



MODERN DEFENCE PROCUREMENT – Managing the True Costs

Adapting to significant changes in defence procurement methods over the last ten years, while maintaining strong engineering and long-term support capabilities, has become an increasingly important activity for Tier 2 suppliers in the UK and across Europe.

Major equipment contracts for vehicles, aircraft, naval vessels etc are awarded to large global Prime Contractors, or typically shared with a group of Partner Prime Contractors (as is the case with the European Fighter Aircraft). Well publicised cost overruns on major programmes have quite rightly led to the UK Government imposing severe penalties for similar inefficiencies on future contracts, and with public spending under constant review, total life cycle costs are at the forefront of the minds of those involved in the decision making process.

Private Finance Initiative contracts have also placed the commercial risk squarely with the private sector – the MOD ranked third after Transport and Health at the end of 2007 in terms of cumulative value of PFI contracts placed in the last 20 years⁽¹⁾. Therefore the prime contractor is now managing up front funding for Design and Development, rather than the MOD, and the pain of this is inevitably cascaded down to the Tier 1 and Tier 2 sub-contractors.

Technical capability and risk is also shared downstream, so that there is not just one large defence company taking responsibility for the entire design and subsequent manufacture of the equipment, but rather a group of product specialists.

This means, for example, that while a customer may have design responsibility for one part of an avionics system, the design authority for the system as a whole may lie with another partner, and responsibility for the integration into the aircraft with yet another. Each of the partners will have its own design and development costs to consider, and there is intense pressure to achieve the design goals with little or no NRE cost.

When companies are making a range of standard products, investment in R&D is perfectly normal and costs are recovered across the whole of the business operations. Where a custom or even semi-custom design is required, there is a need for the cost of development to be properly managed and recovered without adversely affecting the company's commercial or financial performance.

This has required many traditional Tier 2 defence contractors, usually small and medium sized enterprises (SMEs), to rethink their cost/overhead recovery structure. For long duration programmes where NRE budgets are small or non-existent, production may be years in the future and recovery of high initial development costs can only be achieved if other product prices are increased, or at the expense of the bottom line – ie, profitability. If unexpected programme delays occur, or if any of the higher level design partners make changes mid-programme requiring the design to be re-visited or significantly changed, the additional cost can be considerable.

For SMEs, getting this wrong can be catastrophic. In a market where technical expertise and long-term product support are paramount, it should be recognised that to provide these services a company needs to be able to profitably sustain its operations and look after its greatest asset – the people who put so much effort into the business. Cost is not always to be measured in monetary terms – the continuity of the supply chain should be considered too: therefore the life cycle cost of the product design and production run should be of more importance to the Prime Contractor than the initially low NRE option only.

(1) www.hm-treasury.gov.uk/media/B/E/pfi_signeddeals_231007.xls

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