Defense procurement

Five steps to secure better value for money

Industry Edge

Industry Edge is PwC's unique set of capabilities powering how we deliver successful and trusted transformation and business model reinvention outcomes.

PwC's Industry Edge brings together leading industry perspectives and business models, underpinned by technology, data & AI assets, ecosystem partnerships, curated solutions and execution enablers. It is designed to accelerate your journey to the leading edge in your chosen industry sectors.

Background

Amid the growing concern over the current global threat environment, most nations are prioritising the creation of a more effective military deterrent. Over the past five years defense spend across Western Europe[1] has increased by approximately 30%[2], adding £78bn[3] to the annual total – a larger increase than we've seen in either the US or the whole of Asia.

In the everyday experience of European armed forces, however, this extra spend has yet to be matched by a corresponding increase in defense capability. In the UK, for example, much of the additional money has been spent on filling in gaps and shortfalls in the equipment programme rather than increasing defense output.

Improving value for money in defense procurement is a key component in enabling Western European nations to confront the growing security threats effectively.

Here we set out five steps that we believe are key to improving value for money in defense procurement and making sure our armed forces can make the most of the increase in spend.

1. Incentivising performance

2. Increasing investment

3. Effective supplier management

4. Flexible procurement

5. Accelerated procurement

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[1] Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Malta, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, UK

[2] SIPRI Military Expenditure database, summary by region, 2023

[3] SIPRI Military Expenditure database, summary by region, 2023

Incentivising performance

Industry plays a key role in improving value for money in defense. But from a government perspective, it can appear that suppliers do not always exhibit the right behaviours. Common complaints include poor performance, a low appetite for change, outdated production processes, minimal investment, and complacency. We believe that large defense primes behave as they do for rational economic reasons — with their behaviour aligning to their current market, shareholder and contract incentives. Government procurement agencies need to understand these incentives to change supplier behaviours.

Market and shareholder incentives

Defense procurement typically includes a high proportion of non-competitive contracting and procurement through government-to-government and multinational arrangements. In the UK, for example, over 60% of all procurement over the last five years was non-competitive[4].

Even when the initial procurement is competitive, once a supplier has been selected, governments can be locked in from that point with no viable alternative. The majority of defense procurement is therefore not subject to the market pressures normally at play in other industries that incentivise cost control, performance improvement and investment.

Turning to shareholder incentives, the financial markets largely see defense primes as low-risk, low-return investments. They are primarily interested in the size of their order book, minimising risk, and a steady profit rate of around 10%. This creates a problem for the defense suppliers because their activities are not low risk.

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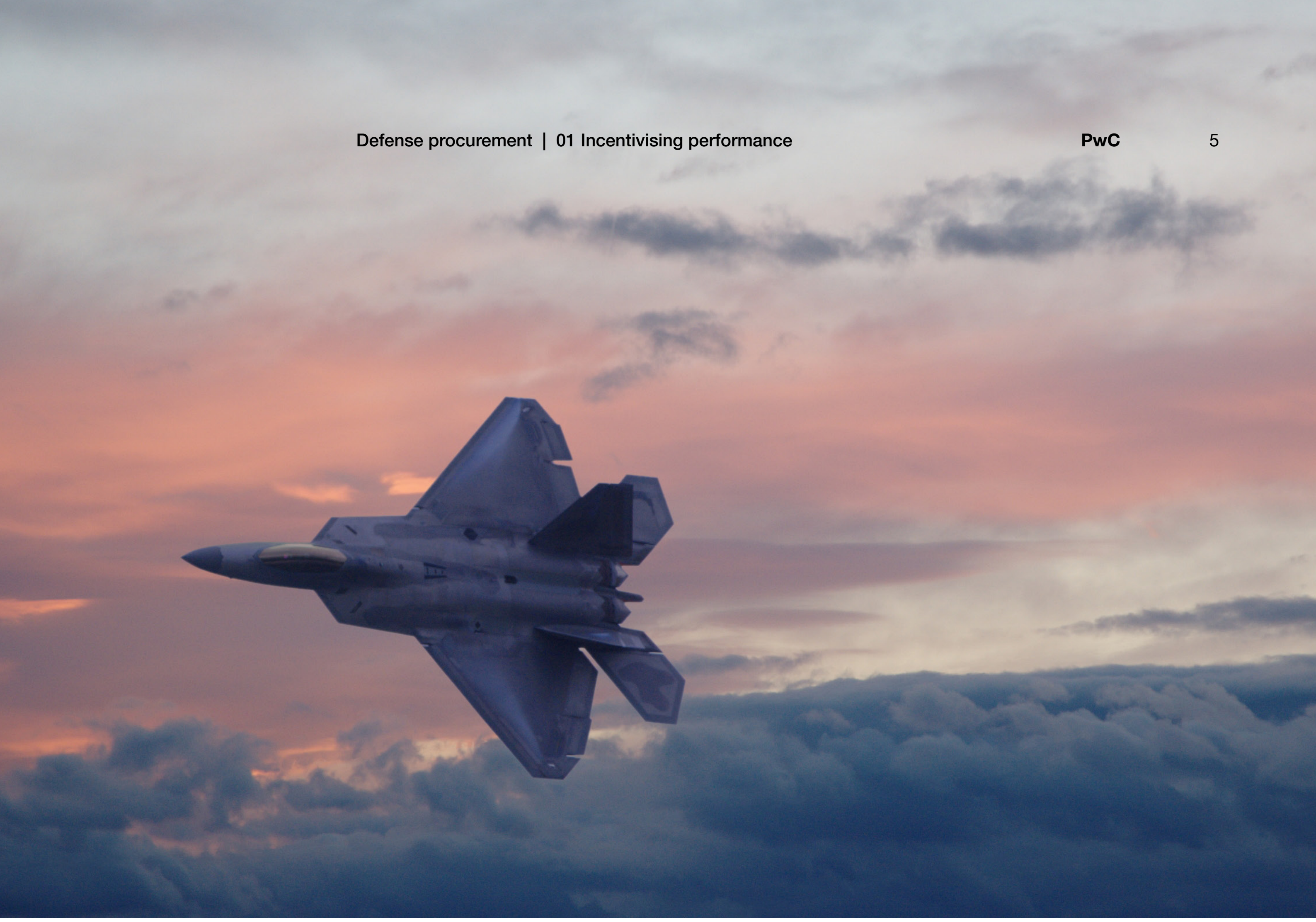
[4] MOD trade, industry and contracts, 2024



Defense procurement is technically complex, with a convoluted supply chain, multiple critical paths, changing requirements and demands, small volumes, and significant obsolescence issues.

This puts suppliers in a difficult position, balancing the demands of shareholders looking to minimise risk whilst actually performing a medium- to high-risk activity. They respond to this by only agreeing to contracts that, whatever their appearance, effectively pass most of the cost risk onto the customer.

Contract incentives

Defense suppliers use a variety of contractual methods to minimise risk. These include adding a large risk allowance onto the price, specifically allocating certain risks to the client, including multiple events that trigger repricing, and using pain-sharing arrangements and regular repricing points. There are also plenty of examples of suppliers warning of contract termination unless it is repriced.

The reality of most defense procurement is that cost risk largely rests with the customer - particularly in the medium- to long-term. This is an inevitable consequence of the market and shareholder incentives under which defense primes operate. This model is often misunderstood, and current government procurement practices tend to focus on transferring cost risk rather than incentivising performance, which can limit overall effectiveness.

Given the market realities and shareholder incentives that apply to primes, their senior executives simply cannot accept high degrees of cost risk and retain their jobs.

Impact

These incentives explain many supplier behaviours that government procurement agencies find difficult to deal with. Suppliers don't focus on performance for the simple reason that they don't have to: when follow up work is largely independent of performance, its more important to reduce costs and hit a 10% profit than it is to perform well.

Similarly, suppliers don't invest because they are not paid to, and again securing future work doesn't require much investment. And suppliers don't change their production approaches because this adds significant risk for little to no financial benefit. This environment has existed in defense primes for many decades and is a key factor undermining performance and eroding value for money across the sector.

A new approach

Government procurement agencies cannot control the market and shareholder incentives for prime. However, they can influence contract incentives. We propose a series of measures to change the incentive regime that currently applies to most defense primes:

- A wider variety of contract types, with a much stronger emphasis on encouraging performance rather than transferring cost risk. These could include, limitation of liability clauses in contracts with profit rates that depend solely on performance levels
- An industrial strategy that mitigates the gaps that result from the market or suppliers and the shareholder incentives they operate under. For example, providing frameworks and mechanisms that pay for long-term investments and productivity improvements in exchange for hard targets.
- Rather than managing cost risk through contract provisions that misalign incentives and create tension between the parties, as is currently the norm, move to jointly agreed cost control measures underpinned by stronger partnerships and a focus on performance.

The role of PwC

PwC has experience supporting defense clients in:

- Designing and providing professional services in connection with the implementation of new commercial models
- Developing strategic relationships and long-term frameworks
- Designing effective performance incentives
- Developing and providing professional services in connection with implementing changes to procurement policy

Increasing investment

Much of the defense industry relies upon old facilities, supported by technology and processes that are far from cutting edge. This reduces productivity, and exportability, and means our armed forces are less well equipped.

While some in the public sector attribute this chronic underinvestment to a lack of vision in the defense industry, we believe it is simply because more defense suppliers are not incentivised to invest. It is often assumed by the public sector that self-funded investments would allow suppliers to increase exports or win more follow-on work.

However, the reality is that follow-on work is usually largely independent of any self-funded investment, and significant investment for speculative increases in exports, which are often politically driven, is usually too high risk to be worthwhile.

To address the investment shortfall, we've identified three key changes: implement strategic investment programmes with key primes; open up the defense sector to private equity, SMEs and academia; and stimulate investment through private finance.

Strategic investment with defense primes

Investment requires funding, and the approach taken by most governments is to pay for investment through contract prices. This limits primes to making investments that are necessary to deliver a specific contract. Cross-cutting investments are rarely worth making when viewed through the lens of a single contract, and the limited duration of contracts precludes investments with a longer return period.

This contract-based approach effectively stops primes from taking a long-term and strategic approach, replacing it with tactical short-term investments and those needed to ‘keep the lights on’ at ageing facilities. Occasionally framework contracts are placed that allow savings from industry-led improvements to be recycled into the programme. However, although this looks good from a government perspective, it does not provide suppliers with any financial incentive to improve as savings just result in more costs and the overall financial envelope remains the same.

Contrast this approach with the ones used in other sectors e.g. in highly competitive markets where a percentage of the prices charged to customers may be allocated to investment programmes prioritised by the Board to meet their medium- and long-term strategic objectives. Meanwhile, in regulated sectors, such as water and transport, regulators may agree to large long-term capital investment programmes that help meet their regulatory objectives. They allow the companies to charge the costs of this investment to their customers while including strong performance measures to check these investments deliver the promised benefits. It is rare to see either of these approaches in defense procurement.

We believe that a new relationship covering investment is needed between governments and the large primes. Supplier-specific strategic investment programmes should be agreed to supplement the contract-specific approaches, focussing on medium- to long-term timescales, cross-cutting objectives, exportability and productivity. These programmes could be funded across contracts in a similar way to that used for central overheads - central costs allocated fairly across a portfolio of contracts and subject to separate agreement and scrutiny.

Opening up the defense sector

The defense sector contains many barriers to entry that discourage private equity (PE) and small-to-medium sized companies (SMEs), and limit input from the wider ecosystem e.g. academia.

To encourage PE investment, governments need to provide structured approaches and forums that allow potential opportunities to be put forward, as well as listening to concerns around international property rights(IPR) and buy-out restrictions. There needs to be standard approaches that allow PE investors to take up-front risk together with the ability to exit when needed to crystalise returns or mitigate losses. To encourage SMEs, as well as having streamlined approaches (see below) that enables direct procurement, government departments need to introduce measures that require their primes to open up their procurement to the wider ecosystem.

These approaches need to be funded - whether separately, through the prime-level strategic investment programmes discussed above, or through contract-level provisions that require primes to offer up opportunities to the market beyond their typical subcontractors.

Accessing private finance

The desire to rapidly increase defense outputs to meet current threats is made more difficult given current financial constraints. In such circumstances, private finance can be a viable option to spread the costs of investment over a longer period.

Even though accessing private finance is standard practice in most other regulated sectors, there has been significant resistance to it in defense. While old approaches - such as PFI contracts - may no longer be fit for purpose, new approaches are available to enable defense organisations to access a rapid injection of investment without overpaying or having to accept contractual inflexibility.

The role of PwC

PwC has experience supporting defense clients in:

- Developing industrial policy
- Supporting supplier-level discussions
- Increasing access to private equity
- Developing new commercial models to help access private finance

Effective supplier management

The lack of competition and market and shareholder incentives for large primes require defense procurement agencies to play a more active role in setting industrial strategies and managing their key suppliers.

Defense departments recognise this, and most have created an industrial strategy and forums designed to enable strategic supplier management. However, these typically have a poor track record in driving value for money in defense procurement. More commonly they act as a useful information exchange with relatively little at stake, and deal with specific emerging issues instead of providing focused leadership and direction.

We believe that this is a real missed opportunity. Because large defense companies are often as dependent upon governments as vice versa, departments have significant commercial leverage. Whilst this might be minimal in individual contract-level discussions, particularly if the placing of a new contract is under significant time pressure for operational reasons, in aggregate the leverage is much greater. It is only in supplier-level discussions that this leverage can be applied effectively.

Effective supplier management will typically include the following.

- Maximising commercial leverage across a portfolio of contracts - for example concessions on one contract, in terms of price or performance, traded against increased binding commitments in others. This requires an understanding of where leverage exists and what outcomes are desired.
- Setting, agreeing to, and monitoring the implementation of cross-cutting and long-term investments - for example reviewing and approving business cases for supplier investments that are largely government-funded, and holding suppliers to account for their delivery.

- Monitoring, influencing and agreeing to indirect costs and wage rate agreements where the majority of these costs are paid for by governments. These costs are usually allocated across multiple contracts and have a very material impact on the prices ultimately paid. This highly material element, often worth hundreds of millions/billions per annum, is often largely overlooked due to its technical nature.
- Increasing access to the market – for example, agreement of approaches that increase access to the market from SMEs and the wider supply chain, including imposing requirements on primes to facilitate this.
- Implementing supplier-level measures that address defense industries' role in supporting wider government policies, such as the environment or social value.

Active supplier management means there needs to be something at stake, with clear outcomes, responsibilities, performance measures and milestones. These will be specific to each supplier. The setting and management of supplier-specific plans is the key activity underpinning effective strategic supplier management. These plans need to be jointly agreed with each supplier, and should include obligations for the government department as well as the supplier. The setting and running of these plans is one of the most effective ways of achieving a true partnership with industry.

The role of PwC

PwC has experience supporting defense clients in:

- Performing leverage analysis across a portfolio of contracts
- Analysing supplier-level costs
- Designing and providing professional services in connection with the implementation of supplier-level governance regimes
- Creating structures and frameworks that open defense procurement to the wider defense ecosytem including SMEs and academia

Flexible procurement

Defense procurement usually follows a process under which the 'customer', typically the armed forces or a National Armaments Director (NAD), defines the requirements to be met. The procurement agency then lets a contract for as close to the requirement as possible given budgetary constraints. This simple process works in some cases, but not all – and it can have a number of unintended consequences that severely undermine value for money.

Requirement change

Although some requirement changes can be ascribed to insufficient time and effort being spent on defining the requirement in the first place, there are also unavoidable reasons why defense requirements change. In terms of acquisition, it typically takes many years, or decades, to design and manufacture a new platform and build an entire fleet. The threat environment changes during this period and the requirement needs to change in response or the equipment will cease to be effective. Another example relates to new technologies, such as cyber capabilities and drones, where the speed of change is rapid and an incremental and agile approach to defining the requirement is needed.

In terms of support, the requirement changes in line with defense tasking. This can result in a significant change in use rates, operating environment, geographic location, and the role the asset is being used for. A solution designed against one set of demands may be significantly limited against another. In summary, while a significant level of requirement change – in both acquisition and support - is simply a fact of life in defense procurement, this is rarely considered in the procurement process.

Unintended consequences

When procurement agencies negotiate with suppliers against a fixed budget, which is often very tight, suppliers typically respond in three ways. First, rather than reduce their price and take on more risk (see above on supplier incentives), they negotiate a reduction in the requirement. Second, they lock the customer into as tight a definition of the requirements as possible - agreeing a fixed price against a firm set of requirements and if and when these requirements change, this comes with a significant cost. Third, they ask for longer commitments, offering a lower price in exchange for a longer contract (again, see above on supplier incentives).

The unintended consequences of all of this is that an equipment programme is often at the lower end of what is needed, is committed over many years, and is highly inflexible. Any change of requirement is expensive, and there's usually very limited additional budget available. Any unexpected issue that arises requires a contract change, which takes time and money to process. There is also only very limited ability to veer and haul across programmes as priorities change. All of these constraints undermine value for money in defense procurement.

What needs to change

The inflexibility we commonly see in many defense contracts is, in most cases, simply not fit for purpose in a defense context. We need commercial models that can deal with change easily – models that can accommodate incremental requirement change in acquisition and allow for in-year veering and hauling in support.

Suppliers largely focus on risk, profit, and the maintenance of a pipeline of work. If a commercial model allows them to achieve all three even if things change, rapid implementation of change will be far easier.

We believe key measures are:

- Working with the armed forces/NAD to better define the range of likely requirements rather than a single requirement
- Commercial models for incremental requirement definition and change
- Commercial models that allow for change within an envelope of cost, risk, and profit

The role of PwC

PwC has experience supporting defense clients in:

- Helping customers develop a range of likely requirements under multiple operational scenarios
- Developing flexible commercial models

Accelerated procurement

Defense procurement is often very slow - typically taking months or a few years from initial requirement to contract let, and in some cases considerably longer. This undermines value for money for three reasons.

First, the requirement may be needed more quickly if operational requirements are to be met. If procurement is slow, either the equipment will arrive too late, or it will be necessary to pay more for something that arrives on time. Second, a long procurement process undermines commercial leverage. It imposes time pressure on the government procurement agency, which may find itself forced into making concessions to avoid a capability gap. Third, it is inefficient - personnel, priorities and processes all change over time, leading to repetitive and often unnecessary work.

To make a significant change to the speed of contracting, we have identified four key measures, set out below.

Streamlined processes linked to different types of procurement

Government procurement agencies typically have a single procurement process with greater levels of scrutiny for high-value or novel contracts. This might work from a financial risk perspective, but not when it comes to providing a streamlined approach for quickly getting on contract. The procurement process for large non-competitive contracts, where the procurement agency needs to focus a large amount of effort on scrutinising and challenging supplier costs, is completely different from the procurement of basic commodities such as clothes. Compared

to an urgent procurement to support operations, arranging a multi-national government-to-government deal requires a completely different approach.

We believe that procurement timescales can be significantly reduced by implementing different processes for these fundamentally different types of procurement. There should be separate training, and access to common artefacts used in similar circumstances, as well as nominated experts in each procurement approach available to support procurement teams.

Specialist resources and 'tiger teams'

Many procurement agencies are organised by domain and platform/system. This makes sense from the perspective of understanding what is being procured and being aware of historic issues. However, defense procurement is dominated by high-value long-duration contracts. Teams can find themselves suddenly having to let a contract with a value in the hundreds of millions despite having minimal prior experience. We believe procurement agencies need to be able to quickly and significantly augment procurement teams with experienced resources when they're involved in major procurements.

Off-the-shelf contracts for different commercial models

It is common practice in high-value defense procurement to generate bespoke contracts for each major deal – contracts that can be in the thousands of pages, each with their own individual approach to change, performance, risk and requirements. Creating these bespoke contracts is very time consuming and makes it difficult to learn from experience in a structured way. We believe that creating a library of standard contract types – which is a common practice in construction, for example - would greatly expedite the procurement process.

Use of technology to improve productivity

Many of the steps in procurement can be made more efficient through the use of procurement tools. In private sector procurement, it is common practice to have:

- Digital contracting tools that allow contracts to be quickly created, and which support version control throughout the contract negotiation process, with easy access to the contract once let.
- Contract lifecycle management (CLM) tools that allow for contract change to be easily managed, and which support the running of contractual governance and performance measurement requirements.
- Workflow management tools that support the end-to-end tendering process and help monitor that steps are correctly followed with the appropriate records and controls.

These tools can have a huge impact on the productivity of procurement staff as well as reducing commercial risk.

The role of PwC

PwC has experience supporting defense clients in:

- Augmenting procurement teams with experienced resources in different procurement channels
- Designing standard contract types for different circumstances
- Developing, and rolling out, training material to upskill procurement staff
- Providing professional services in connection with the implementation of procurement tools, such as digital contracting and CLM

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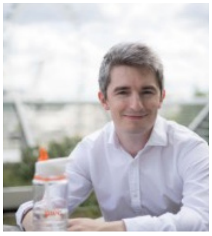

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