



MINISTRY OF DEFENCE

**SCAF ANNUAL CONFERENCE
DESA ROLE IN IMPROVING VALUE FOR
MONEY OUTCOMES IN DEFENCE
22 SEPTEMBER 2009**

**NEIL V DAVIES
SENIOR ECONOMIC ADVISER
MINISTRY OF DEFENCE**

SLIDE 1

VALUE FOR MONEY

- Value for Money (vfm) is optimal combination of
 - Economy – ie Cost of Inputs ($1/M$):Inputs/Money)
 - Efficiency – ie Ratio of Output to Inputs (O/I :Outputs/Inputs)
 - Effectiveness – ie Value of Outcomes from Outputs (V/O :Value/Outputs)
- Hence vfm =
- Vfm is a relative not absolute construct

SLIDE 2

PROBLEM WITH SECURING VALUE FOR MONEY (vfm)

- Where possible in acquisition MOD uses competition to achieve vfm
- But, as recognised in DIS, increasingly MOD no longer able to rely on competition to deliver vfm and sustain industrial capability
- This together with increasing emphasis on incremental acquisition and through life capability management leading to alternative of Long Term Partnering involving monopolist v monopsonist bargaining
- Challenge of
 - asymmetric information
 - moral hazard
 - principal agent problems

SLIDE 3

DESA'S MAIN CONTRIBUTIONS TO VFM IN DEFENCE

A) In Investment Appraisal and Evaluation

- Responsible for MOD policy on Investment Appraisal (IA) and Project Evaluation (PE) and ensuring MOD compliance with HM Treasury's "Green Book" guidance
- Provide advice and guidance on IAs and PEs eg JSP507
- Scrutinise IAs/COEIAs, OBCs for all projects subject to Central Approval (eg Ministers, IAB, DEC)
- Review sample of TLB IAs/PEs for Health of Financial Systems Review

SLIDE 3b

DESA'S MAIN CONTRIBUTIONS TO VFM IN DEFENCE (cont'd)

- B) Input to Industrial and Commercial Policy

- C) Supporting Better Management of Financial Risks particularly Forex and Fuel

SLIDE 4

PURPOSE OF IA

- To ensure Value for Money is obtained from investment decisions
- Effective appraisal and evaluation are fundamental requirements of Treasury delegations

SLIDE 5

BASIC QUESTIONS FOR IA

- Why is it necessary to commit resources?
- What do we want to achieve?
- What options are available?
- How much will they cost?

SLIDE 6

MODEL OUTLINE OF MOD IA

- establish requirement
- define objectives
- identify options
- quantify costs and benefits of (shortlisted) options
- compare these in NPV terms
- evaluate risks and uncertainties
- consider unquantifiable factors
- present results and make recommendation
- plan for Project Evaluation

SLIDE 7

ISSUES WITH IAs/COEIAs SUPPORTING CENTRALLY APPROVED PROJECTS

- We have around 180-200 live projects at any time
- Most IAs at a high standard by the time they go to IAB
- But at draft stage main problems
 - vague/uncertain specification of requirement
 - limited consideration of alternative options/case written around preferred option
 - particular challenges with partnering
 - affordability often uncertain

SLIDE 8

QUALITY OF TLB IAs

- Quality improving from a low base
- Numbers of IAs declining

	<u>01/02</u>	<u>02/03</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<u>Poor</u>	72%	72%	49%	35%	42%	42%	44%	33%
<u>Adequate</u>	19%	23%	32%	44%	34%	38%	35%	56%
<u>Good</u>	9%	5%	19%	21%	24%	20%	21%	11%
Sample of IAs	22	87	78	96	137	74	98	82
Total No of IAs	1154	1355	1207	831	498	389	334	229

SLIDE 9

COMMON ERRORS WITH TLB IAs

- Failure to establish objectives
- Objectives written to favour recommended solution
- Failure to consider alternative options
- ‘Goldilocks’ options presented (ie ‘do nothing’, ‘do everything’ and ‘just right’)
- Alternatives not costed
- Confusion between IA and RAB
- Costs omitted (especially ‘opportunity costs’)/not discounted
- Risks, sensitivities not considered

SLIDE 10

ISSUES WITH PARTNERING SOLUTIONS

- How to demonstrate vfm
- Construction of vfm benchmarks – In-house arrangements and Should Cost Models
- Incentivising suppliers
- Information given to Partner
- Risks

SLIDE 11

ALTERNATIVES TO COMPETITION TO GET VFM

- Contestability
- Benchmarking
- Competition at sub prime level
- Transparency of costs
- Gain sharing/Target Cost Incentive Prices

SLIDE 12

SUPPORTING BETTER MANAGEMENT OF FINACIAL RISKS THROUGH HEDGING

A) Forex:

- Buy Forward Programme for US\$ and €uros (previously DMarks) since 1986/7
- Although “Uncovered Interest Parity” Theorem suggests should involve no systematic cost compared to buying spot actual opportunity cost around 2½%
- Benefit in avoidance of 1 in 20 year risks of over £500M loss
- Reviewed in 2008/9 resulting in refined 3 year layered programme

SLIDE 12b

SUPPORTING BETTER MANAGEMENT OF FINACIAL RISKS THROUGH HEDGING

B) Fuel:

- Use of Hedging reviewed
- Recommending use of 3 year layered purchase of SWAPS

SLIDE 13

ANY QUESTIONS?



MINISTRY OF DEFENCE