Chair: Secretary of State and CDM, welcome to this morning’s session on defence acquisition. We had your statement on Tuesday, so we can take that as background. We do not need to go over all that again, so we can charge straight in with this: why did Portfield withdraw from the competition?

Mr Hammond: Self-evidently, you would have to ask them to get a definitive answer. I think our judgment is that they felt that they could not be confident of the returns they would earn on the investment that they believed they would be required to make up front in order to deliver the transformation, given the very tough stipulations that we made in the ITN—the invitation to negotiate—which were designed to protect the taxpayer, in the sense of ensuring that we were not delivering reward to a GoCo partner unless they could demonstrate that they were directly responsible for the saving that gave rise to the remuneration. Does CDM want to add to that?

Bernard Gray: When they came to see us the afternoon before the Friday on which the bids were due to explain that they were withdrawing, that is essentially the explanation that CH2M HILL, as the lead of the consortium, offered us. They said that they felt that it would require substantial investment up front to put in the kind of systems and processes that would be required to make it a competitive private sector offering. They also said that the
structure we had put in place—they would earn a fee only if they saved money, and the saving demonstrably came from their action, rather than something that would have happened anyway—meant that they could not make those numbers add up. I would add that I think there was a difference of opinion between some of the partners about whether they wished to proceed. The decision was made at a corporate level, with the bidding team from that consortium having a bid ready to submit and wishing to submit it, but the corporate parents decided not to, on the basis that I have just described.

**Q2 Chair:** Secretary of State, you began by saying: “Self-evidently, you would have to ask them”, but I cannot ask them, can I, because they have signed a non-disclosure agreement?

**Mr Hammond:** I would have to defer to CDM on the precise confidentiality arrangements in the ITN. I think the case is that the bid that is submitted is covered by commercial confidentiality. There will be a limit to what we can disclose about the bid that was received, but a bid that was not submitted is not covered, clearly, by such commercial confidentiality. I am not aware of any restrictions on CH2M HILL speaking to anybody.

**Bernard Gray:** Some aspects of the information disclosed by us are covered by that, but I think they have offered a relatively brief statement already about their reasons, which I think is in line with what we have just said, so I think it would be possible to ask them for their reasons for not bidding, at least at a general level.

**Q3 Chair:** Defence procurement in this country is now going to be carried out in the public sector. Is that a fair way of putting it?

**Mr Hammond:** That is the proposal that I set out in the statement—that we will proceed with a central Government trading entity, reinforcing DE&S as a public sector organisation, but retaining the possibility of challenging that fitter, leaner public sector organisation in the future by running a GoCo competition at a time when the management information around the baseline is in better shape. Hopefully, we will thus be able to address some of the concerns that we understand led to the non-bids—

**Q4 Chair:** I will come on to that, but now that defence procurement will be in the public sector, there is presumably no place for a non-disclosure agreement, and you could release CH2M HILL from any restrictions on telling us why they withdrew, because this is now something that should be fully open to parliamentary scrutiny, is it not?

**Mr Hammond:** I am not sure. As I say, I would have to look at what, if any, restrictions there were.

**Q5 Chair:** But as a principle, you would agree with that.

**Mr Hammond:** The fact that we are going forward in the public sector clearly means that what we take forward will be a public sector entity. I am not sure that that automatically
translates into meaning that anything that happened historically as part of a commercial process must now become publicly accessible. I would need to check that; I am very happy to do so, and to write to you.

Chair: Please do so, because we will expect this to be fully open to parliamentary and Select Committee scrutiny, and we are concerned to avoid any defence on your part that it is all subject to commercial confidentiality if it is being carried out in the public sector.

Q6 Mr Havard: Could I be clear about the timing? We will need to understand these things. You say that this new organisation operates from April next year.

Mr Hammond: Yes.

Q7 Mr Havard: That is only several months away.

Mr Hammond: Let us be clear: the current body—DE&S—is a public sector body. The Chairman’s question relates to material and information passed between parties as part of a commercial process that has now ended. I am very happy to look at what, if any, restrictions there are on our ability to release that information.

Q8 Mr Havard: I understood the Chairman’s question the first time round, when we talked about it in the pre-meeting, but you referred to a trading entity. Could you also explain, when you do all this, the difference between a trading entity and a fund?

Mr Hammond: I can do that now if you like.

Chair: Please do it now.

Mr Hammond: Under current legislative provisions and arrangements between the Treasury and the House of Commons—Parliament—a new trading fund cannot be set up as a central Government body. There are existing trading funds that were set up as central Government bodies, but an undertaking has been given that no new ones will be so set up. There is, however, provision for bespoke arrangements to deal with situations like this one, in which an entity has a trading relationship but will be in the public sector and will be a central Government body. That is why I have defined it as a bespoke central Government trading entity. It is not technically a trading fund, because trading funds can only be outside central Government as newly created bodies.

Mr Havard: What scrutiny applies to it?

Chair: We will come back to that in the course of this meeting. Secretary of State, I understand that you need to go at 12 o’clock.

Mr Hammond: Or thereabouts, yes.
Chair: Well, we will come back to that in the course of this meeting to fathom precisely what it means. I said we would also come back to the issue of financial control. During your statement, you said, “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.” That implies that the Portfield consortium withdrew at least partly because they did not trust the MOD baseline figures. Is that a fair way of putting it?

Mr Hammond: I think it is common ground between us, Portfield and many other people that the baseline management information is not as good as we would like it to be. In such an environment, on our side of the table, we have a very clear remit to ensure that, even if we are saving money, we are not remunerating a private sector partner unless we can demonstrate that they have directly contributed to that saving of money. The current level of baseline information creates a measure of uncertainty around what level of remuneration they could earn, and I think, as the CDM has already said, that is one of the concerns that was expressed by the non-bidder.

Bernard Gray: Can I try to be clear about what they actually said to us on the Thursday when they came to see us? They said—

Ms Stuart: Can you give us the date?

Bernard Gray: 14 November—the day before the bids were due on 15 November. It was in the afternoon. They said they were not confident that they could drive out sufficient saving from the baseline, on the basis of the information that they had available through the data room and the other information that we had provided to them, to justify the up-front investment. That is not necessarily the same as saying that they were not confident in the baseline in the way that you have described. It was saying whether they knew, to a degree that meant that they were prepared to invest, that they could save a sufficient amount, out of that baseline, to justify the up-front investment and get a return on their capital. That is the specific reason that they gave us.

Mr Hammond: Can I just clarify, because it may not be apparent from what I have said so far, that I have not met any of the bidders? For reasons of propriety, the discussions took place at official level, so the only information I have available is what has been conveyed to me by officials from those meetings, and what has been written to the Department by the bidders, or potential bidders, in question.

John Woodcock: Good morning, Secretary of State and CDM. By saying in your statement this week, Secretary of State, that you need to develop a more robust baseline, are you not admitting that this whole process, lasting for the duration that it did, was run without sufficient information to bring it to fruition, and do you regret that?

Mr Hammond: No. First of all, we received one bid from an extremely credible bidder, who did feel that there was sufficient information and that the risk around any uncertainty in the information was manageable.
Q12 John Woodcock: Yet you discounted that by saying that you think the information needs to be more robust.

Mr Hammond: No. I believe that the information must in future be more robust. It is a clear part of our plan for DE&S, in whichever configuration it goes forward, that it needs to develop more robust and more granular management information. A recurring theme across the Department is the inadequacy of management information. That is well recognised, but that cannot be turned around overnight, because it is essentially dependent to a large extent on IT. It is clear that with more management information available, it is likely that there would be more bidders interested in a GoCo proposition.

We have been clear from the start of this process—it has been one of the principal focuses of work in the Department—that one of the risks in the process was this tension between our requirement to remunerate only against savings actually delivered by a GoCo partner, and the GoCo partner’s requirement to be able to calculate the amount of remuneration he was likely to gain. If we had been able to say, “Here is our baseline. If the programme is delivered at less than the baseline, we will split the difference with you on some basis,” that would have been relatively easy, but we were not able to say that, because we have taken it to be an obligation of ours, in protecting public money, not simply to split a saving that arises—because, say, of the non-crystallisation of a risk provision—with a private sector partner. He would have to demonstrate that he had done something active to deliver that saving before he could be remunerated against it. That, at its heart, is the challenge in making a Go-Co proposition work where the requirement is that the private sector partner operates at risk and is remunerated only from the savings that he has delivered.

Bernard Gray: If I can amplify that, to be clear, not only did we receive one bid, but the other consortium had a bid, with their 1,000 pages plus of documentation, ready to submit. The corporate evaluation of that is: “Is the rate of return that we can earn on the investment that we have to make up front, and our judgment about what savings we can drive out and demonstrate, acceptable against the risk that we could be wrong about the baseline?”.

That is the judgment that they made in the 48 hours before submitting the bid.

We all would have liked more and better management information. None the less, we had two of the most credible firms in the world working for six months, producing 1,000-page documents. One of them decided that it was prepared to take that risk, and the other, which got ready to take that risk, decided at the last moment not to.

Q13 John Woodcock: I think the Committee will return to your reasons for not proceeding with the bid you had. May I go back to the need to improve the robustness of the financial information? Secretary of State, you made a remarkably candid admission this week, if I may say so, and many will commend you for that. What implications does that have for the statements you made in preceding months about having balanced the budget? If you are candid about the lack of robustness of information on this, surely that raises questions about the other things you said about the finances of the Department.

Mr Hammond: We are confident about the budget position. The issue here is about the level of risk held within these projects, and the contingency priced into them. As I said in
my statement, when the major projects review is published in the new year, I think we will see very strong performance on managing projects within budgets. That does not mean that DE&S has suddenly become a super-performing organisation; it means that the budgets have been set conservatively, with appropriate levels of risk provision, such that we can be confident of delivering against the budget line set. To get the organisation performing as we need, it now needs to drive down costs and improve its estimating skills, so that we start to see those budgets being set and then delivered at lower levels.

I would describe, and have described, the organisation currently as stable but underperforming. It is stable in the sense that we have budgets set which we are highly confident we can deliver within. It is underperforming in the sense that I am also confident that the cost budgets for projects are currently too high. Over time, with better commercial business skills in the organisation, we will be able to drive down the costs of projects going forward and deliver better value for money for the taxpayer. That is the purpose of exploring these alternative options.

Q14 John Woodcock: If you have admitted that the organisation is not good enough at pricing risk at the moment, will people not question your assumption that you are at the high end, and that it can only get better from here, given the history of procurement over recent years?

Mr Hammond: People are entitled to question that. We have spent a lot of time internally—when I came to the Department, the CDM was already heavily engaged in this process—taking an appropriate view of what risk provision should be held, both inside projects and corporately.

I remind the Committee that in addition to the risk provisions held inside projects—the major projects review report, to be published in January, will give a view on that, and will be able to show whether those are adequate, in terms of the current projected costs to complete that portfolio of projects—we also hold more than £4 billion of centrally held risk provision outside the project costing. We are confident that we have an adequate provision for risk.

In my judgment, that is the first challenge: to stabilise the Department from a period when the programme was out of control, with no hope of being able to deliver all the projects in the portfolio within the budget we had. We have now stabilised the programme. The next stage is to turn the organisation into one that can estimate more aggressively and deliver within those estimates, so that we get better value for money for taxpayers over time. I am confident about the budget for the equipment programme, and our ability to deliver within it.

Q15 Chair: Just to be clear about the issue of the baseline figure reliability, it is clear that Portfield was not entirely happy with that reliability. Was that the only consortium not entirely happy with that reliability?

Bernard Gray: Bechtel did not raise this, or MAP, the other consortium that engaged significantly through the ITN process. The KBR consortium never really started, in that sense.
Q16 Chair: So Bechtel did not raise the reliability of the figures?

Bernard Gray: No. They raised a number of questions around the whole thing, but they put in what was intended to be a solid negotiable proposition, based on the baseline.

On Mr Woodcock’s question, there are slightly different questions. One is whether we believe that DE&S can deliver the core equipment programme against the current baseline, bearing in mind that we have a £4 billion provision. To that our answer is yes. There is a separate question: can an incoming consortium, having to invest hundreds of millions of pounds in the organisation up front, be confident enough of driving savings against that baseline that generate an adequate rate of return for them? That is a different question. I do not think that the two statements are actually in conflict. The answer that we got to the second question was in one case, yes, and in the other case, no.

Q17 Mr Brazier: Secretary of State, you told us, as I understand it, that the baseline has two functions. One relates to the degree of conservatism in the estimating process, and the other to the degree of waste in there, which any bidder has to take a view on. We opened this up to international competition. Does not the fact that, at the end of it all, there was only one organisation—one successful bidder—confident enough that, on the one hand, there is enough waste in the process and, on the other, that it is going to be easy enough to separate those two so that they can earn a fee, suggest that this is not the right thing to produce a GoCo on? It is just too complicated for a proper bidding process.

Mr Hammond: What it probably tells us is that only one consortium—there are lots of companies in there but they have chosen to come together—has felt sufficiently confident about the commercial return it could earn and the certainty with which it could earn it, and that it had the skills to deliver that return. I am repeating myself, but the lesson for me is one that we always recognised was a risk: DE&S is not an organisation that is as mature in terms of its management information, its systems and its processes as we would like it to be. The logical conclusion that I draw from that is that we should drive DE&S further down the path of becoming the organisation we would like it to be. I described it as a “match-fit” organisation on Tuesday. At that point, we can test the GoCo proposition again.

I see nothing to contradict the idea that the best way to deliver this process is constantly to challenge the organisation. This is essentially an organisation with a commercial function, and in the commercial world, organisations are used to being challenged. If you do not perform or you do not deliver, someone will challenge for your market or someone will launch a takeover bid. I see no reason not to create an environment of constant challenge.

Q18 Mr Brazier: I am all for challenge, as you will know from the Floor of the House, but better management systems, while clearly a plus, surely cannot accurately gauge risk at the end of the day—not enough to make the kind of distinction that you are trying to achieve.
Mr Hammond: The identification, quantification and management of risk in these hugely complex projects is the challenge. People talk about the cost of projects and the price of equipment, but what they are really talking about is the risk, because these projects by their nature are high-risk. We are almost always designing and developing a new technology at the cutting edge of what is technically possible. It is about correctly identifying and managing those risks.

Q19 Chair: I think you have just effectively said, Secretary of State, that DE&S was not yet ready for a GoCo. Is that fair?

Mr Hammond: CDM may disagree, but the conclusion that I have to take is that the combination of the market’s appetite for risk and DE&S’s information maturity meant that on this occasion we did not generate sufficient market interest to create the competitive tension that we needed for competition.

Bernard Gray: I have a slightly different personal perspective, which is that we should be clear what the assessment phase and the competition are for. We said, at the beginning of that, that part of the purpose of this was to run to understand the market’s appetite for this issue. We had plenty of expressions of interest, prior to going to the market. We set up quite tough terms to the market, which narrowed the field somewhat, but the fundamental purpose of running the competition was to establish the degree of market appetite to contract for this and to run against what freedoms and flexibilities we might negotiate from the Treasury. It is essentially about running that competition between the private sector and the public sector.

What we got to was a clear commitment from one party and a fine judgment by another party about the level of risk that they were prepared to accept to invest in that proposition. Do we think that DE&S needs improving and is therefore not fit for purpose? Well, that is the purpose of running this exercise in the first place. We clearly feel that DE&S needs to improve in a whole variety of ways to be able to do its job well. The constraints that it lives under at the moment make it difficult for the staff to do the job they need to do, as we have said here before.

Q20 Sir Bob Russell: Secretary of State, I have listened intently to the questions from other members of the Committee and to your replies and Mr Gray’s replies, but I am still somewhat perplexed. What are the areas of significant cost that can be driven down to produce profits for a private consortium, without it compromising the defence of the realm?

Bernard Gray: If I took the support area, which is half of our external spend, we spend a bit short of £7 billion a year on new equipment and £7 billion a year on supporting existing equipment. We are currently in the middle of an exercise to drive down the cost of supporting our equipment. In the first phase of those projects, we are achieving savings in the order of 20% against previous contracted support costs.

Q21 Sir Bob Russell: It is a good news story then.
Bernard Gray: I think so, yes. The point is that we have stood up teams in a variety of structures, which we can get into, about how we tackle that issue. If we put commercial disciplines into driving the costs, we can achieve significant savings. And we are doing that.

Q22 Sir Bob Russell: The more savings you make in-house, the less attractive it is going to be in the future for a private contractor. You are achieving value for money without affecting the defence of the realm, you assure me, and you are producing savings. What’s the problem?

Bernard Gray: The problem in part is that I have to get significant external support at the moment to drive the equipment support activity. I need to get skills that we do not have in-house to help us to identify where the costs lie and drive them out. We are doing it on a more ad hoc basis than I would like—we are doing a set of phases.

The purpose of the matériel strategy is to get an enduring, system-wide approach, from either the public sector or the private sector, to drive the costs out. As the Secretary of State said, if for argument’s sake we carry on the process for the next three years and DE&S is completely match fit, and we ran another competition and people felt that there were no savings to be identified, clearly we would have tested the proposition with the market and the public sector would have achieved its objectives.

Q23 Ms Stuart: For the record, may I come back to the process of Portfield’s decision? Was the first indication you had that it would not be proceeding with the bid on Thursday 14 November?

Bernard Gray: Yes. To lay out the events of that week, we had a number of engagements with both bidders at the working team level on Monday and Tuesday of that week, and we had no indication then. Portfield participated as normal. It had a series of board meetings between its constituent parts, which happened to fall in the course of that week. Partly those meetings were to evaluate its bid proposals. It had a bid proposal ready to submit, and it told us when it came to see us that the bid team was in favour of submitting the proposal but the corporate review said no.

It phoned—or e-mailed; I can’t remember—our commercial director, Les Mosco, on Wednesday evening, asking for a meeting with us on Thursday. That meeting happened at about half-past 4 on Thursday afternoon at my office in Bristol. Hill came along representing the consortium and told us that it was not going to proceed with submitting its bid the next day. It had the bid ready to go, but it elected not to proceed with it. We clearly thought that there was something associated with the bid when it asked on Wednesday evening, “Can we have a meeting with you?” It refused to disclose what it wanted to discuss, and wanted to discuss it in person. Partly in our mind was the question, “Is it going to put a bid in or not?”, but we didn’t know until 4.30 pm on Thursday afternoon.

To take it one stage further, we did ask, “Is this your last word? We have clearly put out pretty stringent terms. Is there discussion to be had on all this?” It said, “No, this is a definitive board decision, which the group chief executive does not wish to entertain.
variations on. It is a definitive decision from us.” When we came out of that meeting we informed the Secretary of State and the permanent secretary at 6 o’clock that evening.

**Q24 Ms Stuart:** Just confirm for the record that you had no prior indication, there was nothing you could offer to keep Portfield in the bid, and you therefore feared that there was nothing you could have done to prevent this coming your way.

**Bernard Gray:** Yes. There was no indication prior to the phone call on Wednesday night. We could speculate about what it was about, but we didn’t know until Thursday afternoon. On Thursday afternoon we specifically asked what we might do to explore the problems. To back up slightly, we had two or three conversations with each of the bidders after the invitation to negotiate was issued, in which they fretted about various points. The commercial director and I met representatives of each of the factions on a couple of occasions to discuss their concerns. We felt that we had addressed those concerns a couple of months previously. Then I have just described the events of that week.

**Q25 Derek Twigg:** Secretary of State, in your statement you made the point that you have “started to address the…skills gap”—when did the Department decide that there was a skills gap?

**Mr Hammond:** There was a clear awareness that there was a skills gap in DE&S when I arrived in the Department in October 2011. That might be a better question for CDM.

**Q26 Derek Twigg:** No, it is for you for the moment; I will come to CDM in a minute. So you say October 2011. You said in your statement that there is “a long way to go.”

**Mr Hammond:** Yes.

**Derek Twigg:** Why has it taken two years even to make a start on this issue?

**Mr Hammond:** Well, we are trying to turn around a supertanker, and we are trying to do it within the constraints of the civil service pay structure, civil service terms and conditions, and civil service recruitment processes. Again, CDM can give more details, but it can take a very long time to recruit someone to a critical post if you follow the processes laid down by civil service procedures. We are not able to be nimble.

**Q27 Derek Twigg:** So it is the fault of the civil service pay structure.

**Mr Hammond:** Not entirely.

**Q28 Derek Twigg:** If it is not entirely, what other faults might there be?

**Mr Hammond:** The civil service pay structure makes it impossible for us to retain people against predatory recruiting from the private sector. This is focused in certain areas of
the business. For example, in airworthiness certification there is a particular challenge—the people who do that work are in significant demand in the private sector and we are unable to offer anything like comparable salary packages.

Q29 Derek Twigg: I understand the point you made about the civil service, but you said that there were other things as well and I want to go on to them.

Mr Hammond: In the recruitment process, there are the rules that are laid down in the senior civil service, the processes that have to be followed and the time that those processes take. We are not allowed to go straight to an external recruitment solution, even where that is, to our minds, obviously the most likely outcome. There are also the broader bureaucratic restrictions that we face in the public sector.

Q30 Derek Twigg: Which are?

Mr Hammond: Well, it is not just pay; it is about the terms and conditions package more generally.

Q31 Derek Twigg: So what are you doing about it then?

Mr Hammond: Under the DE&S plus proposition, which we have been working up during the course of this year, we will have a package of freedoms and flexibilities from Treasury and Cabinet Office control that will allow us to be more market-facing. We will clearly not be as market-responsive as a GoCo-led organisation would be able to be, but we will be significantly more able to respond to market conditions than DE&S has been in the past.

Q32 Derek Twigg: Do you think you have the skills and ability in the Department to help you to achieve that goal? Are you satisfied that you have enough people with the right skills and of the right calibre?

Mr Hammond: Sorry, do you mean to fill the posts in question?

Derek Twigg: No, I mean to help you to meet that target of filling the skills gap. You need good people around you.

Mr Hammond: Typically, the situation, which I suspect is common across the civil service, is that we have highly skilled and capable people in very small numbers. They are people who could command significantly higher salaries in the private sector but choose to stay in the public sector. Where there is a significant project to be done, we invariably have to engage support from the private sector, not necessarily because the private sector has skills that we do not have, but because they have the depth and they can deliver the quantity of skill that we need for a particular project.
Q33 Derek Twigg: Do you have confidence in the people in the Department who have the responsibility to deliver that objective?

Mr Hammond: At the top? Yes.

Q34 Derek Twigg: But not necessarily all the way down.

Mr Hammond: We have good people all the way down, but we do not have the breadth and volume of skills that we need all the way down. Is that a fair description, Bernard?

Bernard Gray: Yes. Part of our proposal under the DE&S plus proposition is to get some external support from strategic partners to help us to discharge that—we could talk about that a little more if you want to. In relation to HR in particular, we envisage running a competition effectively for an HR business partner organisation to help us to set up the organisation under a new dispensation because we would grade the organisation in a different way for the administrative civil servants.

Q35 Derek Twigg: Secretary of State, were you concerned that not enough had been done to address the skills gap before you came in October 2011?

Mr Hammond: Already at that time we had a project called matériel strategy, which—

Q36 Derek Twigg: You clearly thought enough had not been done.

Mr Hammond: If you don’t mind, I’ll answer the question—which was beginning to look at the options for transforming DE&S. The intention, clearly, was to take a transformative approach to this rather than an incremental approach. That is not to say that there weren’t things going on within DE&S to try to improve the situation, including the use of eye-watering amounts of external private sector support to backfill roles that we could not recruit for directly.

Q37 Derek Twigg: Sorry, I am conscious about the time. So you were not confident that enough had been done up to the time you took up post.

Mr Hammond: There was a process under way.

Q38 Derek Twigg: But you were not confident.

Mr Hammond: I engaged with that process.

Q39 Derek Twigg: I notice you are avoiding the question.
Mr Hammond: The end intention of that process was to explore a transformative change in DE&S, which is what the matériel strategy was.

Q40 Derek Twigg: Okay, in terms of the appointment of Mr Gray, were No. 10 consulted or did they express a view?

Mr Hammond: Sorry?

Q41 Derek Twigg: The appointment of Mr Gray—

Mr Hammond: To?

Q42 Derek Twigg: To his present post. Were they happy for him to continue in that?

Mr Hammond: I am sorry but I can’t answer that question because Mr Gray was in post when I joined the Department.

Q43 Derek Twigg: Yes, I am just asking the question.

Bernard Gray: Are you talking about 2011 or now?

Q44 Derek Twigg: Now.

Mr Hammond: I am sorry, but I don’t understand the question. Mr Gray has been in post since 2010.

Q45 Derek Twigg: Are they happy for him to continue in post?

Mr Hammond: To continue in—

Q46 Derek Twigg: I will come on to the question why in a minute.

Mr Hammond: The current post? Yes.

Q47 Derek Twigg: And any future post?

Mr Hammond: As it transforms to being the chief executive of the trading entity, yes.

Q48 Derek Twigg: And you have complete confidence in Mr Gray?
Mr Hammond: I do, yes.

Q49 Derek Twigg: Mr Gray, do you think you have any responsibility for the failure in this respect? Do you take any responsibility?

Bernard Gray: I am responsible for the matériel strategy and I am responsible for the outputs of DE&S.

Q50 Derek Twigg: Do you take any responsibility for the failed GoCo solution?

Bernard Gray: I am taking responsibility for the whole process.

Q51 Derek Twigg: So you take complete responsibility or was it someone else’s involvement in it? Is it all down to you?

Bernard Gray: Clearly there are many, many people involved. There are people working for me. There are people in the centre of the Department. There is the Secretary of State. There are other Government Departments involved in all of this. There are many, many people involved in it. But it was my activity that I led.

Q52 Derek Twigg: Right. Do the people you lead—your staff—have full confidence in your leadership?

Bernard Gray: I dare say opinions, as they do with most leaders of most organisations, will vary.

Q53 Derek Twigg: But you don’t know.

Bernard Gray: I had a town hall meeting on Tuesday which was roughly speaking coincident with the statement being made to Parliament to inform the DE&S staff. We had between 400 and 500 staff in the gym. I explained to them what we were doing and I asked them at the end for their opinion about whether we were proceeding in the right way. When asked whether we were proceeding in the right way about two thirds said yes and none of them said no, and then they applauded at the end for the clarity we were giving them. That is the most recent indication that I have.

Q54 Derek Twigg: So you are confident that you have the confidence of the majority of your staff?

Bernard Gray: I have not specifically conducted a piece of market research to ask that question.
Q55 Derek Twigg: You don’t feel there is any issue there? Or you don’t care? Whichever.

Bernard Gray: I have the confidence of the Secretary of State, the confidence of the permanent secretary, the confidence of my board and, when I last asked them, the confidence of my staff.

Q56 Derek Twigg: How would you assess the morale of your staff? Would it be good, medium, okay?

Bernard Gray: There is a Whitehall survey which is conducted every year. The morale of our staff has been broadly speaking stable, rising very slightly but within the statistical margin over the course of the last three years.

Q57 Derek Twigg: I presume that, as leader, you are in touch with what your staff think. I am asking you whether you believe that staff morale is good, bad or indifferent.

Bernard Gray: Our staff morale is, roughly speaking, the same as it has been over the last four years; it is rising very slightly. The two issues that staff are most concerned about are pay, and recognition of the difference between DE&S staff and everyone else in the administrative civil service. Those issues come out in our survey as being salient problems for the staff. The whole purpose of what we are trying to address is to get our organisation into a state of affairs where people can do the job.

Q58 Derek Twigg: So basically you do not currently see a problem with the morale of the staff you lead. There is no need to rebuild morale following the GoCo experience, or given the fact that the GoCo option is still on the table for the future.

Bernard Gray: Well, one—

Q59 Derek Twigg: Are you in touch with your staff? I am asking you a question.

Bernard Gray: Yes.

Q60 Derek Twigg: Are you confident—I will keep asking the question—on whether the morale of the whole staff is good or not, and that they have full confidence in your leadership?

Bernard Gray: What I am saying is—

Q61 Derek Twigg: I am not hearing your answer. You are just avoiding it.

Bernard Gray: No, I do not think I am.
**Q62 Derek Twigg:** I think you are.

**Bernard Gray:** I am saying that the morale of my staff is related to a number of different issues. The significant one that they point to in our survey is about pay and conditions. They are also concerned, as came out in the town hall the other day, about the wider perception of whether DE&S does a good job. They feel that the wider media do not give them credit for the good things they do, and that they are constantly criticised for the problems that exist. There are a wide range of issues with that.

I am trying to drive change in my organisation, which, when I arrived three years ago, I would characterise as being in a defensive state of mind that sought to blame other people for its own problems, just as the centre of the Ministry of Defence tended to blame DE&S. Both sides were pointing at each another. There is a mixture of issues. When changing an organisation—I have changed a number—my experience has been that the uncertainty of change affects staff morale, so I am not, in that sense, surprised by that.

Now that we have a clear way forward, I intend to say to people, “Great, we now have a clear way forward that has come out of this process.” As I said to them the other day, we will spend 2014 building on that to have the clarity that enables us to be characterised as a different organisation from the administrative civil service, enables the skills we need to be recognised, and allows us to focus on delivering the job. I also think that they will take significant pleasure from the outcome of the aircraft carrier negotiation decisions, the sort of progress we are making, and the major project report.

**Q63 Derek Twigg:** I will move on. Secretary of State, in your statement, you said, in terms of the skills gap, that you recognise that there is a long way to go. Could you give the Committee some idea of how far that is? Are you 20% away from filling the skills gap, 50% or 75%? Could you give us some idea of how short you are?

**Mr Hammond:** We have 800 unfilled posts in DE&S at the moment out of a core in the procurement business of about 9,500. That perhaps gives a sense of the order of magnitude.

**Q64 Derek Twigg:** When do you think you will be in a position to close that gap?

**Mr Hammond:** We are expecting, in anticipation of the standing up of the trading entity on 1 April, to begin recruiting in the new year, with freedoms and flexibilities that have been agreed with the Treasury.

**Q65 Derek Twigg:** When do you think you will be able to close the gap?

**Mr Hammond:** It would be foolish of me to—
Q66 Derek Twigg: You have no idea.

Mr Hammond: You can characterise it as having no idea if you like. We have a roughly 10% vacancy position at the moment. I would expect that to start to close. DE&S plus, with its greater freedoms, may want to look at the balance between the number of posts and the level of skills. It may choose not to try to fill all 800; it may choose instead to go for a slightly smaller number of higher-skilled and more expensive people. That will be a decision for the DE&S management to take, but it is clear that it will have a degree of freedom to tackle the problem, in terms of process and remuneration, that it did not have prior to the statement on Tuesday. That can only be very positive for DE&S and, incidentally, for morale among the staff.

Q67 Derek Twigg: But you do not have a date by which you think it would have become critical if you had not succeeded in filling the gap to a certain extent. You have not made a judgment on that.

Mr Hammond: “Become critical” in the sense that—

Derek Twigg: Well, you are a businessman, and I have been a businessman in the past, and you must know that in your organisation, you need a certain number of skilled people to deliver certain objectives. At what point will it become critical if you have not done that? It is a fairly straightforward question.

Mr Hammond: What happens in an organisation is that as you run into manning problems in critical skills, an increased burden is placed on the remaining people. We are very lucky in the public sector that we have people who are prepared, in the short term, to accept considerable additional pressures. You might want to ask the CDM the same question; certainly my perception is that in DE&S, we are now getting close to the point where we are going to start to see a major impact on our ability to deliver the programme if we do not arrest the attrition in skills that we have been suffering over the last couple of years. I think it is about turning it around.

How quickly we will rebuild depends on lots of factors. It depends on what is happening in the broader market. Take aviation; as you will know, the civil aviation market is booming. There is strong competition for the kind of skills that we are talking about in the aviation sector. I cannot tell you how quickly we will rebuild, but I am confident that the freedoms will mean that the direction of travel is upwards, rather than downwards, which is what it has been over the last few years.

Q68 Bob Stewart: Secretary of State, who will be paying the costs of the bidders?

Mr Hammond: The invitation to negotiate makes clear that the Government retain the right to terminate the competition at any point, and that it would not reimburse bid costs if that were the case. We do not offer to reimburse bid costs, and if we receive any claims, our legal advice is that we are very strongly positioned to resist them.
Q69 Bob Stewart: So there will be no cost to the Ministry of Defence, you think.

Mr Hammond: That is our expectation.

Q70 Bob Stewart: How much has the internal procurement process cost the MOD?

Mr Hammond: As I said to the House of Commons on Tuesday, we estimate at just under £7.4 million the cost of running the GoCo competition, and I believe that the decision to run this competition was the right decision. There was a suggestion, I think, in the previous line of questioning, that somehow somebody should be holding their hand up for having run a competition that has proved that there is not currently a GoCo option that can be pursued. I think it was right to pursue that line of thinking to the point of proving it in the GoCo competition. I think when you are trying to reform an organisation with a £15 billion budget in order to deliver billions of pounds-worth of saving for the taxpayer, there will be a need to pursue some of these things and to expend some money. I think the amount that has been expended is reasonable in the circumstances.

Chair: I think you have made that point. I think Bob Stewart was just asking about the figures.

Q71 Bob Stewart: Presumably the DE&S plus proposal is part of the £7.4 million. Or is it the cost of that?

Mr Hammond: No, that is the cost of running the GoCo competition. The DE&S plus team is an in-house team, but it has some external support. Of course, the DE&S plus proposition is building a model for the future of the organisation that we will now take forward. I do not regard it as abortive cost, in the sense that you might regard the GoCo competition in that way.

Bob Stewart: Understood.

Q72 Chair: How much are those costs?

Mr Hammond: There is a third part to this, which is building our customer capability in the central Department, so there are three parts to the current work programme.

Bernard Gray: As part of all this, we have always identified the need for either the centre of the Department or front-line command to become more skilled customers in specifying what equipment they want and in running their programme within that. We have expended some cost on that as well, which is also necessary to implement Levene.

Q73 Chair: How much?

Bernard Gray: The total of those two, additional, is of the order of £10 million, if I remember correctly.
Mr Hammond: You are pretty much spot on: I have just been passed a note that says it was £17.8 million for the total assessment phase.

Q74 Bob Stewart: Have you assessed the legal implications of the decision not to proceed with the competition? Is there legal input to this as well?

Mr Hammond: Of course, we have been legally advised at all times. As you would expect, everyone in central Government is extremely sensitive to the necessity of complying with legal requirements in procurement processes. The advice is clear—and this was by design, not accident—that the ITN was set out in such a way that it would allow the Government to terminate the process at any point, if we decided to do so, without the risk of legal redress by the bidders, or potential bidders.

Q75 Bob Stewart: So the answer is that there is no legal elephant in the room?

Mr Hammond: No, we do not believe so. The bidders entered the process at risk, fully aware that they were being asked to carry bid costs in a process that could be terminated before it reached conclusion.

Q76 Chair: Even if they had done everything you asked them to do, and had improved the education of the Ministry of Defence while doing so? What is the morality of that?

Mr Hammond: The ITN is clear that the bidders were proceeding at risk.

Q77 John Woodcock: I am interested, Secretary of State, in how definite you have been just now in saying that you concluded that the GoCo cannot go ahead—in reaching a binary conclusion like that. The CDM has described to the Committee today a situation where one partner, which I think you described yesterday as arguably the best project management company in the world, had been able to produce a detailed bid and which apparently made a reasonably borderline decision not to go ahead. Bechtel’s bid was produced, as far as they were concerned, in a competitive environment, so you could argue it was a competitive bid. Why are you so certain that you could not have entered into a negotiation now on the basis of the bid that was on the table?

Mr Hammond: That question is what we have spent a significant part of the last three weeks examining. Bear in mind that we use the term “bid”, but strictly speaking it was a proposal as the basis for further negotiation. This is a negotiated process. The question for us was whether we could expect to deliver value for money for the taxpayer by further negotiation with a single bidder, with the only competitive tension in the process being provided by the public sector DE&S plus comparator. Throughout the design of this process, we have relied on competitive tension to deliver value for money for the taxpayer. After examining the situation carefully, we have concluded that we cannot be confident that we
would be able successfully to conclude a negotiation with a single bidder in the absence of the competitive tension that the competition was supposed to provide.

Q78 John Woodcock: Can I ask, CDM, if you took the same view in those discussions?

Bernard Gray: In the end, yes. We debated it long and hard, and there were a variety of views—

Q79 John Woodcock: In the end, yes, because the Secretary of State takes the decision?

Bernard Gray: No. To be fair, Mr Woodcock, I am known as a person who speaks his mind.

John Woodcock: So please do, since you are here.

Bernard Gray: And I am. The point that I am making is that we debated long and hard. If you want my precise sequence of thinking, I started where the Secretary of State was. On that Thursday when we had a teleconference about it, I started with a proposal that said: “We can’t continue with that”. I then looked in detail at what Bechtel was going to produce—because we had not at that point seen what Bechtel was going to produce—and that landed on the Friday. I then looked at it and thought: “This is a very interesting proposal”. So in the course of the following week I started to try to think to myself about whether I could engage with this proposal and drive it through or not, but having got quite interested in it, the issues that the Secretary of State has just described, and the difficulties of delivering on it, however interesting the proposal, came down to a decision that I agreed with: we would not carry on with it.

Mr Hammond: I probably should make it clear, as I did in the statement on Tuesday, that of course this was not a process that was carried out behind closed doors inside the MOD. The Cabinet Office and the Treasury were involved in the process and had been involved in the process before the bid was received.

Q80John Woodcock: The other key decision maker in the MOD is of course, your accounting officer, the permanent secretary. He appeared in front of the Committee and was ambivalent or sceptical, in our view, about going ahead earlier on. What view did he take? Presumably he counselled you not to go ahead with the GoCo option.

Mr Hammond: The permanent secretary’s view is very much in line with what I have just set out—that after exploring the options, his advice, as the accounting officer, was that he did not feel that value for money could be guaranteed by the process proceeding with a single bidder.
Q81 John Woodcock: Did he ever suggest that if you were to proceed with the GoCo option, he would require a letter of direction?

Mr Hammond: I do not recall us having that discussion. I do not think we got to that point.

Q82 John Woodcock: Just as one final question, CDM, when you appeared in front of the Bill Committee to give evidence, you explained how—you admitted it was an estimate—£900 million could be saved over 10 years through a GoCo process. You suggested clearly that the profit motive of bringing in a GoCo operation that could make a cut on this was a prime driver. I wonder—for either of you, without an exact figure yet—how much less do you assume you are going to be able to save by going through the in-house route?

Bernard Gray: We clearly know, although it is subject to commercial confidentiality, what Bechtel proposed, but a key issue, as the Secretary of State has just outlined, is that we do not know what was deliverable against that proposition in the end. So they made their proposal to us, and a key consideration against our baseline of making sure that any savings were genuinely attributable to them, rather than to either a reduced requirement or the non-crystallisation of risk, was difficult for us to assess at that point. Although we have a set of proposals in DE&S plus, we are now working those up further, so I do not really have an estimate of the difference between the two in savings terms, because that is not essentially the decision that we ended up making.

Q83 John Woodcock: But you both accept that it will be less.

Mr Hammond: I believe that it will be less, yes. I said to the House of Commons on Tuesday that I think we can make significant progress through injecting skills and injecting private sector support in an advisory and supportive role into DE&S, with the benefit of additional freedoms and flexibilities. Those are definitely worth banking and will deliver real value to DE&S. Will they deliver the culture change that a GoCo would have delivered? I do not believe so. The question of how much additional value is produced for the taxpayer by the culture change that a private sector environment delivers is a subject that will be hotly debated between people who have different views on the subject. However, it is clear to me that once we have got DE&S through the public sector construct into a proper form, as fit as it possibly can be, it would then be appropriate and in the interests of the taxpayer to test again the question of whether a private sector GoCo partner, by changing culture and behaviour in the organisation, could add yet further value. I do not know the answer to the question. It is a genuine question, as it was a genuine question when we posed it at the beginning of this competition.

Bernard Gray: I would add to that that I agree; my opinion would be that it would be less. I do not know how much less, but the job here for all of us is to drive to get the maximum improvement that we can in DE&S under the current dispensation.
Q84 Chair: After the decision that was announced on Tuesday, I think we can safely assume that both the CH2M HILL consortium and the Bechtel consortium are broken up, if not completely disintegrated and scattered to the four winds. Would that be fair?

Mr Hammond: The consortium will have come together for the purpose of making the bid.

Q85 Chair: And much of the skill that they would have injected into the Ministry of Defence.

Mr Hammond: I do not think that that is right. In both cases, the consortium was put together with a view to being able to reach back into the respective organisations to create the required skill set. Breaking up the consortium simply leaves the supporting skill sets where they are in those individual organisations. We have not quite got into this space in the discussion today, but our view is that, as we go forward with DE&S plus, we will explicitly not be looking for consortium-type partners to provide support. We will be looking for specific individual businesses to provide defined skill sets to us on an advisory-and-support basis. We will therefore not need the consortium structure.

Chair: Do not worry; we will come on to that.

Bernard Gray: We have specific thoughts around that and we are likely to step forward with those in January, which might well encourage those teams to refocus on these subsequent competitions.

Q86 Ms Stuart: In the House, you confirmed that the statement was the one that you “did not want to make. I hoped that we would find a wide field of GoCo competitors able to engage with the process”.

Mr Hammond: Of course.

Ms Stuart: What are the circumstances under which you would relaunch the competition?

Mr Hammond: It was presented to me by the Opposition spokesman as though it was some revelation that it was a statement that I did not want to make. Self-evidently, I was hoping for the competition to run to its conclusion with a strong field of GoCo bidders producing a strong bid that we would test against a strong DE&S comparator. That was the intention. As I have said, I think what we now have to do is to get this organisation match fit in the public sector and doing everything that it is possible to do within the public sector. There are, however, some things that we cannot do within the dispensation that we have. We cannot introduce a fully private sector culture. We cannot enshrine irreversibility of the process, because as long as it remains in the public sector—
Q87 Ms Stuart: That is a quite general statement. Do you have certain indicators that would tell you it is now time to relaunch? Could you just give the Committee three concrete things that would mean that you could go again?

Mr Hammond: Yes, we have some specific systems and process improvements that we will want to engage external partners to deliver on a task-and-finish basis within DE&S. You can take it as read that we now accept that the organisation would not be ready to be tested again until those systems were installed, in particular an earned-value management accounting system across the project portfolio. We will need to address—this goes back to Mr Twigg’s question—the skills gap through exploiting the new freedoms and flexibilities. I cannot say whether that will take us nine months or two or three years. It depends on the market.

Q88 Ms Stuart: But of the 900 figure, which is your shortfall at the moment, what would you look for? Would it be once we are down to 500? 300?

Mr Hammond: I do not think that it is right to look at it in quantitative terms, because the freedoms that we now expect to have will allow us to look again at the way we do things. One of the constraints in a public sector organisation, where you effectively have caps on what you can pay, versus a private sector organisation is that you quite often end up having a larger number of people than a private sector organisation would choose to have at a lower level of marketable skills.

Q89 Ms Stuart: So there are accounting procedures and the skills gap, but what would be the third thing that would suggest to you that you are ready to go?

Mr Hammond: It is closing the skills gap and installing the systems. I suppose it would come down to judgment about the granularity of the management information that we have and, therefore, the ability—we are not at this point yet—to start reducing some of the contingency and risk provisions that we hold. When we are confident enough in the organisation to start going back to our project budgets and saying that we can take 5% out here and 10% out there because we are confident that we will not need them due to the granularity of the information that we now hold, I think that will be the point when we will be starting to get towards match fitness.

Q90 Ms Stuart: May I have a final attempt with Mr Gray? When Mr Twigg wanted to know about staff morale, you were very good at giving us a trajectory and describing the process, but I cannot work out what the baseline is. If the baseline is stable and going up slightly, were we starting from a very miserable position? Was it halfway okay? Was it brilliant?

Bernard Gray: Unfortunately, the staff survey is not quite characterised in those terms.
Q91 Ms Stuart: But, as you explained, it stayed the same or slightly increased. You must know what the baseline was.

Bernard Gray: I do, but what I am saying is—

Q92 Ms Stuart: Would you like to share that?

Bernard Gray: I am trying to.

Q93 Ms Stuart: Good, bad or miserable. May I have just one adjective? I am giving you a choice. Which one is it?

Bernard Gray: Forgive me, but it is impossible to answer the question. The net measure is a survey designed by the central civil service called a net engagement score. Our score—

Q94 Ms Stuart: If that’s the basis, we are not going to get an answer.

Chair: Allow him to answer.

Bernard Gray: I am trying to answer the question from the data that we have. The civil service designed a system that produces a net engagement score, which is the measure that it takes. I did not design the system, which is civil service-wide. Our score is around 53% on that measure, which does not measure happy/unhappy; it measures net engagement. That is in line with the rest of the Ministry of Defence. Roughly speaking, our score is, and has been, the same as the rest of the Ministry of Defence.

Q95 Chair: Can you compare it to other Government Departments? How is it doing in comparison?

Bernard Gray: There are measures against other Government Departments, and it is also split between large Departments and small Departments, because the large Departments tend to be an unhappier group than the small Departments, for whatever reason. I do not have the figures in my head, but I am sure we can supply them to you.

Q96 Chair: But roughly, where is the Ministry of Defence as a whole if DE&S is on a par with it?

Mr Hammond: I honestly cannot remember, but I can send you the information as soon as I get back to the office. It is a published dataset that is publicly available, and I am very happy to send it over to you this afternoon.

Chair: Thank you. Please do.
We said that we would get on to the skills issue and what the new organisation will look like.

Q97 Mr Brazier: Can you tell us a little more about what the freedoms and flexibilities actually are?

Mr Hammond: I think there are three key issues. First, there is the freedom to move outside the senior civil service pay structure so that, where we need to employ people with certain commercially marketable skills, we can approach the market at market rates.

Secondly, there is the ability to move to recruit without going through civil service processes, which are, frankly, the kiss of death to getting anything done quickly and effectively. When a skill gap appears, I expect we will be able to go straight to the market for key commercial skills, rather than having to go through civil service processes of internal advertising and recruitment.

Thirdly, there is the flexibility, agreed with the Treasury, to veer and pull between what we spend on pay and the very large amount that we currently spend on private sector consultancy support. We are buying skills from the private sector on a day-rate basis. In some cases, those are skills that we need on an ongoing basis in the business, so it would make much more economic sense to hire those skills directly into the business, but we will have to pay market rates to do so. Establishing a ring fence around what we call the framework agreement for technical support budget and the pay bill budget and allowing us to optimise the mix of externally contracted support and directly employed people will deliver an important part of the change.

Q98 Mr Brazier: To take the example that Mr Gray quoted in, I think, our very first hearing, if you have an RAF wing commander aged 54 years and 11 months with a particular skill and you want him, on his 55th birthday, to become a civil servant doing the same job from the same desk, will a nine-month process still be required to achieve that? Has that been solved?

Bernard Gray: That specific issue does not, unfortunately, lie within the ability of the Treasury, the Cabinet Office or us to resolve. That is a matter for the civil service commissioners. Under the current dispensation, they have refused to allow us that flexibility. Everybody will remain a civil servant under the proposed new structure. It will still be a matter for discussion with the civil service commissioners about whether they will allow us the freedom that they have so far denied us.

To reinforce the Secretary of State’s analysis of this, we currently have a grading structure that is based on the administrative civil service structure. What it does not recognise is that in subjects such as airworthiness, nuclear engineering, finance or other specialisms, there are very different competitive marketplaces in the private sector for those skills. One of the exercises that we would run through in the first phase of setting up the new organisation is effectively to run a grading structure process through to understand what we need to be
competitive in each of the sectors, and then to grade off, as it were, what our skills and market-facing requirements are, rather than off the traditional civil service—

**Q99 Mr Brazier:** Thank you. I will break in there, just because time is very short. What other Departments, if any, have these flexibilities at the moment?

**Mr Hammond:** My understanding is that none has them at the moment, but the Treasury is proposing a limited pilot scheme with some Departments that would allow some ring-fencing around part of the pay bill, which would allow flexibility between numbers and pay levels to deal with specific skill shortages.

**Q100 Mr Brazier:** It has been recognised for a very long time that NHS employees are not civil servants. In France, the entire procurement executive are uniformed and have a role of their own. In Britain that was the case with naval procurement until less than a generation ago—the Royal Corps of Naval Constructors—and they actually spent part of their time at sea. Is it not time that we recognised that these people should not be considered to be civil servants at all and should become a separate organisation?

**Mr Hammond:** If the organisation remains a central Government organisation, they will be civil servants. It is as simple as that.

**Bernard Gray:** The DGA is not a military organisation. My opposite number in France is a civilian, as are both the people who work for him.

**Q101 Mr Brazier:** Yes, but they are still a separate entity, and they still, from memory, have uniform of a sort that they wear occasionally.

**Bernard Gray:** The structure in France is quite similar to DE&S. You have military secondees into the DGA. The DGA is a civilian-led organisation with a significant number of civilian engineers, finance professionals and so on within it.

**Chair:** I think there is a limited appetite for discussing the structure in France.

**Q102 Mr Brazier:** But certainly naval procurement was a separate service. The Royal Corps of Naval Constructors was, until 15 or 20 years ago, recognised to be different. Is it not time we recognised that kind of difference again?

**Bernard Gray:** Part of the problem that we have, dating back over a long period of time, is that we no longer design or build sufficient ships to maintain a separate cadre for that purpose. We do not have enough people to man such a structure, which is one of the reasons why one of the support areas that we go outside to—to companies such as BMT—is for things like naval architecture. We just do not have enough work in house to be able to maintain a standing army for that.
Q103 Mr Brazier: I am trying to help you in your discussions with the Treasury. Why is it that NHS employees have for a very long time been recognised as being a special case? Why can this not be made more permanent?

Mr Hammond: Because the NHS employers are not part of central Government. The NHS trusts are not central Government organisations; they are part of the wider public sector. I am not being facetious when I say that we are genuinely grateful for the help. It is very important that the Treasury and the Cabinet Office have recognised the need for these freedoms and flexibilities in the specific case of the DE&S business. Everything that highlights and emphasises that need is helpful in our ongoing discussions with them.

Q104 Chair: It sounds as though you have a long way to go in actually hammering out the details of these freedoms and flexibilities.

Mr Hammond: We have agreed with the Treasury and the Cabinet Office that there will need to be significant freedoms and flexibilities. We have, at official level, agreement about the broad scope of how they will work and, indeed, the broad order of magnitude within restrictions that will remain.

Q105 Chair: We all know what it is like, negotiating with the Treasury.

Mr Hammond: Indeed, we do. We have agreed that we will sit down in the new year, at official level, and work out the specific details, but I had a sufficient degree of confidence in what had been agreed at senior level, directly agreed between myself and the Chief Secretary and myself and the Minister for the Cabinet Office, endorsed by my accounting officer in discussion with Treasury civil servants and the Cabinet Secretary. I had a sufficient degree of confidence in that to make the statement that I made on Tuesday and I am confident that, when we sit down in January, we will be able to pin down the details of a regime that will not be total freedom—we understand well that we are not going to get total freedom—but will provide a sufficient degree of freedom and flexibility from the bureaucratic operation of the rules and the constraints of the civil service pay-grading system, to allow us to deliver what we need to deliver.

Q106 Chair: In that negotiation with the Treasury, you have just thrown away your trump card of GoCo.

Mr Hammond: No, I have not, Chairman. I made it clear to the House of Commons that we intend to retain the ability to test DE&S plus in future, against private sector comparators, by running a future GoCo competition.

Q107 Chair: You see the private sector scattering to the four winds, do you not?

Mr Hammond: No, I do not. I think that the players involved in this are all grown up. They all understand how things work. They understand—
Q108 Chair: And several million pounds worse off.

Mr Hammond: They understand exactly what we are doing in taking DE&S forward in this way. I would expect that we would only want to test a GoCo proposition in future if we were confident that the market appetite for that proposition had expanded, at that point.

Q109 John Woodcock: Given that you said to the Committee today that the skills gap and vacancies are reaching critical level in the organisation, do you wish in hindsight that you had got to this detailed level of negotiation with other Departments about freedoms earlier in this process?

Mr Hammond: We had a discussion with other Departments about freedoms earlier in the process, when we started designing the matériel strategy and looking at what the DE&S plus comparator might look like. Can I just ask the CDM to address the question of criticality in the skills gap, because he might have a much more granular view?

Q110 John Woodcock: Please do. But forgive me. The GoCo process must have slowed down this detailed negotiation.

Mr Hammond: The Chairman put his finger on it in his intervention a couple of moments ago. It is not clear to me that, absent the pursuit of the private sector alternative, there would have been an awakening of understanding across central Government of the need to offer freedoms and flexibilities on the scale we are now talking about.

Q111 John Woodcock: Collectively, in terms of Government responsibility, you say you are, what, months away from not being able to function properly as a DE&S procurement contracting organisation?

Mr Hammond: You are trying to make a rather more dramatic statement out of what I said. There has clearly been a problem over time with skills in DE&S. The problem is driven primarily by competition from the private sector, although we have also lost some good people to other bits of the public sector that are not constrained by civil service pay structures. The wild card is that we now have a rapidly recovering economy and our skills position—our ability to recruit and retain—will be significantly influenced by what is going on in the broader economy. To take one area of the business, aviation, because the civil aviation market is booming, that will be a challenge for us. Perhaps I can ask CDM to add to that.

Bernard Gray: First, I do not think that we would be in the room having a conversation about significant freedoms with the Treasury had we not run this process. I am really clear about that. I appreciate—

Q112 John Woodcock: That is a pretty damning indictment of the Treasury, is it not?
Bernard Gray: Take it whichever way you like, but I am pretty clear about that. My evidence for that would be that it has not happened in the past 30 years, because the problems we have here are pretty endemic. We identified them in the 2009 report, but that was tracking back over a set of problems that we have had over a long period. When we benchmark our pay for key skills, we are, depending on the particular job title, level of seniority and so forth, anything between 20% and 75% short of what the private sector is paying similar skills. We have a very significant problem that has existed for a long time.

I have said to the Treasury permanent secretary on a number of occasions, “Within an overall pay envelope, why do you care exactly how many people we employ?” They seek to control not only the total pay envelope, but the “manpower control total”, as it is called, meaning the number of people in the organisation. I am saying, “Surely you should be incentivising us to drive down the total cost of running the organisation, but exactly how we do that should be a matter for management up to a point—a significant point.” I have never had a particularly satisfactory answer to that question, frankly. That is part of what we are pursuing under this policy. It has not existed before and it is unique, so I am postulating that the process has driven us to the point where we are able to be in the room having that detailed negotiation with them now.

As far as the skills inside DE&S, I need to set out a couple of things that we have had to do. In order to meet the defence review requirements, we have already reduced the staffing count within DE&S by more than 20% in the past three years and, with the exception of one or two programmes that everyone knows about, such as maritime patrol aircraft and Harrier, we have, broadly speaking, had to keep the same output going. We have achieved a 20% productivity increase in our staff in the past three years. We have conducted a number of exercises to try to pin things down. We have not done nothing, as it were.

We have had the matériel strategy running to try to solve the problem strategically. On a more tactical basis, we have had, as I said when I gave evidence before, a number of activities to ensure that we have the appropriate structure. We ran an exercise with Booz & Company to resize the organisation and ensure that we ended up with the maximum amount of skills in the best places we could. From memory, that started two years ago and finished about a year ago. We have implemented that. We have also started a further review to understand now to what degree we can take it forward.

To answer a question you asked the Secretary of State earlier, Mr Twigg, in the intervening period we ran, and were required to run, an internal recruitment process, which ran for about 12 months, trying to recruit from within the civil service. That did not add many people on a net basis. We established an external partnership with PwC to run an external recruitment process, which started last spring. That process is designed to fill not only the 800 gap that we have today, but has also filled several hundred posts in the intervening period. We are trying to get out there under the current constrained dispensation to recruit with some external help. The amount of bureaucracy we have to go through is a significant issue. We have an applications finance running inside that, but there is the amount of time it takes to get through that. Ultimately, the reasons for not accepting offers are around terms and conditions and pay, principally, at the end of that process. That is running today and has filled a number of post.

Finally, and very briefly—
**Chair:** Very briefly.

**Bernard Gray:** Take a key issue, such as airworthiness. We were short of about 100 airworthiness engineers a year ago, before we started the process. We have recruited people, but, as the Secretary of State says, in a buoyant civil market we are still short of about 100 airworthiness engineers today, because we lose people to the outside world, so we have a continuing problem. I do not recognise the catastrophic cliff edge; what I recognise is a chronic condition, which has existed for a long period of time and makes it harder to do our job.

**Q113 Mr Havard:** I have always understood that, in a sense, this was about efficiency, but it is also a political project, as far as you are concerned, Secretary of State. There is nothing wrong with that. It is legitimate. You think the GoCo option eventually is the better option, and this process has helped you stimulate the understanding for change. You are now taking that forward and you will get extra people in to help with the transformation. That is where we are. As part of that, you make statements about the new entity having a hard boundary with the rest of the Ministry of Defence, but state that we will have integrated project teams and all the rest of it.

We will not get to this today, because we have run out of time, but can I flag this up? At some point, will you explain to us, much more clearly, what you mean by a hard boundary when you need an integrated process? You also say that it will stimulate the wider community, such as the budget holders—the heads of service—to be part of that integrated community. So you want a boundary, but also integration. Will you also explain at some point what you mean by a hard charging regime as the stimulus mechanism, and the discipline in introducing that process?

**Mr Hammond:** Yes, I can do that now.

**Mr Havard:** While the transformation clearly needs to take place, that will run into the next Strategic Defence and Security Review. You will not have a GoCo by 2015. It would be helpful if you explained those things.

**Mr Hammond:** Well, we will definitely not have a GoCo by 2015—that is absolutely clear. I would like to disabuse you of any notion that the GoCo is a political project. I am a pragmatist, looking for the best way to deliver the outcome that I am required to deliver. Many of the changes that need to be made can be made in the public sector; the behaviour and culture change I doubt can be driven within the public sector. We will see how far the freedoms and flexibilities can work in practice to address the problems we have in this particular organisation. This is specific to this organisation and the way it interacts with the commercial sector.

My principal attraction to the GoCo idea, from the time it was presented to me in late-2011, has always been that it allows you to make the leap to a private sector-led organisation with a private sector culture, changing the way the relationship between management and employees works and the sense of the future direction of the organisation. We have seen how that works in organisations that make the leap from the public to the private sector.
I recognise that some people’s political views will incline them to think that that is not always a positive thing. My observation is that that has been generally positive in terms of enhancing the performance of organisations and enabling the skills and abilities of their employees to be utilised to the fullest extent.

On hard boundaries and hard charging, what we mean by a hard boundary is that we have to have a clearly defined interface between the military customers and the organisation that supplies the goods and services, so that there cannot be an informal and unstructured adjustment of the specification of output required in a way that sometimes undermined projects in the past. That does not mean that the military customers will not have a significant presence in the organisation. They will, and they will continue to operate that presence.

A hard charging regime would imply that DE&S plus, instead of having a budget allocated to it by the central Department, would instead recover its operating costs by charging its customers for the work it did on their behalf, thus exposing to them the cost of that work—their budgets would be compensatingly increased. For example, if the Army command asked DE&S to cost 30 variants of the future infantry fighting vehicle, DE&S would present it with a bill for the work involved. I suggest that that would drive more disciplined behaviour on the part of customers than we have seen in the past.

**Q114 Chair:** This new central Government trading entity, which we heard about first on Tuesday, strikes the Committee as being an ideal candidate for a pre-appointment hearing for the appointment of the chief executive and, indeed, the chairman. Since you announced on Tuesday that Mr Gray had agreed to be the chief executive, for us to hold a pre-appointment hearing in January might seem to be a bit late, but we intend to do that anyway. Some of the questions we will need to ask about precisely how it is going to work can come up then. We will also need to know—it would be helpful if you could write to tell us—precisely how you intend to approach and appoint the new chairman of this organisation; precisely how you came to the conclusion that Mr Gray would be the chief executive. We can consider those issues in an evidence session in January. Arising out of that, Derek Twigg would like to ask something.

**Q115 Derek Twigg:** For the record, is Mr Gray’s appointment permanent and does it have a contract period?

*Mr Hammond:* Mr Gray has an existing contract for his appointment as the CDM. The new entity will take over the existing DE&S activity and all posts will transfer across. There will be no redundancies or changes of post as a result of the standing up of the central Government trading entity on April 1. All posts will continue in the new entity.

**Q116 Derek Twigg:** So Mr Gray’s appointment is permanent and there is no change in contract.

*Mr Hammond:* Mr Gray’s existing contract will roll over into the new entity.
Q117 Derek Twigg: And it is a permanent appointment.

*Bernard Gray:* It is not a permanent appointment, it is a four-year appointment.

*Mr Hammond:* It is a fixed-term appointment.

*Derek Twigg:* Right.

Q118 Sir Bob Russell: So are all these people public sector workers or private sector workers? I would not want you suddenly to have a reduction in the public sector and an increase in the private sector by switching people across. You wouldn’t want to do that, would you?

*Mr Hammond:* They are civil servants and they will remain civil servants.

Q119 Sir Bob Russell: But you would not want to give the impression that your public sector staff has gone down and the private sector work force has gone up, would you? Because there have been suggestions that some of the fall in public sector workers has actually just gone across to show an increase in private sector workers. That could be construed by some as rigging the figures—you are not in that business, are you?

*Mr Hammond:* Sir Bob, I would not wish to give the impression that anything was the case that wasn’t the case. I could not have been clearer that these people are currently civil servants and, because this will be a central Government trading entity rather than a trading fund outside of central Government, they will remain civil servants.

*Bernard Gray:* If I might add to that, by defining together both our permanent staff, who are civil servants or military personnel, and our current technical assistance cohort, where we are getting assistance from the outside sector, that will potentially allow us to make some decisions to recruit people. We are currently constrained by the manpower totals we are given, but we will be able to make decisions and say, “Actually, we do have a need for this type of person or that type of person,” and we can recruit them rather than being forced into using contractors, as we are at the moment. So it will allow us to go in the opposite direction, in fact.

To make a point to the Chairman, I would like to make it clear that I did say to the Secretary of State as part of this process that if he did not wish me to continue—I have a four-year contract that expires at the end of next year—

Q120 Derek Twigg: Next year?

*Bernard Gray:* At the end of next year. That is a matter of public record. I have made it clear to the Secretary of State and the permanent secretary that if they did not wish me to carry on, I would not do it. But they have made it clear that they do want me to carry on, so there is no sense of my wishing to carry on doing something and clinging on for dear life. I am doing something here because people have asked me to do it, not for any other reason.
Chair: Thank you very much. That ends our evidence session, which I found absolutely fascinating.