



*Mr. Aire - to see.  
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*R 21/4*

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MO 8/2/12

17th November 1980

*Tim Not really  
very informative  
Dear Tim, when you study it!*

*Ann Smith*

*Mod's reports about  
defence contracting.*

THE DEFENCE PROGRAMME 1980/81

Thank you for your letter of 3rd November.

*Frank A*

Although your letter does not call for a reply, my Secretary of State thought that it might be helpful to have on record a note about our attitude to non-competitive contracts, particularly given the complaints at the moment from industrialists that they are earning too low a real rate of return on Government work.

*R  
21/11*

Free market forces as we would normally understand them do not operate in the customary way over most of the defence industries: the industrial base is simply too small, and our resources too limited, to allow for significant domestic competition on the major areas of our business. This is not a situation unique to Britain and even the United States is finding it increasingly difficult to award contracts for major systems on a competitive basis.

Our approach to this basic problem is to seek to simulate competitive pressures through providing contractors with worthwhile incentives to carry out the work efficiently and to time, whilst at the same time to expose them to the risk of a loss, or of a reduced profit, should efficiency and cost consciousness fall short.

The fact that often we are a monopsonist facing a monopoly supplier does not mean that we simply pay up on a cost-plus basis. Three quarters (by value) of our non-competitive contracts are in fact concluded on some kind of incentive basis, the vast majority being tied to either a fixed or a maximum price. We resort to cost-plus contracts only for work for which definitive specifications

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cannot be provided in advance - such as research and study contracts and some development work. However, even in those cases part of the profit takes the form of an efficiency allowance (currently up to 3% on costs). Our aim is to increase further the proportion of contracts negotiated on an incentive basis and to achieve earlier pricing so that we can switch at the first sensible moment on any project to an incentive contract.

In addition to the Public Accounts Committee, which keeps a careful eye on our pricing arrangements, there is also an independent Review Board for Government Contracts. This Board was set up in 1968 following the Ferranti and Bristol-Siddeley scandals, when it was found that we had paid unreasonably high prices. Perhaps I can draw to your attention the attached copy of the recently published Third General Review by the Board, which is still under consideration by the Financial Secretary to the Treasury, and which shows that defence contracts do not represent easy pickings for industry. You will see that the average return for 49 contractors whom the Board consulted was nearly 2% below the intended return. Industry is currently arguing that profits for non-competitive work are likely to be quite inadequate to permit investment and maintain viability should the Government adopt the recommendation of the Review Board not to disturb the present target rate.

Yours ever,

(D B OMAND)