to cannibalisation trends so as to implement our recommendations across both the Navy and the other Front Line Commands.*

Contingent liabilities

In negotiating contracts, the Department needs to identify any potential contingent liabilities. These are potential uncertain obligations that may arise if certain events happen. They are frequently indemnities built into contracts during negotiations that limit the liability of private sector firms, and require HM Government to cover the remaining costs. Because of the possible cost implications for the taxpayer, contingent liabilities require scrutiny by HM Treasury and Parliament. Departments must comply with long established procedures for notifying the Treasury and Parliament before entering into contracts containing contingent liabilities.

10. **The Department has repeatedly failed to comply with long established procedures, denying both Parliament and the Treasury the opportunity to scrutinise the extent to which the taxpayer might be exposed to huge liabilities.** The Department is required to seek approval from Treasury and notify Parliament of the existence of contingent liabilities when agreeing a contract. The Department has now drawn our attention to 16 cases going back to 2007 where it had failed to comply with requirements. As a result, in most cases, Parliament has not had the opportunity to scrutinise and raise any objections, even though the taxpayer could be exposed to huge costs. These failures are signs of an organisation with weak internal controls and senior management oversight. We are also surprised that, before we challenged them on the point, the Department had been unaware if there were consequences for the legal status of contracts where it has not complied with due process before entering into them, and that it is unable to quantify the possible exposure in many cases.

Recommendation: *The Department must ensure all contingent liabilities are notified properly to the Committee and the Treasury. We expect it to take disciplinary action if this does not happen. We expect the Department to set out clearly the rationale for contingent liabilities in all cases, and to rigorously place a value on the liability involved, wherever possible, working with others as necessary.*

1 Non-competitive procurement of defence equipment

1. On the basis of a Report by the Comptroller and Auditor General we took evidence from the Ministry of Defence (the Department) on what progress it is making in improving the value for money from non-competitive procurement of defence equipment.¹

Reducing the amount of single source procurement

2. The Department requires high-quality equipment to fulfil its operational objectives. Since 2012, the government's stated policy has been to use competition wherever possible in order to secure the best value for money. Nevertheless, there are a range of circumstances where there may be only one appropriate supplier.² The Department told us that in a perfect world all contracts would be competed, but the desire to retain sovereign capability, as well as consolidation within the defence industry, meant that in some cases there were a limited number of suppliers able to provide the sophisticated equipment that was needed by the armed forces.³ Despite the desire for greater competition, the proportion of contracts let competitively has remained largely unchanged for five years at around 50%.⁴

3. The Department said that it had made significant attempts to develop the competitive landscape in the UK, and there had been a reduction recently in the value (as opposed to the number) of contracts let non-competitively; around 36% over the last three years as opposed to 51% over the last nine.⁵ It said it had tried to change the mindset within the Department and be more challenging about business cases when they proposed a single source approach.⁶ Approvals mechanisms within Defence Equipment and Support (DE&S) and, for bigger contracts, in the Department's Investment Approvals Committee, were designed to challenge any attempts to tailor specifications in ways which could only be met by one supplier. The Department is to set up "pre-sourcing" committees in 2018 to gain a better understanding of the requirements of the services at an earlier stage so that they can be met through competition.⁷ The Department is concerned that requirements change fundamentally part-way through a procurement, which effectively creates a new requirement, but with a single supplier already tied to the project.⁸ On a more positive note, the delegation of budgets to the commands as part of the Levene reforms had made the commands far more careful about how they spent their money, and reduced the likelihood of poor value for money decisions.⁹ The Department said it was also talking to potential suppliers earlier in the process, and considering more widely what the market can offer.¹⁰

1 Report by the Comptroller and Auditor General, [Improving value for money in non-competitive procurement of defence equipment](#), Session 2017–2019, HC 412, 25 October 2017

2 [C&AG's Report](#), paras 1.2–1.4

3 Q 45

4 [C&AG's Report](#), Figure 3

5 Q 47

6 Q 49

7 Qq 51,53

8 Qq 52, 95

9 Q 52

10 Q 56

4. Despite these initiatives, the Department said it did not expect to see a “massive reduction” in the proportion of non-competitive contracts given the continuing consolidation of contractors. It said its priority was to get the right solution, rather than drive down a percentage for the sake of it. It considered that good value for money could be secured in variety of ways, including single source contracts.¹¹ However, the Department recognised that improving how it specified requirements could greatly increase the number of low-value procurements open to competition.¹²

Scope of the Single Source Contract Regulations

5. In order to secure better value for money from non-competitive procurement, in 2014 the Department introduced the Single Source Contract Regulations (the Regulations). These apply to non-competitive contracts over £5 million and qualifying sub-contracts over £25 million, which are known as Qualifying Defence Contracts.¹³ The Department said that the regulations were a great improvement on the previous regime established in 1968, and were seen overseas as an innovative regulatory practice.¹⁴ The Regulations are leading to increased transparency and improved information for contract managers, and are strengthening the hand of commercial staff in contract negotiations. Some suppliers have been holding out against the Regulations, but DE&S told us that this picture is improving.¹⁵ A particular concern is that the SSRO is not getting timely access to the information it needs and to which it is entitled. In particular, senior staff in suppliers are not obliged to provide any assurance that the data supplied are correct. We are pleased that the Department is actively considering how these issues can be remedied.¹⁶

6. The Department said it was trying to place high-value contracts under the Regulations as quickly as possible, and still aimed to have 100% of all eligible contracts under the Regulations by 2019–20. The Director General for Commercial at DE&S told us that within that organisation 92 new contracts were eligible and, of these, 90 were now Qualifying Defence Contracts, and two had been exempted for business reasons.¹⁷ However, not all contracts are being brought into the regulations. The Department has particular difficulties with contracts that pre-date the Regulations that may be brought into the regime ‘on amendment’, since this change requires contractors to agree to their incorporation within the regime. Only eight such contracts have been included since the Regulations were introduced in 2014. There is also uncertainty about whether qualifying sub-contracts are being brought within the regime. The Department told us that they are making progress on this.¹⁸

Savings achieved

7. One of the main aims of the Regulations is to reduce the cost of procuring equipment. The Department has a target of £1.7 billion in savings from the application of the Regulations over 10 years, which is an important contribution to managing its wider

11 Qq 60–61

12 Q 53

13 [C&AG's Report](#), paras 1.9, 4.7, footnote 14

14 Q 69

15 Q 75; [C&AG's Report](#), paras 6, 4.5

16 Qq 92, 97–99; [C&AG's Report](#), Figure 8

17 Q 74

18 Q 94; [C&AG's Report](#), paras 4.6–4.7

affordability challenges on which the Committee has commented regularly in the past.¹⁹ The Department said it had so far made reductions of £330 million to initial contact prices. The Department told us that it was confident that most of this was genuine cashable savings, rather than simple cost avoidance. On this basis, it had already removed these amounts from the budgets of the projects concerned by mutual agreement. It considered it was on track to deliver the forecast savings and was undertaking work to improve its confidence in tracking and delivering the savings. However, actual savings achieved so far are only £3 million.²⁰ Realisation of further savings will depend on effective management of the contracts over their lifetimes. This in turn will depend on the outcome of efforts to transform DE&S, and the successful recruitment of staff with commercial skills who will manage the contracts. The Department said it was making progress here and DE&S had increased its commercial staffing by 234 in 2016–17, whilst reducing by over 50% its use of external manpower.²¹

Strength of the regulatory regime

8. The Defence Reform Act 2014 also set up the Single Source Regulations Office (SSRO). It has a number of roles including recommending to the Secretary of State the baseline profit rate for non-competitive contracts each year, issuing guidance on allowable costs and issuing opinions and determinations on issues arising from contracts.²² The interim Chief Executive of SSRO considered that the organisation had had a successful first three years and created a framework within which there is greater clarity about allowable costs and profit rates. This had helped the Department to make savings and enabled industry to secure a fair return. Although the C&AG's Report highlighted some tensions in the early days of the SSRO, he said that the organisation had worked hard in the last year to build further its relationships with the Department and industry. For example, it had released more information about its methodology for calculating the profit rate and was consulting more with industry.²³

9. The Department said one of the benefits of the way in which the Regulations were framed was the requirement for a statutory review on a regular basis—initially after three years, and then every five years thereafter.²⁴ The SSRO, industry and the Department have made recommendations for changes to the Regulations. The SSRO currently does not have many of the powers of a typical regulator. We heard that the SSRO had made recommendations for powers in several of the areas discussed during our session, including timely access to all the contractual information SSRO needs to carry out its role, and to address the Department's inability to require the inclusion of eligible amended contracts within the Regulations without the supplier's agreement.²⁵ In December 2017, the Secretary of State announced that he had completed his review and would make a further announcement “in due course”, which the Department told us is likely to be very soon.²⁶ The Permanent Secretary said he could not pre-empt the decisions of the Secretary of State, but he said it was important that the Regulations could not be undermined.²⁷

19 [C&AG's Report](#), para 4.16

20 Qq 100–104

21 Qq 108–111; [C&AG's Report](#), para 4.16

22 [C&AG's Report](#), para 3.8

23 Qq 78–82, [C&AG's Report](#), paras 3.10–3.11

24 Q 69

25 Qq 91–92

26 [C&AG's Report](#), para 3.12, Qq69–71, Ministry of Defence written statement, HCWS351, 14 December 2017

27 Qq 91, 99

Continuing support to British industry and Brexit

10. There are a number of significant procurements to be completed in the coming years. The Department explained that the recent Type 26 frigate contract was the first occasion for a first-in-class ship where it had used a “target cost incentivised framework” approach, rather than contracting on a traditional “cost-plus” basis. It was also trying to move its supply chain away from cost-plus contracts.²⁸ Another imminent procurement is the Mechanised Infantry Vehicle. The Department told us that no final decision had yet been made on who to contract with or on the final specification. At this time, the Department said there remained every opportunity for British suppliers to compete for this contract.²⁹ The Department also commented that it hoped to maintain appropriate diversity within the supply chain, including at the smaller end in the UK. It also did not want to fall into the traps it had in the past whereby large companies in the UK supply chain absorb some of the smaller ones, with the result that the ability to procure competitively is reduced.³⁰

11. We asked the Department whether it thought that the UK had the onshore ability to deliver the needs of the Ministry of Defence and our armed forces in the future, particularly in light of Brexit. The Permanent Secretary said that “Strictly, the answer to that question must be: no, we do not have the ability indigenously to supply all of the equipment that our armed forces need.” He added that it was important to be vigilant as the country left the European Union that UK defence contractors were not disadvantaged in selling their products or entering into international alliances and stressed this was something the Department was intensely aware of and working hard on alongside colleagues across government.³¹ He said that he did not want to be complacent about relationships that may emerge that disadvantage UK companies in an international environment, with part of the Department’s role being to encourage and help British industry to be successful in this area.³²

28 Q 107

29 Qq 39–41

30 Q 94

31 Q 112

32 Q 113

2 Support arrangements and cannibalisation of naval equipment

12. On the basis of a report and memorandum from the Comptroller and Auditor General, we also took evidence from the Ministry of Defence (the Department) and the Royal Navy on support arrangements and cannibalisation of naval equipment.³³

13. In 2016–17, the Royal Navy spent £9 billion on the equipment, people and support needed to meet its commitments. This includes procuring new vessels such as the HMS Queen Elizabeth aircraft carrier, and the Astute-class nuclear submarines. To keep its fleet operational, the Navy also spent £1.8 billion supporting its ships and boats, including on spare parts, fuel, and maintenance.³⁴ Since 2000, the Navy’s fleet size has reduced by almost a third from 123 to 84 vessels, including a reduction in the number of destroyers and frigates from 32 to 19.³⁵ This reduction has affected the Navy’s flexibility, with it having to quickly fix problems to keep vessels operational, rather than being able to replace a defective ship with another one while it is being fixed. In 2017, the Government announced its commitment to halt the decline in ship and submarine numbers, and increase the size of the Royal Navy Fleet by the 2030s.³⁶

14. The Navy’s ships and submarines are highly complex engineering systems. For each type of vessel, the Department needs to identify and put in place appropriate maintenance and support for vessels to remain operational. This involves predicting the required type and quantities of spare parts, as well as the frequency and scope of maintenance periods. Where the Department does not have the spare part required for either maintenance or where an unexpected defect has arisen, it may choose to take the required part from other ships and submarines. Each instance—termed ‘cannibalisation’ or ‘store robbing’—can increase costs and technical risks and divert resources.³⁷ Over the last five years, there have been 3,230 instances of ship and submarine cannibalisation involving 6,378 parts.³⁸

Support arrangements for Type 45 Destroyers and Astute-class submarines

15. The Department acknowledged that when the Type 45 Destroyer and Astute-class submarines were brought into service, the support arrangements had not been as good as expected.³⁹ For example, the National Audit Office (NAO) found the increased Astute-class equipment cannibalisation (107% increase in the last five years) resulted, in part, from a critical shortage of spares given ‘poor inventory management and an incorrectly defined, managed and resourced’ support approach. The NAO also reported that the Navy had decided to make savings by not cataloguing or labelling some parts of the Type 45 Destroyers. This had then made it harder to identify the parts needed or where they might be available.⁴⁰

33 Report by the Comptroller and Auditor General, [Investigation into equipment cannibalisation in the Royal Navy](#), Session 2017–19, HC 525, 1 November 2017; National Audit Office [RUC0001](#)

34 Q 56, NAO ([RUC0001](#)), para 4, figure 2, p 5

35 *Ibid*, para 7, figure 4

36 *Ibid*, para 16

37 [C&AG’s Report](#), paras 3, 7

38 [C&AG’s Report](#), para 2.3

39 Qq 24–25, 32

40 [C&AG’s Report](#), para 3.14, figure 3

16. It can be more difficult to predict support requirements for new ships and submarines given the uncertainty of how this equipment will perform and the limited information available on which to make decisions. In 2016–17, in an effort to improve support, the Navy invested an additional £8 million on Astute submarine spare parts and spent £1.5 million improving technical documentation for the Type 45s.⁴¹ The Department told us it had learnt lessons about introducing new equipment, which it had put into practice with the new Queen Elizabeth aircraft carrier, where it expects to have 95% of the spares available.⁴²

Availability of spare parts

17. Alongside improving the support for new equipment being brought into service, the Department also recognised the need to improve its planning of scheduled maintenance to ensure spare parts always available when required.⁴³ The NAO reported that in the last five years, 60% of the recipient ships and submarines that needed parts were in maintenance or low readiness.⁴⁴ In September 2017, only 67% of parts ordered by the Ships team in Defence Equipment and Support (DE&S), and 58% by the Submarine team, were delivered on time (against targets of 95%). In 2014, the Department introduced a programme designed to improve the availability of spare parts for ships and submarines. This involved building inventory management skills, better planning of maintenance, and ensuring the supply chain delivered parts on time.⁴⁵ The Department told us it now required all teams to look two years ahead to examine each planned maintenance period and the associated spare part requirements.⁴⁶

18. We questioned the Department on its ability to ensure adequate funds would be available to support its in-service ships and submarines given the well-recognised budgetary challenges it faced. The Department acknowledged these financial challenges, but explained that, as the Navy had received funding reprioritised from across the Department, it felt the service had sufficient resources to deliver its commitments.⁴⁷ However, we note that despite this, in 2016–17, the Navy reduced its maritime support budget by 6% (£271 million), and the Department expected the Navy to make savings of £1.6 billion from its support budget over the next 10 years.⁴⁸ The Department told us that it expected to be able to make the necessary savings without a disproportionate impact on vessels' ability to operate.⁴⁹

Reliance on cannibalisation

19. Previous Committees have recognised equipment cannibalisation can be acceptable and necessary in some cases. However, they have also warned that the Department needs to ensure cannibalisation is the most effective solution and that there is a clear threshold

41 Q 33; [C&AG's Report](#), para 3.14

42 Q 25

43 Qq 35–36

44 [C&AG's Report](#), para 2.8

45 NAO ([RUC0001](#)), para 14, figure 7

46 Q 36; [C&AG's Report](#), para 3.8

47 Q 11

48 [C&AG's Report](#), para. 3.13; NAO ([RUC0001](#)), para 5

49 Q 15

for when it becomes unacceptable.⁵⁰ This is line with the Department’s own guidance that cannibalisation will only be “used if no other solution is available due to the risk of damage to equipment components”.⁵¹ The Department reiterated that there was no policy to increase the use of cannibalisation, which would only be conducted to ensure high-priority ships and submarines remained operational.⁵²

20. Despite this, the NAO reported that cannibalisation has become a routine part of equipment support, with a 49% increase in the instances of cannibalisation between April 2012 and March 2017. In 2016–17, there were 795 instances of cannibalisation, equating to 66 instances per month, compared to 30 instances per month in 2005, at a time when the Navy was larger. In particular, the Department had relied on cannibalised parts to resolve 28% of Astute-class submarine defects during 2016–17. This contributed to 110 parts being taken from the Astute-class production line in 2016–17, a 43% increase from 2012–13. The NAO also reported that cannibalisations have resulted in a 42-day delay to, and £4.9 million cost impact to, Boat 3, and a further estimated £40 million cost increase for those submarines in production.⁵³ The Department acknowledged that in some areas the use of cannibalisation had become systemic rather than one-off, and it would need to take some action. This was particularly the case with the Type 45 Destroyers and the Astute-class submarines, where it was ‘more problematic’.⁵⁴

21. The Permanent Secretary told us he was “not uncomfortable” with the routine levels of cannibalisation being conducted at present. The witnesses expressed concern that some parts were being repeatedly cannibalised, and the Permanent Secretary told us this was an area on which the Department would now focus as a matter of urgency.⁵⁵ The NAO found that 26% of the instances of cannibalisation, where data were available, involved parts which had been cannibalised on three or more occasions. Parts most often cannibalised included non-safety critical valves (costing an average of £2,541 each) and control and surveillance machinery (average cost £8,115).⁵⁶ The Department stated that of the repeated parts identified by the NAO, 64% were now either on the shelf or had been ordered.⁵⁷

Plans to reduce cannibalisation

22. The Department does not routinely monitor the use, causes and impact of cannibalisation across the Navy. The NAO found that without information, and a strategic oversight of cannibalisation, the Department had not determined a threshold beyond which cannibalisation was unacceptable. The Navy does, however, use a metric to assess cannibalisation across the Merlin helicopter fleet: the average number of cannibalisations per 100 flying hours.⁵⁸ When we challenged the Department, it could not say what an appropriate level of cannibalisation for ships and submarines would be. It also told us that

50 House of Commons Committee of Public Accounts: [Management of the Typhoon project](#), Thirtieth Report of Session 2010–12, HC 860, 20 April 2011; [Assessing and reporting military readiness](#), Twenty-sixth Report of Session 2005–06, HC 667, 28 February 2006

51 [C&AG’s Report](#), para. 1.5

52 Q 31

53 [C&AG’s Report](#), paras 2.3, 2.17, figure 10

54 Qq 45, 48

55 Qq 24, 34, 36

56 [C&AG’s Report](#), paras 2.4, 2.11

57 Q 26

58 [C&AG’s Report](#), paras 2.6, 3.2–3.4

it expected cannibalisation rates to fall as the Navy gained experience operating the ships and submarines more recently brought into service, but could not say by how much or by when.⁵⁹

23. The NAO also found that the Department did not routinely assess the costs, either engineering or administrative, of cannibalisation. The Department told us that it is refreshing its cannibalisation policy so teams must assess and provide the wider cost implications of cannibalisations and refer cannibalisation decisions to a more senior officer if they may have significant wider cost implications.⁶⁰

24. The Department acknowledged that cannibalisation occurred across all the Armed Forces.⁶¹ It described cannibalisation as a recognised practice for both the Army and the Royal Air Force when all other supply options had been exhausted. However, the Department was unable to provide the Committee with authoritative information for the other Commands to the same level of detail as the NAO report on the Navy. It committed to looking at the data available to make sure the lessons learnt from the report on the Navy were applied to the same level of rigour across the other Commands.⁶²

59 Qq 24, 33–34

60 Q 17

61 Q 48; [C&AG's Report](#), para 5

62 Qq 48–50; [Correspondence with Ministry of Defence](#), 22 January 2018, paras 9–14

3 Contingent Liabilities

25. On the basis of correspondence from the Ministry of Defence (the Department), we took evidence regarding the Department's repeated failure to secure Treasury approval for contingent liabilities and to notify Parliament in line with requirements.

26. A contingent liability is a potential obligation that is uncertain, but may arise if specific conditions are met or particular events happen. They are frequently indemnities built into contracts that limit the liability of private sector firms should, for example, an event such as an accident, leak or explosion occur, and require HM Government to cover the remaining costs. In some cases these costs could be unlimited. Consequently, where departments wish to enter into a contract which gives rise to a contingent liability in excess of £300,000, it must obtain Treasury consent, and Parliament should be notified through a departmental minute, accompanied by a ministerial written statement. The Department should not incur the liability until 14 parliamentary sitting days after issuing the Minute, thereby allowing time for appropriate scrutiny.⁶³

27. In January 2017, we examined the Permanent Secretary about the failure of the Department to notify Parliament of the contingent liability relating to the Phalanx Close in Weapons System Availability contract. He apologised and said that changes to guidance would prevent it happening again.⁶⁴ Subsequently, the Department identified three further cases relating to the Astute-class submarine Boats 5 and 6, and the Type 26 Frigate Manufacture Phase Contract. In each case, Parliament had not been informed and given the opportunity to scrutinise the contingent liability. In July, the Department initiated a review of all 3,200 open contracts within its Defence Equipment and Support (DE&S) organisation to identify any further cases.⁶⁵ This was completed in December 2017 and identified a further 12 contracts, going back to 2007. A review of contracts within the Defence Infrastructure Organisation and the Information Systems and Service organisation was still under way at the time of our evidence session in January 2018.⁶⁶

28. Of the 12 further cases identified, none had received Treasury approval and 10 had not been notified to Parliament as required. They had arisen in three particular operating centres within Defence Equipment and Support (DE&S): submarines, helicopters and land equipment.⁶⁷ The Permanent Secretary told us that this position was unacceptable and it was clear that some project teams had not appreciated the existence of a contingent liability. As a result, the Department had taken a number of steps to avoid a repetition. These are mandated training across the organisation to make sure relevant staff understood the rules; clearer policy and procedures; staff briefings to the senior management group within DE&S; and extra controls in the approval process to make sure that staff cannot forget to check whether there is a contingent liability.⁶⁸

63 National Audit Office ([RUC0001](#))

64 House of Commons Committee of Public Accounts, [Delivering the defence estate](#), Forty-seventh Report 2016–17, HC 888, 22 March 2017, Minutes of Evidence Q 1

65 [Correspondence with Ministry of Defence](#), 13 July 2017, para 6; Q 4

66 [Correspondence with Ministry of Defence](#), 4 January 2018, para 1; [Correspondence with Ministry of Defence](#), 22 January 2018, para 5

67 [Correspondence with Ministry of Defence](#), 4 January 2018, para 3; Q 7

68 Qq 3–4, 7

29. The Department accepted that failing to secure Treasury approval and notify Parliament were serious matters and, given that procedures had been improved and training now provided, failure by staff to follow the procedures may lead to disciplinary action in the future if appropriate. It had submitted details of all the cases to the Treasury in December 2017, and was working with it to regularise the position.⁶⁹ There remains a possibility that the Treasury will not approve the cases. Given the significance of these contracts, we were surprised to discover at our evidence session that the Department had not thought to check whether they were legally valid and enforceable as a result of the failure to follow required procedures. The Department has since written and stated that “Legal advice has confirmed that there is no circumstance where a court would regard such arrangements as being legally unenforceable because the Department had not followed an internal government administrative process, in failing to declare contingent liabilities arising from those contractual arrangements. The contracts therefore remain fully enforceable.”⁷⁰

30. The Department reported to us that the liabilities were “unquantifiable” in eight of the cases identified. Here the nature of the contingent liability means that it is unable to predict a series of scenarios with which to accurately cost the liability. For example, the costs associated with dismantling and decommissioning facilities for strategic weapons cannot be anticipated to a degree of certainty.⁷¹ The Department added that it always tried to assess and quantify the liability where it could, and tried to disclose where it was not possible to know the size of the potential liability.⁷² The Department has since written to explain that only where it is not possible to obtain a reliable estimate, due to the nature, scope, range and scale of possible scenarios that might occur, are contingent liabilities treated as unquantifiable. In the future, it proposes to set out the rationale for the contingent liability more clearly during the approvals process, and is working with HM Treasury to better articulate the maximum exposure and potential examples of the scenarios that could lead to unquantifiable contingent liabilities.⁷³

69 [Correspondence with Ministry of Defence](#), 4 January 2018, para 2

70 Qq 16–19, [Correspondence with Ministry of Defence](#), 22 January 2018, para 3

71 [Correspondence with Ministry of Defence](#), 4 January 2018, para 3 and Annex A

72 Q 32

73 [Correspondence with Ministry of Defence](#), 19 February 2018, paras 4–5

Formal minutes

Monday 19 March 2018

Members present:

Meg Hillier, in the Chair

Sir Geoffrey Clifton-Brown

Layla Moran

Caroline Flint

Anne Marie Morris

Gillian Keegan

Lee Rowley

Draft Report (*Ministry of Defence: Acquisition and support of defence equipment*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 30 read and agreed to.

Introduction agreed to.

Conclusions and recommendations agreed to.

Summary agreed to.

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

Ordered, That the Chair 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 till Wednesday 21 March 2018 at 2.00pm]

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the the [Non-competitive procurement of defence equipment inquiry publications page](#) and the [Reuse of components in the Royal Navy inquiry publications page](#) of the Committee's website.

Wednesday 10 January 2018

Question number

Stephen Lovegrove, Permanent Secretary, Ministry of Defence, **Rear Admiral Richard Stokes**, Assistant Chief of Naval Staff (Support), Colin Evans, Finance Director, Royal Navy, and **Sir Simon Bollom**, Chief of Materiel (Ships), Defence Equipment and Support

[Q1–82](#)

Wednesday 10 January 2018

Stephen Lovegrove, Permanent Secretary, Ministry of Defence, **Cat Little**, Director General, Finance, Ministry of Defence, and **Michael Bradley**, Director General, Resources, Defence Equipment and Support

[Q1–43](#)

Stephen Lovegrove, Permanent Secretary, Ministry of Defence, **Cat Little**, Director General, Finance, Ministry of Defence, **Nick Elliott**, Director General, Commercial, Defence Equipment and Support, and **Neil Swift**, Interim Chief Executive, Single Source Regulation Office

[Q44–117](#)

Published written evidence

The following written evidence was received and can be viewed on the [Reuse of components in the Royal Navy inquiry publications page](#) of the Committee's website.

RUC numbers are generated by the evidence processing system and so may not be complete.

- 1 National Audit Office ([RUC0001](#))

Published correspondence

The following correspondence was also published as part of these inquiries:

- 1 [Correspondence with Ministry of Defence relating to Re-use of components in the Royal Navy and Non-Competitive procurement of defence equipment](#)

List of Reports from the Committee during the current session

All publications from the Committee are available on the [publications page](#) of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2017–19

First Report	Tackling online VAT fraud and error	HC 312 (Cm 9549)
Second Report	Brexit and the future of Customs	HC 401 (Cm 9565)
Third Report	Hinkley Point C	HC 393 (Cm 9565)
Fourth Report	Clinical correspondence handling at NHS Shared Business Services	HC 396 (Cm 9575)
Fifth Report	Managing the costs of clinical negligence in hospital trusts	HC 397 (Cm 9575)
Sixth Report	The growing threat of online fraud	HC 399 (Cm 9575)
Seventh Report	Brexit and the UK border	HC 558 (Cm 9575)
Eighth Report	Mental health in prisons	HC 400 (Cm 9575)
Ninth Report	Sheffield to Rotherham tram-trains	HC 453 (Cm 9575)
Tenth Report	High Speed 2 Annual Report and Accounts	HC 454 (Cm 9575)
Eleventh Report	Homeless households	HC 462 (Cm 9575)
Twelfth Report	HMRC's Performance in 2016–17	HC 456
Thirteenth Report	NHS continuing healthcare funding	HC 455
Fourteenth Report	Delivering Carrier Strike	HC 394
Fifteenth Report	Offender-monitoring tags	HC 458
Sixteenth Report	Government borrowing and the Whole of Government Accounts	HC 463
Seventeenth Report	Retaining and developing the teaching workforce	HC 460
Eighteenth Report	Exiting the European Union	HC 467

Nineteenth Report	Excess Votes 2016–17	HC 806
Twentieth Report	Update on the Thameslink Programme	HC 466
Twenty-First Report	The Nuclear Decommissioning Authority's Magnox	HC 461
Twenty-Second Report	The monitoring, inspection and funding of Learndirect Ltd.	HC 875
Twenty-Third Report	Alternative Higher Education Providers	HC 736
Twenty-Fourth Report	Care Quality Commission: regulating health and social care	HC 468
Twenty-Fifth Report	The sale of the Green Investment Bank	HC 468
Twenty-Sixth Report	Governance and departmental oversight of the Greater Cambridge Greater Peterborough Local Enterprise Partnership	HC 896
Twenty-Seventh Report	Government contracts for Community Rehabilitation Companies	HC 897
First Special Report	Chair of the Public Accounts Committee's Second Annual Report	HC 347