Dear Lord Jay,

DEFENCE REFORM BILL

Thank you for your letter of 11 December regarding two issues raised by the Constitution Committee on Part 1 of the Defence Reform Bill.

As you will be aware, on the 10 December the Secretary of State for Defence announced that we have decided not to continue with the current commercial competition for a GoCo to run the Defence Equipment and Support organisation (DE&S). A copy of his statement is attached. We believe that the GoCo remains a potential future solution to the challenge of reforming DE&S and that the legislation in Part 1 of the Defence Reform Bill should proceed for that reason. The provisions in Part 1 of the Bill will not, however, be commenced unless, and until, a future Government decides that they wish to proceed with the GoCo option.

The decision not to proceed with the GoCo option at this point clearly has a bearing on the points raised in your letter but I have set out our position on them below.

Is the Bill drafted so that functions which are inherently governmental could be contracted out, should that be desired in future? Or do the Government believe that inherently governmental functions may not be contracted out under the Bill?

The white paper, Better Defence Acquisition: Improving how we procure and support Defence equipment, states that:

Departmental and wider Government roles that are inherently governmental or pan MOD are currently not expected to be transferred to a Contracting Entity or Operating Company.
In this context, the term *inherently governmental function* relates to roles which includes Department of State functions such as the development of government policy.

Should the GoCo option be adopted in the future, we do not expect any function that rightly belongs to Government to be contracted out. This would include the management of foreign relations with respect to defence procurement, and the setting of MOD commercial policy. Under a GoCo both of these functions would be transferred out of DE&S to the MOD Head Office prior to the contract becoming operative.

Clause 1(7) reflects this by making clear the extent of the responsibilities delegated to the GoCo. The clause clarifies that the GoCo could be required to exercise any discretion of the Secretary of State in carrying out procurement services, but makes it clear that the responsibility for the exercise of the function remains with the Secretary of State.

It is intended that any future GoCo would be subject to a delegated authority from the Secretary of State and the control framework set out in the Contract. The GoCo, would have the authority to seek tenders for, award, agree, amend and terminate contracts on behalf of the MOD; manage, monitor and, to a certain extent, enforce contracts; accept goods/services and authorise payments; and any other MOD contractual rights. The MOD would ultimately retain all contractual obligations, liabilities and indemnities.

In conclusion therefore, we would expect any functions that need to be carried out by Government to remain with the MOD in future and not to be contracted out.

**What arrangements will the Government put in place to ensure that Parliament is satisfied with the proposed means of accountability of a contractor?**

Accountability for the procurement budget (both equipment procurement and equipment support) now lies with the front line commands and is exercised through the PUS as the department’s accounting officer. The Chief of Defence Material (CDM) is the accounting officer for DE&S and, as such, is accountable for the operating costs of DE&S.

Should the GoCo option be adopted in future, a similar accounting role to that of the CDM would be taken on by an additional accounting officer appointed to the board of the Operating Company. This will be specified in the articles of association of the Operating Company. Therefore, accountability, as it relates to managing public money, will be carried out in the same as it currently occurs with the accounting officer taking on CDM’s current responsibilities to account for the operating costs of the defence procurement organisation.

Should a future Government decide to proceed with a GoCo we would expect the accounting arrangements to be clearly spelt out to Parliament and for these to be subject to the scrutiny of the Public Accounts Committee and others.

**LORD ASTOR OF HEVER DL**
Statement by Phillip Hammond, Secretary of State for Defence.

With permission, Mr Speaker, I should like to make a statement on the government’s plans for reform of defence procurement.

The 2010 SDSR set out the government’s vision of an agile armed forces designed to face the challenges of the 21st century. Central to delivering and sustaining that vision, is the ability to procure and support the equipment the armed forces need. There is a widespread acceptance that the present defence acquisition process is not good enough. While there have been notable successes, there have also been many examples of poor performance and sub-optimal outcomes for the armed forces and the taxpayer.

Bernard Gray’s report for the previous government identified three root causes of these problems:

- an overheated programme;
- a weak interface between Defence Equipment and Support and the rest of the MOD, too often leading to repeated changes to the requirement;
- a lack of business skills in DE&S

This government has moved to address all three:

In May 2012, I announced that we had resolved the £38 billion black hole we inherited and balanced the defence budget, with over £4 billion of centrally held contingency to address risks as they crystallised, and a much more disciplined and formalised approach to investment approval, committing funding only when project proposals were properly mature.

As a consequence, DE&S effectiveness is no longer undermined by an overheated programme.

We have also strengthened and improved the interface between DE&S and its MOD customers. We have accepted and implemented the recommendations of Lord Levene’s report on Defence Reform more clearly to define the customers of DE&S as the front line commands, and to give them substantial responsibility for managing their own budgets and prioritising their own requirements. We still have further to go, but we can already see an improvement, and with a substantial reduction in the number of changes to requirements, this is already becoming less of a negative factor in DE&S performance.

We have also started to address the business skills gap within DE&S, through the appointment of Bernard Gray as the Chief of Defence Materiel, and by the recruitment of new senior finance and commercial staff from the private sector.

We are beginning to see the evidence of progress, and while I do not want to pre-empt the Major Projects Review report the NAO will be publishing in the New Year, I am confident that it will show significant improvement in respect of the period since we balanced the budget in May 2012.
But we recognise there is still a long way to go. The reforms we have already instituted are only a start and the challenge of recruiting and retaining the necessary business skills in DE&S is growing, not diminishing – and is likely to get bigger still as the economic recovery gathers pace. A more radical reform of DE&S is necessary if it is to sustain the skills it requires to support our armed forces effectively.

That is why we developed the ‘Materiel strategy programme’.

To address the skills challenge and improve the delivery of complex programmes, DE&S needs to have the freedom to shape its workforce to be world class and to engage effectively with the best of the private sector. The Materiel Strategy is about removing the obstacles to bringing in critical skills and exploiting the capabilities of the private sector, by exploring alternative models for DE&S.

I announced in April that the government had concluded that a ‘Government-owned, Contractor-operated’ model, a GoCo, might well be best placed to deliver the changes required in DE&S; but that we needed to test the market’s appetite for that model, and confirm that it would, indeed, deliver value for money, through a competition. In parallel, I announced that we would work up a public sector comparator, exploring the maximum extent of flexibility that could be achieved within the public sector, a model we have called “DE&S plus”.

The government has maintained an open mind as to which option would prove, overall, to deliver the best balance of risk and potential reward once bids were received.

On 19 November, I informed the house that we had reached the ‘detailed proposals’ stage of the competition, with only one proposal being received from the two consortia remaining in the process. That proposal was from the Bechtel-led Materiel Acquisition Partners. I further informed the house that the government would consider carefully how best to proceed in the light of this development.

I can confirm to the house today that I have decided not to continue the present competition.

The heart of our approach was to test the market’s appetite for delivering a GoCo along the lines we had set out, using the competitive process to drive innovation and value. We have always recognised that there are risks inherent in the GoCo approach. With only one bidder remaining in the competition at this stage, I have had to make a judgment about whether the public-sector comparator alone would generate sufficient competitive tension to ensure an effective outcome for the armed forces and value for money for the taxpayer.
I wish to place on record, Mr Speaker, that ' Materiel acquisition partners' have engaged effectively with the very challenging brief we set out. They have presented us with a credible and detailed bid, but we do not have a competitive process. I have therefore concluded that the risks of proceeding with a single bidder are too great to be acceptable.

We have gained many valuable insights from bringing the proposition this far and understanding the issues raised by bidders and potential bidders. My conclusion is that a GoCo remains a potential future solution to the challenge of transforming DE&S, but that further work is necessary to develop DE&S financial control and management information systems to provide a more robust baseline from which to contract with a risk taking GoCo partner.

We are clear that the only realistic prospect of resolving the challenges facing DE&S in an acceptable timescale is through a significant injection of private sector skills. I have, therefore, decided to build on the DE&S plus proposition, transforming DE&S further within the public sector, supported by the injection of additional private sector resource, thus ensuring that the organisation becomes "match-fit" as the public-sector comparator for a future market-testing of the GoCo proposition.

To do this:

We will recognise the unique nature and characteristics of DE&S as a commercially-facing organisation by setting it up as a bespoke central government trading entity from April 2014;

We will give the new entity a hard boundary with the rest of MOD, a separate governance and oversight structure with a strong board under an independent Chairman, and a Chief Executive who will be an Accounting Officer, accountable to Parliament for the performance of the organisation, delivering another of Levene's recommendations;

And crucially, we will permit the new organisation significant freedoms and flexibilities, agreed with the Treasury and Cabinet Office, around how it recruits, rewards, retains and manages staff along more commercial lines to reflect its role running some of the most complex procurement activity in the world.

We will of course consult with trades unions on the practical arrangements for implementation.

These changes will reinforce the customer-supplier interface between the military command customers and DE&S, facilitating a more business-like approach, allowing us to move earlier to a hard-charging regime and thus further addressing one of the weaknesses identified in the 2009 Gray report.
They will allow DE&S to procure crucial private sector input through a series of support contracts to deliver key changes to systems and processes, and to strengthen programme management while organic capabilities are built. And they will permit the recruitment into DE&S of key commercial and technical staff at market rates and with minimum bureaucracy.

Mr Speaker, Bernard Gray has agreed to become the first Chief Executive of the new trading entity, thus providing a vital thread of continuity between the original Gray report and the continuing DE&S reform agenda.

Alongside the changes to DE&S, we will continue with the reform of MOD's wider acquisition system, which is focusing on up-skilling our customer capabilities, a key role for our military, alongside the important role they will continue to play within DE&S.

Mr Speaker, these changes will drive significant incremental improvements in DE&S as well as delivering the mechanisms that will give the organisation a robust performance baseline. That will allow MOD, at a future date, to re-test the market's appetite for continuing the DE&S evolution into a GoCo, and its ability to deliver value for money against a significantly enhanced public sector comparator.

On both counts, this course of action represents the best way forward, both for our armed forces and for the taxpayer, and I commend this statement to the house.

Sincerely,

John Ashton