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Proposed Guidance on Open Ended Contracts.

TRADE

MAY 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~6.5.80~~		~~8.4.87~~					
~~7.5.80~~		~~16.6.87~~					
~~2.5.80~~		~~22.6.87~~					
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~~6.4.87~~							

PREM 19/2553

Y [illegible]DDFA GYMREIG
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Switsfwrdd)
01-270 0538 (Llinell Union)
Oddi wrth Ysgrifennydd Gwladol Cymru

The Rt Hon Peter Walker MBE MP

WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-270 3000 (Switchboard)
01-270 0538 (Direct Line)
From The Secretary of State for Wales

22 June 1987

NON COMMERCIAL CONDITIONS IN LOCAL AUTHORITY CONTRACTS

Thank you for sending me a copy of your letter of 16 June to Willie Whitelaw.

I am content generally with the provisions relating to non-commercial conditions. However, one point does concern me and that is the inclusion of the Development Board for Rural Wales in the list of bodies to which the provisions apply. The bodies to which the Development Board for Rural Wales is most akin are the Highlands and Islands Development Board in Scotland and the DOE's own Development Commission in England. These are not included in this Schedule and the inclusion of the Development Board for Rural Wales is therefore anomalous. The presumption here is that the Development Board for Rural Wales was included because of the inclusion of New Town Development Corporations. When the New Town Development Corporations are wound up the inclusion of the Development Board for Rural Wales will be even more anomalous.

Consequently, I suggest for the time being at least, that the Development Board for Rural Wales be excluded from Schedule 2.

I am copying this letter to the Prime Minister, other members of H, the Foreign Secretary, the Secretary of State for Trade and Industry, the Attorney General, Sir Robert Armstrong and First Parliamentary Counsel.

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment

TRADE

OPEN ENDED CONTRACTS

5/20

CONFIDENTIAL

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:
Your ref:

The Rt Hon Kenneth Clarke QC MP
Paymaster General
Department of Employment
Caxton House
Tothill Street
LONDON
SW1

8 April 1987

Dear Kenneth

THE USE OF LOCAL LABOUR IN LOCAL AUTHORITY CONTRACTS

Thank you for your letter of 31 March. You will by now have seen the letter of 2 April from the Lord President's office asking that officials from the 3 Departments most concerned meet urgently to explore whether a way can be found to overcome the problem. You will also have seen Geoffrey Howe's minute of 6 April.

I should emphasise, however, that the problem does not relate to the compatability of our policies of stopping political clauses in local authority contracts and supporting the use and training of local labour in inner city contracts.

The problem is a clash between the way in which you want to pursue the local labour policy and the EC law on public sector contract procedures.

If that clash cannot be resolved I think you have a problem whether we legislate on political clauses or not. If it can be overcome then I am, of course, content to see an appropriate provision in the political clauses legislation to enable you to continue to pursue the local labour policy by means of contract conditions.

I am copying this letter to the Prime Minister, the Lord President, the Foreign Secretary, members of H, the Attorney General, First Parliamentary Counsel and Sir Robert Armstrong.

Yours ever
Nicholas

NICHOLAS RIDLEY

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Trade: Proposed Guidance on open ended contracts 5/80

FCS/87/088

SECRETARY OF STATE FOR THE ENVIRONMENT

The Use of Local Labour in Local Authority Contracts

1. Thank you for copying to me your letter of 30 March about your plans to introduce those parts of the Local Government Bill which were postponed in February. I have also seen Kenneth Clarke's letter of 31 March.

2. As you indicated in your letter, our legal advice is that the inclusion of local labour conditions in public contracts, as contained in the draft clause circulated by your officials, is in conflict with the EC Directives on public supply and works contracts. I agree that the Law Officers should be consulted forthwith.

3. Kenneth Clarke also suggests that we should consult the Commission for their views. To do so would alert the Commission to the fact that we were proposing to act in a way which they would certainly regard as being contrary to Community law.

/As

4. As far as other member states are concerned, it is quite probable that their Local Authorities do favour local contractors. Local authorities in the UK doubtless do so too. That is quite different from introducing a provision in our law to authorise them to do so.

5. I am copying this minute to the Prime Minister, Members of H and L Committees, the Attorney General, First Parliamentary Counsel and to Sir Robert Armstrong.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

6 April 1987

TRADE – Open Ended Contracts
5/80.

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CCBG

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

2 April 1987

NBPM.

Dear Robin,

JAP.

USE OF LOCAL LABOUR IN LOCAL AUTHORITY CONTRACTS

In my letter of 31 March I said that the Lord President wished the policy issue raised in your Secretary of State's letter of 30 March to be brought to an early meeting of H Committee, with the possibility of a further meeting to consider Parliamentary handling soon afterwards.

The Lord President has now seen the Paymaster General's letter of 31 March raising a number of questions about the European Community issues mentioned in your Secretary of State's letter. The Lord President considers that these matters must be clarified before the H discussion. He would be grateful, therefore, if officials from your Department, the Department of Employment, and the Foreign and Commonwealth Office could meet under Cabinet Office chairmanship and with the relevant legal advisers to agree a position on the EC points at issue and take a view on the value of an approach to the European Commission; and report back to Ministers before Easter. The meeting of H can then take place as soon as possible after Easter.

I am sending a copy of this letter to David Norgrove, to the Private Secretaries to the members of H and L Committees, to First Parliamentary Counsel and to Trevor Woolley.

Yours sincerely,

Mike Eland

M J ELAND
Private Secretary

Robin Young Esq
Private Secretary to the Secretary of State
Department of the Environment

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TV ads; open ended contracts

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CCB

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

31 March 1987

Dear Robin

NBPM.

LOCAL GOVERNMENT BILL: POLITICAL CONTRACT CONDITIONS

The Lord President saw your Secretary of State and the Chief Whip last night to discuss your Secretary of State's letter of 30 March.

The meeting agreed that in the light of the substantive point of policy in dispute between your Secretary of State and the Paymaster General and the uncertainty of the impact in the Bill's timetable of adding substantial new material to it, your Minister of State, when speaking to backbench amendments at Committee Stage, must avoid words which might later be construed as an undertaking or commitment. Instead there should be an early meeting of H Committee (which I understand is being arranged for Wednesday of next week) to discuss the policy issue and, depending on the outcome of that, a further meeting to consider Parliamentary handling soon afterwards.

I am sending a copy of this letter to David Norgrove, the Private Secretaries to the members of H and L Committees and First Parliamentary Counsel and to Trevor Woolley.

Yours sincerely
Nick Gibbons

M J ELAND
Private Secretary

Robin Young Esq
Private Secretary to the Secretary of State
Department of the Environment

TRADE open ended contract

DM/69 **CONFIDENTIAL**

CCBG

010

Department of Employment
Caxton House Tothill Street London SW1H 9NF
Telephone Direct Line 01-213 5949
Switchboard 01-213 3000

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for the Environment
2 Marsham Street
LONDON SW1P 3EB

31 March 1987

NBPM.

Dear Secretary of State,

THE USE OF LOCAL LABOUR IN LOCAL AUTHORITY CONTRACTS

(WILL REQUEST IF REQUIRED)

In your letter of 30 March, you report that you are unable to deliver the agreement we reached on the inclusion of local labour conditions in public contracts.

I am very disappointed to hear that doubts are being raised again about the compatability of the two policy objectives upon which we all agreed so recently - our opposition to "political clauses" in contracts and our support for the use and training of local labour in inner city contracts. I do not accept that we should allow ourselves to be bounced suddenly into a weakening of the second in quick response to backbench pressure.

I realise that there is some theoretical risk of being held in infraction of Community law, though I doubt strongly whether there is any probability in practice. Community and Commission policy is strongly slanted in favour of regional policies aimed at local economic regeneration and the proposed clauses in your bill would have been consistent with that.

You mention FCO advice in your letter but there is no mention of whether the Law Officers have been consulted. Nor do you mention contacts with the Commission's Services on the matter. I cannot imagine that, for example, our French, Italian or Greek colleagues would feel particularly inhibited by advice from their own foreign ministry without contact with the Commission. Until your letter arrived, I believed that our lawyers were considering whether an approach to the Commission should be made. I strongly suggest that we need to take the time to think about this and other legal answers to the problem before we simply drop our earlier agreement.

I note that you will be putting detailed proposals to 'H' and I hope we shall have time to consider their wider ramifications for other matters for which this Department is responsible.

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I am copying this letter to the Prime Minister, members of H and L Committees, the Attorney General, First Parliamentary Counsel and Sir Robert Armstrong.

Yours sincerely

Jeanie Cruickshank

pp KENNETH CLARKE

Approved by the Paymaster General and signed in his absence

TRADE

OPEN ENDED

CONTRACTS

5/20

PRIME MINISTER 4 DEN 15/10. 15 October 1986

LOCAL AUTHORITY CONTRACTS

H Committee returned today to the thorny question of outlawing non-commercial clauses in local authority contracts. You will recall that whilst there was broad agreement that such clauses should be oulawed Kenneth Clarke wished to be able to specify the use of local labour in certain contracts as part of the inner cities initiative.

The approach agreed at this morning's meeting is that there should be a general prohibition on non-commercial clauses in local authority contracts but an order-making power to allow conditions relating to employment in certain areas. Lord Hailsham was unhappy with the proposal both because he thought the courts would find it difficult to avoid the charge that they were taking political decisions in determining whether clauses were 'commercial', and because the precise form of the order-making power was unclear. The Department of Transport were unhappy because they saw the order-making power as the thin end of the wedge.

It was left that Nicholas Ridley had the necessary drafting authority but that the Committee would need to consider the precise terms of the clause once the necessary drafting had been undertaken.

Conclusion

This outcome is not entirely satisfactory. The Committee has fallen back on the expedient of an order-making power because there is no coherent rationale for allowing certain non-commercial clauses but not others. We shall need to see whether the proposed legislation when drafted gets over this problem to any extent.

Peter Stredder

PETER STREDDER

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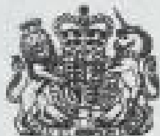

DEPARTMENT OF EDUCATION AND SCIENCE
ELIZABETH HOUSE YORK ROAD LONDON SE1 7PH
TELEPHONE 01-934 9000

FROM THE SECRETARY OF STATE

The Rt Hon Viscount Whitelaw PC CH MC
Lord President of the Council
68 Whitehall
LONDON SW1

14 October 1986

Dear Willie,

LOCAL AUTHORITY CONTRACTS

I am sorry that because of an unbreakable engagement I shall not be able to attend the meeting on 15 October at which H Committee will discuss Nicholas Ridley's paper, H(86)41, setting out an alternative approach on the question of political clauses in local government contracts. I am afraid that my Junior Ministers are also all tied up and cannot attend in my place.

I have some hesitation in intervening in this debate where there are marked differences of view between colleagues who are likely to be more closely affected by the provisions. Nevertheless I would like to register some concern about the way this is going, and in particular if the approach offered in Nicholas's latest paper were to be adopted. This seems to me an uneasy compromise (and I think rather detectably a compromise) which both fudges the issues of principle and potentially offers practical difficulties in the way of enforcement.

My main worry on the score of practicability is that it would be difficult to frame the prohibitions exemplified in paragraph 4 of the paper so that a reasonably ingenious left wing authority could not penalise contractors with a South African or strike breaking connection by means of what would be called in another context "indirect discrimination". Depending on the circumstances, such arrangements might or might not be vulnerable to challenge in a particular case but the overall effect might well be to leave an area of uncertainty and potential injustice which our supporters would rightly resent.

I recognise that Nicholas himself has put forward this approach without commitment and I fully accept his essential point that

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we must legislate on this question and effectively. I conclude that what we must have is a provision which provides a clear basis for effective challenge of abuses and which is based on clear cut general principles. Whether these are couched in terms of "commercial considerations" or perhaps something wider, such as the authorities' fiduciary responsibilities - which might for example allow an opening for consideration of the needs of the local labour force where appropriate - is a matter for consideration.

I am copying this to the Prime Minister, other members of H Commitee and Sir Robert Armstrong.

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DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

The Rt Hon Viscount Whitelaw CH MC
Lord President of the Council
Privy Council Office
68 Whitehall
LONDON
SW1 2AT

9 October 1986

Dear Lord President,

LOCAL AUTHORITY CONTRACTS

I regret to say that because of a longstanding engagement outside London I shall not be able to attend the 15 October meeting of H, when the issue of discriminatory contract practices by local authorities will be discussed again. I am asking Michael Spicer to attend in my place, but would like to set down my views in advance of the meeting.

I could not agree more with Nicholas Ridley when he says, in his memorandum H(86)42 for consideration at the meeting, that our supporters will be furious if our Bill does not address this issue. They would have every right to be. We need legislation on this in order to have a firm and explicit basis for challenging the abuses by local authorities which we have seen and which appear to be spreading.

I am particularly concerned with the activities of authorities acting as my agents in respect of trunk road maintenance; while no provisions in a Local Government Bill could apply to contracts made by the Crown, it would be easier for me to use my powers to direct authorities not to impose objectionable conditions if legislation outlawed them for authorities' own contracts. In the recent case of Birmingham''s Motorway and Trunk Road agency, which has now led to the agency's termination, Birmingham pointed to their Standing Order that all contracts should contain such conditions.

I am also, of course, interested in authorities' own contracts for highways and other work, including their new contrtacts for non-commercial but socially necessary bus services. It makes little sense for us to take steps to improve authorities' value for money by exposing their services to competitive tender if authorities artificially restrict the extent of competition. But my main concern is the issue of principle; like Nicholas Ridley, I feel strongly that these politically-motivated conditions are wrong and we should take action against them.

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As for the narrower approach of specific prohibitions set out in Nicholas Ridley's latest memorandum, I am not attracted to it. It offends against the principle that contracts should not be blunted by non-commercial considerations, and I am sure it could be a breeding-ground for loopholes. I would accept it only if colleagues cannot agree to the original proposals.

I am sending a copy of this letter to the Prime Minister, all Cabinet colleagues, other H Committee members and to Sir Robert Armstrong and Sir George Engle.

Yours Sincerely

J. Cunliffe
(Private Secretary)

pp JOHN MOORE

(approved by the Secretary of State and signed in his absence)

CONFIDENTIAL

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

cc BG

My ref:

Your ref:

The Rt Hon The Viscount Whitelaw CH MC
Lord President of the Council
Privy Council Office
Whitehall
LONDON
SW1

NBPM. 9 September 1986

Dear Lord President,

LOCAL AUTHORITY CONTRACTS

file with DRN

Quintin Hailsham sent me a copy of his letter of 1 September commenting on my memorandum on Local Authority Contracts (H)86(39), which we are to discuss on 16 September.

I agree that we must avoid legislation which will involve the Courts in political judgements. In my memorandum I am proposing that we should prohibit all non-commercial contract conditions imposed by local authorities except those imposed in pursuit of statutory requirements, and not simply all conditions of a political nature. I do not, therefore, envisage that the legislation will refer to "political conditions" and I believe that it will avoid the problems to which Quintin refers.

In the end, of course, this is a question of how the legislation is drafted. I will certainly ensure that careful consideration is given to framing it so as to ensure that we achieve our objective without courting the dangers to which Quintin refers. You may well feel, however, that if H Committee is content with my policy proposals it should be left to Legislation Committee to decide whether the legislation achieves this. If it would be helpful my officials would be glad to arrange for Quintin's to be consulted at the drafting stage.

I am copying this letter to the Prime Minister, all other Cabinet colleagues and to Sir Robert Armstrong and Sir George Engle.

Yours sincerely

BH Conrad Private Secretary

PP.

NICHOLAS RIDLEY

(Approved by the Secretary of State and signed in his absence).

This is 100% recycled paper

Trade: Proposed guidance on open ended contracts - May 1980.

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

9 September 1986

Dear Nicholas.

POLITICAL CLAUSES IN CONTRACTS

In my letter of 14 July I informed colleagues that Birmingham City Council had been seeking to make unauthorised additions to tendering requirements for our trunk road works including one which would have excluded firms having trading links with South Africa. You and other colleagues subsequently agreed that I should write to them directing them to refrain from this practice and to confirm that they would do so, failing which I should consider myself free to terminate the agreement under which they act as our agents for maintaining the motorway and trunk roads in their area.

The purpose of this letter is to let you know that the Council have now written to us not only refusing to give the necessary undertaking but themselves serving notice of termination of the agency agreement, and they have publicised their reply. Councillor Knowles has also written a personal letter to me in which he alleges that my approach stems from the Government's partiality towards "friends in South Africa".

In the circumstances, there is no alternative but to accept notice of the termination of the agency agreement. This will not present us with intolerable problems since we have the alternative of using consultants. We shall be pressing on with firming up the new arrangements which will need to be in place by 1 April next year. In the meantime I shall be making clear in response to Councillor Knowles and the related Press queries that our stance has nothing to do with South Africa or anywhere else but stems

from a wider policy of resisting the intrusion into tendering requirements and contracts of non-commercial conditions which have no bearing on the job to be done and are liable to limit effective competition.

I am copying this letter to the Prime Minister, all other Cabinet colleagues and Sir Robert Armstrong.

JOHN MOORE

TRADE CONTRACTS 5/86

FROM:
THE RT. HON. LORD HAILSHAM OF ST. MARYLEBONE, C.H., F.R.S., D.C.L.

HOUSE OF LORDS,
LONDON SW1A 0PW

1st September 1986

CONFIDENTIAL

Dear Willie:

Local Authority Contracts

I have seen Nicholas Ridley's memorandum H(86)39 in which he explains his proposals for legislation to prevent local authorities from imposing political contractual conditions.

As I said most recently in my letter to you of 21 November 1985, my preoccupation remains that any such legislation should present properly justiciable issues to the courts, and not require them to make political judgments. I note, in this regard, that the proposed legislation would be based on the model of sections 12 and 13 Employment Act 1982 and the publicity provisions in the Local Government Act 1986. Whilst these precedents are undoubtedly close to the result which is sought, it nevertheless remains true that they were concerned with a narrow, and relatively easily defined, range of activities i.e. prohibition on union membership requirements on the one hand and party political publicity on the other.

The sort of conduct aimed at by the proposed legislation is potentially much wider in scope, and poses a corresponding difficulty of definition. The contractual conditions imposed by

/...2

The Right Honourable
The Viscount Whitelaw CH MC
Lord President of the Council
Privy Council Office
Whitehall
London SW1A 2AT

local authorities have concerned such disparate matters as defence policy (e.g. cruise missiles or Trident), racial discrimination, and foreign relations (e.g. South Africa) and I am concerned lest the courts be drawn into a long controversy over what does, or does not, constitute a clause of a purely political nature. I am equally concerned lest the courts be drawn into the question of the political considerations which lead to the imposition of such clauses. I would therefore welcome a little more consideration by Nicholas Ridley of the precise means he intends to employ to achieve his objective without courting the dangers I have referred to.

I am copying this letter to the Prime Minister, all other Cabinet colleagues and to Sir Robert Armstrong.

CONFIDENTIAL

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

31 July 1986

Dear John

NBPM

POLITICAL CLAUSES IN CONTRACTS

I have seen a copy of your letter of 28 July to Nicholas Ridley, in which you explain the timetable constraints on your proposed action.

My concern on timing is similar to Geoffrey Howe's. While I appreciate that your action is founded on the general principle of opposition to political clauses in contracts as such rather than on objections to the clause on South Africa in this particular contract, we must be prepared for attempts to portray it otherwise.

For the reasons you give, I recognise that you cannot acommodate the delay I had envisaged. I would therefore be content with an earlier announcement provided you keep in close touch with Geoffrey on the exact timing and presentation.

I am sending a copy of this letter to the Prime Minister, the members of the Cabinet, the Chief Whip, the Law Officers and Sir Robert Armstrong.

Yours ever
Willie

The Rt Hon John Moore MP

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TRADE
CONTRACTS
5/20

CONFIDENTIAL AND COMMERICAL IN CONFIDENCE

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:
Your ref:

The Rt Hon John Moore MP
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

30 July 1986

Dear John

POLITICAL CLAUSES IN CONTRACTS

Thank you for your letter of 28 July.

I understand the Lord President's concern about possible links between the action that you propose to take and the Government's general stance on South Africa. But, as you say, there has already been widespread speculation in the press about the Government's response to Birmingham's action, and in those circumstances I do not think that an early announcement can do any harm.

On the other hand we must be in a position to terminate the agency agreement on 1 April next year if Birmingham do not recant, and delaying action increases the risk of legal challenge. I therefore agree with the timetable that you propose.

I am sending copies of this letter to the Prime Minister, all other Cabinet colleagues, the Law Officers and to Sir Robert Armstrong.

I made some fairly stringent criticisms of Birmingham's action on the Radio today in Birmingham

Yours ever

Nicholas

NICHOLAS RIDLEY

TRADG Contracai 5/80

CONFIDENTIAL

ROYAL COURTS OF JUSTICE
LONDON, WC2A 2LL

01-936-6201

30 ~~August~~ July 1986

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON S W 1

Dear John.

POLITICAL CLAUSES IN CONTRACTS

Thank you for copying this correspondence to me.

I agree that if Birmingham City Council refuses to act in accordance with your direction the best course would be to give notice of termination rather than rely upon the assertion that the Council's refusal to comply amounted to a fundamental breach of the agreement.

The latter course might allow the Council to argue that they were simply carrying out their statutory duty under section 71 of the Race Relations Act 1976, and while I doubt whether that claim would succeed, I do not think it is worth putting the matter to the test when there is a safer means of terminating the agreement.

I am sending copies of this letter to the Prime Minister, members of the Cabinet and to Sir Robert Armstrong.

Yours ever.

Michael

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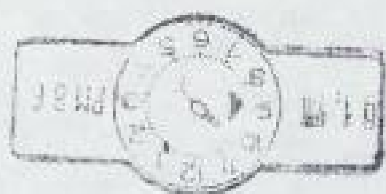
TRADE
CONTRACTS
5/10



MC/B13

Department of Employment
Caxton House Tothill Street London SW1H 9NF
Telephone Direct Line 01-213 5949
Switchboard 01-213 3000

The Rt Hon John Moore MP
Secretary of State
Department of Transport
2 Marsham Street
LONDON SW1

28 July 1986

Dear John,

POLITICAL CLAUSES IN CONTRACTS

Thank you for your letter of 18 July in reply to mine of the same date about use of local labour in a housing refurbishment contract in Handsworth. I am grateful that you propose to distinguish the presentation of the issue with which you are concerned, about unauthorised clauses inserted by Birmingham City Council in tender documents, from my aim of encouraging the use of local labour by agreement with the contractor.

I am sorry, however, that you still have reservations about my proposal. I believe the distinction between that and contract compliance is quite clear. We are asking a contractor to undertake work in Handsworth which will benefit our policies in three distinct ways: physical refurbishment; employment; and skills training for local people, in line with the objectives of the Inner Cities Initiative. The contractor will obviously incur some additional costs in meeting these objectives - for example training costs and the costs of using labour that will not be fully experienced - and if the contract is to be on a sound commercial footing he should be paid for them. I do not therefore see that my approach is in any way non-commercial. It is merely a matter of defining more clearly the full extent of the product we want to buy and then negotiating a good price for it. We have a number of objectives we are pursuing, not just better buildings. My aim is to secure value for money in attaining those objectives as you are aiming to do in arranging the simpler objective of road maintenance.

Copies of this letter go to the Prime Minister and recipients of the earlier correspondence.

Yours ever,
Ken

KENNETH CLARKE

TRADE : CONTRACTS : May 80

CCBG

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON SW1P 3EB

28 July 1986

Prime Minister 2
DEW 29/7.

Dear Nicholas.

POLITICAL CLAUSES IN CONTRACTS

I am grateful to you and colleagues for the wide support shown for the action I proposed in my letter of 14 July. However there has been some concern about the timing of any action.

The Lord President has asked that I should defer any announcement until late August or early September; and I understand that the Foreign Secretary would like me to delay action until after the Commonwealth Review Meeting on 5 and 6 August. I can accommodate the latter but I am afraid that the contractual constraints placed on me by the agency agreement with Birmingham City Council do not allow me to delay matters any further.

because one of the objectionable conditions relates to trading links with South Africa.

As I indicated in my earlier letter, two options are available - to regard the City Council's action as so flagrant a breach of their agency agreement that I may regard the agreement as at an end, or to serve the prescribed notice of termination on the Council. On the basis of the legal advice I have received, I intend to take the latter course. The agency agreement can be terminated only with effect from 1 April in any year, after 6 months notice. This means that, if as is probable Birmingham refuse to modify their contracts, I must serve notice on the Council in September. I must, of course, before then give them sufficient time to consider and reflect on their response to my direction. A month seems desirable, especially given that we are entering the holiday period. The matter is already the subject of some speculation in the press. Given the publicity such action would undoubtedly receive and the risk of legal challenge, it is important that I am seen to have been procedurally correct and to have acted reasonably.

I therefore intend that my direction to the City Council should be despatched on 8 August and that, failing a satisfactory reply from the Council by 8 September, notice terminating the agency agreement with effect from 1 April 1987 should be sent not later than 19 September.

I am sending copies of this letter to the Prime Minister, all other Cabinet colleagues, the Law Officers and to Sir Robert Armstrong.

JOHN MOORE

TRADE

CONTRACTS

5710

CONFIDENTIAL 2pps CCBG

QUEEN ANNE'S GATE LONDON SW1H 9AT

24 July 1986

Dear John.

NBPM.

POLITICAL CLAUSES IN CONTRACTS

FILE WITH DRN

I have been following the correspondence under the above heading which was triggered off by your letter of 14 July to Nicholas Ridley. My concern now is not to seek to persuade you to any different conclusion on the question of whether or not you should give notice of an intention to terminate your agency agreement with Birmingham, although like Willie Whitelaw, I think that you will need to watch very carefully the timing of your announcement of any such intention. What happens in relation to South Africa over the next few weeks could be very significant; and we must minimise the risk of your action being misunderstood or misrepresented. Rather I am writing about the separate point, raised by Kenneth Clarke, of the use of local labour by local authority contractors in inner cities, especially in those areas which, like Handsworth, have been designated as "pilot" areas for our current 'Task Force' initiative.

I very much share Kenneth Clarke's concern that whatever you do about Birmingham's position as your agent in relation to motorway maintenance should not have any adverse effects on the arrangement which he, the local authority and the Handsworth Task Force are trying to make with a contractor in relation to a housing refurbishment scheme in the task force area. As you know, the hope here is to obtain a non-contractual undertaking from the firm concerned that it will use local labour for the project. For my own part, I have always regarded as a cogent criticism of Government-supported expenditure in inner cities the fact that it has often failed to secure that local people benefit from employment which it makes possible. That is a situation which, as an act of deliberate policy, we are now trying to change - at least in the eight 'pilot' areas. I share my colleagues' concern for value for money. But this is not an abstract concept. It must be related to objectives. And, in the Task Force areas our objective is not only to improve the environment by a community refurbishment scheme (if it was <u>only</u> that, I would agree that we must ensure that the work is done effectively on a 'least cost' basis); our objective is also to ensure that local people benefit from the employment opportunities thus created. That may mean that a contract costs slightly more than it would do if the second objective was not

/there:

The Rt Hon John Moore, MP

CONFIDENTIAL

there: it may have to contain a training element and it may for that reason, or because of the inexperience of those involved, take longer to complete. But given that we do have the second objective, then, provided we are satisfied that any 'extra' costs are kept to the minimum necessary, and that the arrangement which we are making will be able to deliver our twin objectives, we can, I think, still claim that we are getting value for money from it.

We have invested a good deal of political capital in the inner cities initiative; and one of the things which we have let it be known we would be trying to deliver is an increased benefit to local people from major items of public expenditure. We went into the initiative declaring, in effect, that we would be ready to treat Task Force areas as special cases and as places in which the ordinary rules of Government programmes might need to be modified - after consideration and for approved purposes. That is what Kenneth Clarke wants to do with the Handsworth contractor and in seeking to do it informally, and without any contractual condition, he has my full support.

I am sending copies of this letter, like yours, to the Prime Minister, other Cabinet colleagues and to Sir Robert Armstrong.

Yours,

Douglas

TRADE
CONTRACTS
5/40

025/2984

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon John Moore MP
Secretary of State for Transport
Department of Transport
2 Marsham Street
London
SW1P 3EB

24 July 1986

Dear John,

POLITICAL CLAUSES IN CONTRACTS

I have seen a copy of your letter of 14 July to the Secretary of State for the Environment.

The sooner we are in a position to bring forward legislative proposals to stop local authorities imposing non-commercial contract conditions the better. In the meantime it will be important to stress that we object to the use of all political clauses in contracts and not just clauses concerning South Africa or Fair Wages in particular. We need to ensure our approach is clearly understood and that Birmingham are seen to be responsible for any consequent delay to the motorway maintenance programme.

I am copying this letter to the Prime Minister, all other cabinet colleagues and to Sir Robert Armstrong.

Yours ever,

John

JOHN MacGREGOR

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

TRADE

Open-ended contracts

5/20

CCBG

Y SWYDDFA GYMREIG
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-233 3000 (Switsfwrdd)
01-233 6106 (Llinell Union)
Oddi wrth Ysgrifennydd Gwladol Cymru

WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-233 3000 (Switchboard)
01-233 6106 (Direct Line)
From The Secretary of State for Wales

The Rt Hon Nicholas Edwards MP

22 July 1986

CONFIDENTIAL AND COMMERCIAL IN CONFIDENCE

Dear John

POLITICAL CLAUSES IN CONTRACTS

I am writing to express my full support for the robust line you propose taking with Birmingham City Council as explained in your letter of 11 July to Nicholas Ridley. It is unacceptable that the letting of contracts should be influenod by issues which have no bearing on the execution of the works in question and there can be no question of the awarding of Government contracts being influenced in this way.

We have been fortunate in Wales that so far we have been able to resolve such problems through official exhortations. Gwent County Council, for example, has a "South African exclusion" clause in its standing orders relating to the letting of contracts but the County Surveyor has been told that this may not be applied to Welsh Office contracts undertaken on an agency basis and so far we have experienced no difficulty in that respect. However, there can be no doubt that, unless you are able to hold a firm line with Birmingham, Gwent and perhaps other County Councils would be unlikely to toe the line in future.

I have no comment to offer regarding the way you propose to resolve the impasse as I see no practical alternative but for your Department to terminate its agency agreement with Birmingham City Council. Hopefully such firm action will dissuade other potentially recalcitrant authorities from following Birmingham's unhappy precedent.

Copies of this go to the Prime Minister, Cabinet collagues and Sir Robert Armstrong.

Yours ever
Nick

The Rt Hon John Moore MP
Secretary of State for Transport

TRADE
CONTRACTS
5/80

CONFIDENTIAL AND COMMERCIAL-IN-CONFIDENCE

Chancellor of the Duchy of Lancaster

CABINET OFFICE
WHITEHALL, LONDON SW1A 2AS

Tel No: 233 3299
7471

21 July 1986

Richard Allan Esq
Private Secretary to the
Secretary of State for Transport
Department of Transport
2 Marsham Street
LONDON
SW1P 3EB

NBPM

Dear Richard,

POLITICAL CLAUSES IN CONTRACTS

The Chancellor of the Duchy has seen a copy of your Secretary of State's letter of 14 July to the Secretary of State for the Environment.

The Chancellor agrees with the way in which your Secretary of State proposed that he should proceed against Birmingham City Council.

I am sending a copy of this letter to the private secretaries to the Prime Minister, other members of Cabinet, and to Sir Robert Armstrong.

Yours sincerely,

Andrew Lansley

ANDREW LANSLEY
Private Secretary

CONFIDENTIAL AND COMMERCIAL IN CONFIDENCE

DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Secretary of State for Social Services

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON
SW1P 3EB

July 21 NBPM

Dear Nick.

POLITICAL CLAUSES IN CONTRACTS

I have seen a copy of John Moore's letter of 14 July.

We clearly cannot continue to allow local authorities to insert politically motivated clauses in contracts which they administer as agents of central government. I therefore agree with John's assessment of the problem and support the course of action he proposes.

I am copying this letter to the Prime Minister, Cabinet colleagues and to Sir Robert Armstrong.

Yours Norman.

NORMAN FOWLER

CONFIDENTIAL AND COMMERCIAL IN CONFIDENCE

ccBG

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

Prime Minister ?
This question could well be raised at E(A) on Monday.
This raises very difficult questions.
DW 18/7

July 18. '86.

The Rt Hon Kenneth Clarke MP
Paymaster General
Department of Employment
Caxton House
Tothill Street
LONDON SW1H 9NF

Dear Kenneth,

POLIITICAL CLAUSES IN CONTRACTS

Thank you for your letter of 18 July in reply to mine of 14 July about the action by Birmingham City Council, while acting as my agent, of inserting in tender documents unauthorised clauses, including a requirement that tenderers sign a declaration relating to their trading relations with South Africa.

I welcome your support for my proposal that, unless the Council desists, I shall take steps to terminate the agency agreement. As I made clear in my letter of 14 July, my action would have nothing to do with South Africa and everything to do with an abuse of authority. I am concerned in these circumstances quite specifically with an attempt by an agent to introduce non-commercial clauses into a straight-forward contract, of which there are many let on my behalf each year up and down the country by local authorities acting as my agents. This is an issue which stands in its own right and I would present it as such.

Your letter draws a careful distinction between the political clauses in the tender documents under our agency agreements with Birmingham and the action you propose in Handsworth to encourage use of local labour which will be discussed at E(A) on Monday. As I have made clear above, I agree there is a difference in kind and I will seek to present it as such - although I am not sure that Birmingham will observe the distinction. I do, however, have serious general reservations about your proposals and as I will not be able to attend E(A) it might be helpful if I record them here.

The line between contract compliance and your proposal is I think far more difficult to draw than your letter, and the paper you have circulated to E(A) (E(A) (86) 35), suggests. As I understand it, you intend to encourage Birmingham to effect a housing refurbishment project by using a contractor willing to undertake to employ a high proportion of local labour. This undertaking will not be a part of the contract per se but somehow an extra contractual requirement for which he will receive payment. The bald fact, however, is that the contractor will be paid to exercise positive discrimination.

Your proposal does not make it clear whether the contract will be put out to tender or whether Birmingham will simply select a sympathetic contractor, but it is clear that unless the contractor is prepared to participate he will not be eligible for the contract. I really cannot see how we can reconcile this with the further consideration which Nicholas Ridley intends to give to the banning of non-commercial contract conditions by local authorities which we discussed at H Committee on 15 July (H (86) 22 refers). Nicholas' line is I believe based on the principle that it is the duty of the local authority to get the best value for money for its ratepayers in the exercise of its proper functions. Encouraging Birmingham to engage in positive discrimination at the ratepayers expense will I think set a most unfortunate precedent. Nor do I think that positive discrimination, be it towards local labour, particular ethnic groups, or any other minorities, is a course we wish to adopt.

I am sending copies of this letter to the Prime Minister and recipients of the earlier correspondence.

JOHN MOORE

TRADE
CONTRACTS
5/80

Department of Employment
Caxton House Tothill Street London SW1H 9NF
Telephone Direct Line 01-213 5949
Switchboard 01-213 3000

The Rt Hon John Moore MP
Secretary of State for Transport
2 Marsham Street
London SW1P 3EB

18 July 1986

Dear Secretary of State,

Thank you for your letter of 14 July about the action you propose to take to terminate your agency agreement with Birmingham City Council on the basis of the political clauses that they have been including in tender documents.

I entirely support your action. I suspect that other advantages will flow if the agency agreement is terminated as consultants could well provide better value for money in their management and organisation of maintenance work. In any event it is plainly important that we stop the spread of these non-commercial conditions in contracts of this kind.

I write to ask you to distinguish clearly between the political clauses in tender documents under your agency agreement and the negotiations which are in hand between Birmingham City Council and a major contractor to place a housing refurbishment contract in Handsworth on a basis which includes an undertaking to use local labour. I have been closely involved, first with Kenneth Baker and now with Nicholas Ridley, in progress towards concluding that contract. The local labour undertaking will not be a term of the contract. The undertaking is not a purely political requirement but it will be based on an agreement to pay a specified extra sum for an extra ingredient in the contract, added with the approval of the Government.

This Handsworth contract is an attempt to get better value for money out of inner city expenditure under the Housing Investment Programme and the Urban Programme by placing the contract in a way which secures both improved buildings and increased work experience in training for inner city residents. This is plainly distinguishable from political clauses in straight commercial building contracts and contracts for the maintenance of roads.

I am sure that you will take care to handle the announcement of your decision in a way which clearly distinguishes it and does not prejudice the continuing discussions on the inner city contract.

I am copying this letter to the recipients of yours.

Yours sincerely,

Carol Franklin

for KENNETH CLARKE

(Approved by the Paymaster General and signed in his absence)

From:

The Rt. Hon. Lord Hailsham of St. Marylebone, C.H., F.R.S., D.C.L.

House of Lords,
London SW1A 0PW

CONFIDENTIAL AND
COMMERCIAL IN CONFIDENCE

18 July 1986

NBPM

My dear John. POLITICAL CLAUSES IN CONTRACTS

I have seen your letter of 14th July 1986 to Nicholas Ridley.

I wholeheartedly agree that you should deal with this abuse of authority by Birmingham City Council as you propose. They are your agents. They cannot be allowed to put you into a position where your conduct could well be challenged by way of judicial review on grounds both of Wednesbury unreasonableness and of vires

I am sending copies of this letter to the Prime Minister, all other Cabinet colleagues and to Sir Robert Armstrong.

Yrs:

The Right Honourable
John Moore, M.P.,
Secretary of State for Transport.

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

18 July 1986

Dear Richard

The Lord President has seen a copy of your Secretary of State's letter of 14 July to Mr Ridley about Political Clauses in Contracts. He has asked if it would be possible to defer any announcement until late August or early September.

I am sending a copy of this letter to David Norgrove (No 10), to the Private Secretaries to the members of the Cabinet, and to Michael Stark in Sir Robert Armstrong's office.

Yours sincerely

Nick Gibbons

N F J GIBBONS
Asst Private Secretary

Richard Allan Esq
Private Secretary to the Secretary of State
Department of Transport

DEPARTMENT OF TRANSPORT
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

PM seen.
PA.

The Rt Hon Nicholas Ridley MP
Secretary of State for the Environment
Department of the Environment
2 Marsham Street
LONDON SW1P 3EB

14 July 1986

Prime Minister[2]
To see in case this is mentioned at Cabinet tomorrow. I suggest await comments eg from the Law Officers to whom I have asked that this should be copied. ARW 14/7.

Dear Nicholas,

POLITICAL CLAUSES IN CONTRACTS

Colleagues have been concerned for some time about the growing extent to which some local authorities are including their own contracts clauses which are not in any way directly connected with the performance of the contract itself but are related to some political objetive of the local authority. This letter seeks your and colleagues' views on the course I propose to follow in a case in which my agent authority, Birmingham City Council, have inserted a number of unauthorised clauses in tender documents for maintenance of a section of the M5, including a Fair Wages Clause and a requirement that tenderers sign a declaration relating to their trading relations with South Africa.

Under the agreement by which Birmingham act as my agent for maintenance of motorway and trunk roads in their area, the City Council are obliged to comply in all respects with my requirements relating to the performance of the work. Informal approaches by my officials have failed to secure removal of the non-commercial clauses. I therefore propose, under the terms of the agency agreement, to give a direction to the Council requiring them to desist from the practice and to confirm that they will do so. I shall make clear that if there is a failure to comply with that direction I shall consider myself free to terminate the agency agreement.

Termination may be obtained in one of two ways:

> either, as provided in the agreement, by formally giving six months' notice before 30 September, which will bring the agency to an end on 31 March 1987; or
>
> by regarding the refusal of the Council to comply with my requirements as such a fundamental breach of the agreement that it may be regarded as having been brought to an end by their deliberate action.

My own preference is to follow the former course, because of the time needed to make alternative arrangements.

Termination of the agency would be followed by appointment of consultants to manage and organise the maintenance work, as has already been done following the abolition of the South Yorkshire and Greater Manchester Metropolitan County Councils.

Termination of the agency could also have implications for City Council staffing. This might be a factor which would sway the Council in favour of complying with my requirements. Nevertheless, the Council may well perversely allege that my motives are political rather than contractual.

But, as I trust you and colleagues will agree, my action would have nothing to do with South Africa and everything to do with dealing with an abuse of authority.

I should be glad to learn that you are content for me to proceed in this case on the lines indicated above. If I do not act firmly, I am sure that other local authorities will follow Birmingham's example. We shall be seen to have run away from a problem on which our present policy is to encourage contractors to take legal action. If they are to take legal action in this sort of case, it would involve me as the principal as well as the authority as my agent.

The immediate effect is that this contract will not be let this year. I shall need to tell tenderers that it cannot proceed on the basis on which Birmingham invited the tenders. It will not now be possible to invite fresh tenders and get the work done before the opening of the Motor Show, when there definitely should be no work in process on motorways in its vicinity. It should clearly be seen as Birmingham's responsibility that this £1m or so of work has to be postponed.

I am sending copies of this letter to the Prime Minister, all other Cabinet colleagues, and to Sir Robert Armstrong. I should be very glad to receive your agreement to my proposed action by 18 July.

JOHN MOORE

JU

Trade

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

4 January 1982

The Rt Hon Leon Brittan QC MP
Chief Secretary
HM Treasury
Treasury Chambers
Parliament Street
London SW1

Dear Leon,

NON-COMPETITIVE GOVERNMENT CONTRACTS

Thank you for sending me a copy of your letter of 15 December to John Nott on this subject. I am content with your proposed course of action with the CBI and the Review Board. I take it that if the Review Board does not wish to carry out the review, officials would then consult and make recommendations about the next best alternative.

2 I am copying this letter to the Prime Minister, John Nott, Geoffrey Pattie and to Sir Robert Armstrong.

Yours ever

Patrick

Prime Minister

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Nott MP
Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

15 December 1981

Dear John,

NON-COMPETITIVE GOVERNMENT CONTRACTS

Following correspondence between Geoffrey Pattie and myself in October a group of officials under Treasury chairmanship has been considering the scope of a review of the arrangements for non-competitive Government contracts. I attach a copy of their report.

As you know, pressure for a review has come from Sir Robert Telford in the NDIC forum. In addition, the JRBAC were dissatisfied with the target rate of profit recommended in the last Review Board's report, and have proposed a reference to the Board to seek an "objective" target rate. Also, the Defence Committee and the PAC will be reporting on these arrangements this Session, from rather different points of view. Finally we ourselves need to be sure that the 1968 arrangements are still appropriate to present and future circumstances. In particular we want arrangements which provide a strong incentive for the contractors to become more efficient.

While accepting the need for a review, I felt that we should consider carefully to what extent it should cover those aspects of the 1968 arrangements which have formed an important safeguard for the taxpayer. The 1968 Agreement has, after all, served us well in that we have not been faced with cases in which contractors have made exorbitant profits.

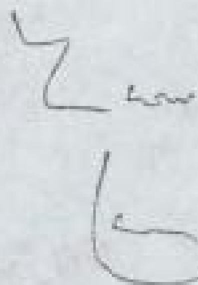
Officials recommend that the two major features of the 1968 Agreement, the comparability basis for determining the target profit rate, and post costing, should be covered by the review. I agree with their conclusion. There are now a number of aspects of comparability that need to be looked at, and as Geoffrey Pattie said in his letter of 11 November, the Telford criticisms of post costing have to be dealt with, even if we see very little in them.

The terms of reference in Annex B of the report are therefore wide, but they rightly stress two important points - the need for fairness as between taxpayer and contractor, and the pressure for greater efficiency in the performance of Government contracts.

Our officials consider that the Review Board is by far the best qualified to carry out this review. Although there is a certain awkwardness because the Board would to some extent be reviewing its own raison d'etre, I agree that it should be given first refusal. There are informal indications that Mr Davison, the Chairman, would be willing to take on the task. If in the event the Board does not do the job, the only alternative would seem to be a suitably qualified individual, heavily supported by consultants. It would not be sensible to create a new body, which would inevitably be very like the Review Board, while the Board itself remains in existence. But if we have to rely upon an individual, who is not familiar with the subject, the review is bound to take longer; and in the circumstances I am sure you agree that the review should start as soon as possible, and be completed within the 6-9 months proposed by our officials.

If you and Patrick Jenkin are content, I will now write to the President of the CBI seeking his agreement to a formal approach to the Board. Meanwhile our officials can have informal discussions with the various parties concerned, so that the review can start as quickly and smoothly as possible.

I am copying this letter to the Prime Minister, Patrick Jenkin and Geoffrey Pattie, and to Sir Robert Armstrong.



LEON BRITTAN

NON-COMPETITIVE CONTRACTS

Report of a group of officials representing Treasury, Ministry of Defence and Department of Industry, under the Chairmanship of Mr J G Littler, Treasury

In his letter of 22 October to the Parliamentary Under Secretary of State for Defence Procurement the Chief Secretary proposed that an inter-departmental group of officials under the Chairmanship of Mr Littler should consider the scope of a review of the arrangements for pricing non-competitive contracts. The group took as their terms of reference:-

> To consider the arrangements for non-competitive Government contracts, having regard to their objectives, including their effect on present and future industrial efficiency, in order to report to Treasury, Ministry of Defence, and Department of Industry Ministers by 14 December on:
>
> (i) which features of the present arrangements would now be suitable for review by an outside body;
>
> (ii) the appropriate body to carry out such a review, and the terms of reference which it should be given;
>
> (iii) the means by which issues excluded from the outside review should be carried forward.

1968 Agreement

2. The present arrangements for pricing non-competitive Government contracts* were established in 1968 as a direct consequence of the

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*Almost all of these are MOD contracts currently involving payments of £2.3bn a year. The rest of the contracts are placed by DHSS.

exorbitant profits made on certain defence contracts. The 1968 Agreement between the Government and the CBI had three main elements:

(1) a target rate of profit for non-competitive contracts based on comparability with the return on capital employed in UK manufacturing industry

(2) the right of the department to equality of information at the time prices are negotiated, with the right to ascertain the outturn on individual contracts (post-costing)

(3) an independent review board would carry out a comparability exercise about every three years, and recommend a target profit rate for the next period; it would also determine any adjustment to the profit on individual contracts referred to it where exceptionally high or low profit levels had been revealed by post-costing.

These arrangements were justified at the time as a means of achieving fairness as between taxpayer and contractor, and of avoiding a repetition of the cases of excessive profits. The comparability principle could also be justified as a means of achieving an economic allocation of resources between Government business and other demands on manufacturers.

Criticisms of the present arrangements

3. In theory these arguments are no less valid today; and as recognised in recent Ministerial correspondence they have served us reasonably well. There has been no repetition of the embarrassing problems that gave rise to the 1968 arrangements. But they have attracted growing criticism because:

(1) the general level of profitability in manufacturing industry has fallen to a very low level, and has stayed there for a substantial period. Such a situation was not foreseen in 1968. In both 1977 and 1980 the Review Board recommended profit rates above those being achieved in manufacturing industry and the Government accepted those recommendations.

(2) with the rapid growth in the cost of military equipment, at a time of severe constraint on public expenditure, the level of efficiency among defence contractors has become increasingly an issue. This leads naturally to questioning the extent to which the profit formula arrangements as a whole encourage efficiency.

(3) the introduction of CCA accounting has raised questions about the appropriateness of making comparisons with industry on the existing basis of a return on capital measured in historic cost terms; and of pricing on a similar basis.

(4) it has been alleged by industry that post costing of individual contracts leads to late pricing of contracts (negotiators not wishing to be shown by post-costing to have done a bad deal), and thereby inhibits efficiency.

The defence industries have made two proposals:

(i) that the Review Board should be asked to make an "objective" assessment of the target profit rate necessary to maintain the long term viability of the defence industries (proposed by the JRBAC, the CBI body which represents contractors)

(ii) present methods of post-costing should be scrapped in favour of a check on the overall level of a company's profitability on defence contracts (Sir Robert Telford of GEC/Marconi).

The foregoing needs to be seen however against the background that

a. there is no reluctance on the part of firms to take on defence contracts priced at the current terms,

b. there is no shortage of firms seeking defence business.

The MOD is not therefore in a situation in which it thinks concessions to be called for. On the contrary, it would wish at this stage to use its muscle to secure even better value for money.

Comparability

4. The Government have acknowledged that industrial profits are at present at too low a level. It is difficult therefore to claim that comparability should be rigidly enforced - indeed they waived that claim in 1977 and 1980. On the other hand, it is difficult to conceive of any basis for determining the profit formula target rate which does not have some regard to comparability. The CBI would probably agree with that. The issue is the degree of flexibility in interpreting comparability.

5. There are various ways in which greater flexibility might be expressed. Contractors might be given a higher rate of profit than the rest of industry at a time when profits generally were cyclically low, and vice versa. There may be a case for seeking a closer analogue than "UK manufacturing industry" in order to reflect eg the importance in the defence sector of high technology firms. The profit formula might be adapted to give greater incentive to improve efficiency and technical competence, and to reflect the different needs of high and low technology industries since, it might be argued, the averaging process in the relatively simple structure of the present formula protects the inefficient.

6. The measurement of capital in historic cost terms is unsatisfactory. While it is not possible to adopt a full CCA basis for pricing, because contractors do not intend to convert their management accounts, there may be scope for study to see whether there are simpler but effective steps that could be taken towards an inflation adjusted basis. Study also needs to be given to the method of defining the rate of profit, in relation to capital and to costs, and the timing of companies' expenditure and receipts.

7. It is clear that within the principles of comparability there are a number of aspects that now need to be considered. The Government cannot at present meet the criticisms of the present system, or dispel the dissatisfaction that has been expressed. There is likely to be further adverse (and diverse) comment from the Defence Committee and the PAC, which in the present Session are looking at the administration of these contracts. Faced with continuing low levels

profit in industry, the Review Board would have an extremely difficult task in its next review in 1983, in recommending a profit rate within the 1968 Agreement. The defence contractors express deep dissatisfaction with the present target profit rate although it is undeniable that the profitability of defence firms is currently rather better on the whole than non-defence businesses so that, viewed in the short term at least, comparability has not done defence contractors a disservice.

8. In allowing these issues to be reviewed the Government would not necessarily be rejecting comparability as an important element in the solution. It would be essential to ensure that the terms of reference of any outside review stressed the need to maintain fairness as between the taxpayer and the contractor. They should also look towards the system which provides incentives to efficiency and technical competence in carrying out contracts, and is reasonably cheap and simple to administer.

Post-Costing

9. MOD undertakes post-costing

a. to assist with the pricing of subsequent purchases of the same or similar items;

b. to check on the accuracy of the estimating techniques used in pricing the contract;

c. to provide for a selective scrutiny of the outcome of particular contracts.

10. The sample of contracts post-costed includes those in excess of £2.5m except where it is clear that post-costing would serve little useful purpose (ie in the pricing in individual cases of follow-on orders or as a check on estimating techniques). A limited number of contracts and sub-contracts of less than £2.5m are also selected having regard to:

a. the objectives referred to at paragraph 9 a and b above;

b. the "track records" of individual contractors which may indicate a need to post-cost more extensively than would otherwise be the case.

About 80 contracts a year are post-costed representing 4-5% by number but about one-third by value of eligible contracts; and involving about 15 man years of work in MOD.

11. Feed-back from the selective post-costing of, and scrutiny of the outcome of, individual contracts is extremely important. It helps in the pricing of follow-on orders, and more significantly it enables the MOD staff to improve their techniques and to form a judgment on the performance of particular contractors in the pricing process. It encourages a responsible attitude on the part of contractors in preparing their quotations. Any adjustment of prices is seen by the Ministry as a less important objective than securing the visibility on individual cases central to "equality of information" when negotiating the price of contracts. In fact to date out of 360 post-costing cases in which profits exceeded the target rate there have been only 64 cases in which the circumstances in which the outturn profit arose have necessitated refunds to MOD. In all but five instances (which were referred to the Board) the cases have been dealt with by direct negotiation. Refunds totalling some £2m have been secured.

12. Sir Robert Telford has argued that the right to post-cost individual contracts is the root cause of late pricing, which in turn blunts the incentive to increased efficiency. He argues that pricing is delayed because the negotiators are unwilling to be found by post-costing to have done a bad deal. He greatly oversimplifies. Early pricing will not guarantee improved efficiency; if it means slack pricing it would simply lead to enhanced profits. Late pricing also troubles the MOD and the Review Board. Only on one-third of contracts on which a risk rate of profit is paid has the price been agreed when one-quarter of the work has been completed, and half of contracts are unpriced when half the work is done. As a result the risk to the contractor is reduced, as is the scope and incentive to achieve greater efficiency, and thereby additional profit. But it is highly questionable (see Annex A) whether post-costing presents an obstacle

early pricing. Sir Robert Telford also criticises the bureaucratic cost of post-costing. He would substitute a check by MOD on the overall level of profit achieved by defence contractors on their MOD business revealed by their auditors in the financial accounts of the companies. This would tend to mask the reasons for (high or low) profit outturn, but we doubt whether it would do much to encourage efficiency.

13. Equality of information at the stage of negotiating the price of contracts would seem to be an essential safeguard for the taxpayer. The questions raised by Sir R Telford do not directly address this point, but are directed at how post-costing is dealt with. His proposal for a more general scrutiny of the profit achieved by each company or manufacturing unit would sacrifice transparency in the outturn of individual contracts and would therefore fail either to provide the essential input for equality of information, or to make for increased efficiency on the part of contractors. We would expect any review which had due regard to the interest of the taxpayer to confirm the essentials of the present system.

The scope of the review

14. We conclude that the present basis of comparability should be reviewed, for the reasons set out in paras 4-8 above. We would expect Government evidence to support the principle of comparability. It would also offer suggestions and perhaps proposals about how the rate of profit should be defined and calculated, having regard to the promotion of industrial efficiency and technical competence as well as administrative cost. We are not convinced that on merits post-costing needs to be reviewed now, but it is clear that Sir R Telford and those contractors who support him believe strongly that the present post-costing system should be changed. We conclude (as did Mr Pattie in his letter of 11 November to the Chief Secretary) that Sir Robert Telford's criticisms must be addressed, although we would expect the Government's evidence to emphasise that post-costing on broadly the present lines remains an essential safeguard for the taxpayer.

15. Although this report has discussed the profit rate and post-costing separately there are many strands which connect them, and the 1968 Agreement represented an integrated solution. The fact that industry has put forward two separate proposals (para 3 above) reflects the fragmented representation of industry, not a logical separation of ideas. We conclude that all the relevant issues should be considered within one review.

16. We consider that the review should be based on the terms of reference in Annex B.

Who should carry out the review

17. As the CBI are parties to the 1968 Agreement, they should be consulted on the terms of reference of any review, and if possible the terms of reference and the review body should be agreed with them.

18. We consider that the Review Board is the most appropriate body to carry out the review and should be approached first of all. The Board* comprises an independent chairman and two nominees representing the Government (Sir K Berrill and Mr Cass) and two representing the CBI. In other respects, too, it is well balanced; for example defence contractors might object to a body dominated by accountants, but there is only one on the Review Board. While the Board, and its secretariat have considerable experience of the subject, the Chairman (and one other member) has only just been appointed and comes to the subject uncommitted by previous recommendations of the Board. The review would require substantial resources and organisation, and the fact that Binder-Hamlyn are well established in support of the Board would be of considerable help.

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*Mr I H Davison, FCA, Managing Partner, Arthur Andersen & Co (Chairman)
Sir Kenneth Berrill, KCB, Chairman, Vickers da Costa
Mr E G Cass, CB, OBE, previously Deputy Secretary, MOD
Mr E Swainson, Managing Director, IMI Ltd
Mr J Dent, CBE, Director of Dunlop Holdings

19. We have considered alternatives to the Board, both on merits and in case the Board refused the task. No other suitable committee or board exists, and we do not consider that it would be sensible or desirable to create a second Review Board. We have therefore considered the names of individuals who might lead the review. Such an individual would have to be prepared to devote a substantial amount of time to the task, and be acceptable to the Government and the defence industries. He would have to be supported by consultants, preferably Binder-Hamlyn. Even so it would be bound to take such an individual substantially longer than the Review Board to complete the review, because of the time required to become familiar with a complex subject. There is also the question of the Review Board's next normal triennial review, on which it would, according to its normal timetable report in 1983, and collect evidence during 1982. The Board will not be able to start work seriously until the outcome of the review is known. If the Board carries out the review that triennial review will on many aspects emerge from it. If the major review was not carried out by the Board there could be difficulties and discontinuities in moving to the next triennial review.

Timing of the Review

20. The terms of reference are wide and a considerable amount of work will be involved, but it is important that the issues are resolved quickly. We recommend that the review should start as quickly as the arrangements can be made, and it should be the aim for the review to be completed within 6-9 months. The reviewing body should be asked to consider whether it would be appropriate to produce an interim report on certain aspects of the terms of reference.

Recommendation

21. We recommend:

(1) The review should be based on the terms of reference in Annex B.

(2) The Review Board should be asked to carry out the review. If for any reason it is not able to do so, a suitably qualified individual should be asked to head the review.

(3) The review should start as quickly as possible with the aim of achieving completion within 6-9 months.

NON-COMPETITIVE CONTRACTS - THE OBSTACLES TO EARLIER PRICING

If the full advantages of risk prices are to be achieved the prices need to be settled as early as possible in the course of the contract, since delay inevitably reduces the extent of, and the incentive to, effective control over costs. In recent years, however, the general pattern has been that, by value, only about half of the Ministry's non-competitive risk contracts are priced by the time that half of the work has been done. Even those figures represent a marked improvement on the position in the early 1970s. But it would be a misleading over-simplification to assume that the application of either greater effort or resolution could lead readily to the bulk of the Ministry's contracts being priced - on any responsible basis - significantly earlier than at present, or indeed that prices could be agreed at the outset of the work in any very much greater proportion of the contracts than is already the case.

2. No recent independent study has been undertaken of the reasons for delays in price fixing or of the obstacles to earlier pricing. Nor has any study yet attempted to define the stage in the progress of the contract by which it would be reasonable to expect that pricing on a basis of responsible risk taking should be achieved for the various categories of work (and degrees of complexity) that are covered within the ambit of the Ministry's non-competitive fixed price contracts. In the course of periodic examinations of the Ministry's pricing statistics, the Review Board for Government Contracts has made a general observation to the effect that it is hoped that the stage could be reached overall where the volume of contracts remaining unpriced by the time that half of the work has been completed could be reduced eventually to no more than one third of the total. That may well be a realistic goal to seek to attain on a consistent basis, taking one year with another. It is certainly a fairly ambitious objective given that much of the work undertaken by the Ministry is such that if pricing is to be undertaken on a risk basis at all, it needs to be accepted that in many cases the prices cannot reasonably be fixed at any very early stage in the work.

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3. In the absence of clear statements on what would be the appropriate stage at which to seek to fix prices for the various kinds of risk work, there tends to be no real focus to discussions about delays in price fixing and of reasons for late pricing.

APPROACH TO RISK PRICING

4. Both the Ministry and Industry agree that in general they should seek not only to increase the proportion of contracts priced on a risk basis but also to settle the prices as soon as can sensibly be achieved. However, as indicated above the fact that prices often cannot reasonably be settled at an early stage is not so much a reflection on the methods adopted for price fixing as of the type and complexity of the work. For example, only rarely are new development tasks defined well enough for fixed price treatment, at least in the early stages, although after project definition has been completed it may be possible to introduce some form of incentive in suitable cases. Initial production contracts are often placed long before development and trials programmes have been completed - and therefore before the production standard has been stabilised - and in those cases, too, the risk involved in premature price fixing could be excessive to both sides.

5. In short there are essential criteria to be met before prices negotiation can take place. These include:

(a) A clear specification which defines the Ministry's requirements and which states - in terms acceptable to both sides - precisely how achievement will be determined.

(b) A realistic estimate of costs - agreed between the two sides. An estimate studded with unsubstantiated contingencies is of little use for pricing purposes.

(c) Stability in the programme (i.e. assurance that there will be no radical changes to the specification

/of....

of the requirement or to the direction of the work during the course of the contract).

The data at (a) and (b) above and the assurance at (c) will often not be available in acceptably complete form until the contract is well under way. Failure or further delay in its provision means that the pricing becomes very late. In addition, there needs to be an assurance of the operation by the contractor of reliable cost estimating and accounting systems which give assurance that costs intended to be covered by an agreed price cannot flow into separate cost plus packets of the same or similar projects, thus involving double charges.

6. In the context of realistic cost estimates and price quotations (paragraph 5(b) above) the Ministry seeks to achieve an estimating accuracy for fixed price purposes of ± 10% or better (i.e. with the risk of possible over-run or under-run evenly balanced). A tolerance of ± 10% is about as accurate an estimating average as either the Ministry or the industry's negotiators and cost engineers can reasonably expect to attain for many of the types of complex equipment purchased. Even on that basis, however, an under-run of 6½% on estimated costs is enough to result in a profit rate higher than the Review Board "excess" profit reference point. One result of that is that in about 30% of those post costing cases which have shown profits in excess of the reference point, the accuracy of the estimate on which the price was based has been within the ± 10% range. Perhaps this suggests that the margin between the target profit rate for risk contracts (23% on capital) and the "excess" profit reference level (37½% on capital) needs to be widened if the existing margin - which at least in cost terms is rather narrow (6½% (or less) for firms with average (or higher than average) cost of production/capital employed ratios) - is not to act as an inhibitor to early price fixing.

7. Industry has suggested that because of the possibility that a contract might be selected for post costing Ministry officials tend to play safe (but not the contractors?) and

/to be...

to be unwilling to agree prices until in possession of factual evidence of the accuracy of the estimates. However the industry side has offered no evidence to support this sweeping assertion, which seeks of course to place most of the blame for the failure to achieve earlier pricing on the MOD and the 'system'. Statistics published by the Review Board in successive triennial reports clearly show, however, that pricing has tended to be earlier in recent years than was the case in the early 1970s before any experience of post costing became available. It could well be therefore that, to the extent - if any - to which post costing arguably might act as an inhibitor to earlier pricing, it is the narrowness of the margin between the target rate of return and the "trigger fiture", rather than the process of post costing itself, which is an obstacle.

[8. By way of a footnote to the comment about estimating accuracy it needs to be borne in mind that in cases where requirements and estimates are adequately defined (paragraph 5 above), but where, because of technical uncertainties, etc, the confidence in the estimate is necessarily less good than ± 10% - say perhaps as wide as ± 15%, or even ± 20% - it may nevertheless be possible to negotiate incentive terms even though the contract is unsuitable for fixed price treatment. The classic course in such cases would be a target cost arrangement (perhaps within a maximum price), where cost over-runs or under-runs would be shared by the two sides in agreed proportions and where therefore there would remain powerful incentives to efficiency but with less exposure to excessive or reckless risk for either side.]

9. The present broad brush approach of the profit formula which distinguishes only between a risk and a non-risk rate of profit, with no regard either for the complexity of the work or for the stage at which pricing takes place, requires, with one minor exception, that a decision be taken by the time that the contract is signed whether or not it is to be regarded as a risk contract. Strictly speaking, therefore, a contract categorised at the outset as a

/risk...

risk contract still attracts the risk rate of profit even if the contractor holds back from providing his quotation until all the work has been completed and the actual costs are known. This situation arguably could serve to encourage the more cautious contractors to delay negotiations in situations where uncertainties during the early stages of the work are judged to be such as to entail a risk of sustaining a loss. Any review of the obstacles to earlier pricing should consider this aspect. In 1977 the Review Board endorsed an arrangement whereby in cases of genuine doubt at the outset about the suitability of the work for risk pricing the contract would initially be placed on a non-risk basis with a specific statement of intention to introduce incentive pricing at an agreed stage of the contract for the whole of the work, but with express provision for the contract to run out at cost (with non-risk profit) should an incentive price not be agreed while a significant degree of risk remained. But in endorsing such ("hybrid") arrangements the Board cautioned against possible abuses and said that it would be wrong to apply the arrangements to "contracts in which the difficulty of classification was not truly exceptional and which would otherwise have been placed on a risk basis." It needs to be considered whether a more general application of the "hybrid" sort of approach within less rigid but nevertheless still carefully defined guidelines might help to remove such obstacles to earlier pricing as derive from the present requirement that contracts must be determined as risk or non-risk at the outset.

10. It needs to be borne in mind that in the context of Government non-competitive risk prices the abilities of the two parties to live with the consequences of an untoward outcome are assymetrical. Too great an incidence of unconscionably excessive profits, if it arose in circumstances which could not demonstrably be attributed to greatly improved efficiency, would involve serious embarrassment for the Government, regardless of the existence of adjustment mechanisms. Contractors, on the other hand, would be unable to sustain too great an incidence of losses, and if

/these....

these were to occur firms would soon be in serious difficulties and some would go bankrupt. Yet it would not be appropriate to contemplate as a matter of policy that prices should be fixed deliberately on any basis which incurred a greater probability of cost under-run (and hence of enhanced profit) than of over-run (and hence of reduced profit or even a loss). In that general context the PAC commented in paragraph 53 of its Third Report of Session 1980/81 that:

> "to attempt to settle a fixed price at an early stage of development of a complex defence project would be wildly expensive, as the contractor would be bound to insure against very high potential cost increases; and that even so it might well be impracticable to hold a contractor to the fixed price if costs nevertheless escalated even higher, possibly threatening actual bankruptcy".

11. Finally, in addition to the uncertainties inherent in cost estimating for complex items of defence equipment, other uncertainties in the industrial scene or doubts about general trends in the economy at large sometimes cause one side or the other to seek to delay the settlement of prices for particular contracts until it can be seen which way the various cats will jump. And, too, there are administrative delays on both sides (which can interact on one another). Delays by contractors in the submission of claims for settlement of overhead rates and CP/CE ratios and the failure to supply forward projections (or forward estimates of rates and ratios) are also frequently cited as holding factors in pricing activities. Agreements with individual contractors, as foreshadowed in the Working Guidelines for the Pricing of Non-Competitive Risk Contracts agreed between the Government and the JRBAC, and which provide for a more systematic approach to the pricing task (including in particular provision for regular pricing programming meetings) should help in time to reduce delays in the submission of overhead claims.

/CONCLUSIONS...

CONCLUSIONS

12. Any objective investigation of the obstacles to earlier price fixing of non-competitive risk contracts would need to take into consideration the following factors amongst others:-

(a) the need to define for various types and categories of contract what would be a "due" stage or date for pricing. Only cases where prices are fixed later than the "due" stage can reasonably be regarded as cases of delayed or late pricing. (The attempt to define for various categories of contract or work what would be the appropriate "due" stage for pricing might well lead in some cases to recommendations that certain types of work presently dealt with on a risk basis, but where in practice early pricing cannot be achieved, should be dealt with in future on a non-risk basis.)

(b) the essential prerequisites to the agreement of fixed prices on a reasoned and responsible basis (and their bearing on the findings or any recommendations in response to (a) above).

(c) the accuracy tolerance factors within which the Ministry seeks to work in the negotiation (i)of fixed prices on a risk basis and (ii) of other types of incentive arrangement (e.g. target cost incentive schemes); and its requirement that the pricing arrangements should be pitched at the level where the risks of under-run or over-run of the cost estimate on which the price is based are judged to be evenly balanced.

(d) whether in the context of the limitations on estimating accuracy ((c) above) the margin

/between...

between the target rate of return on risk contracts and the excess profit trigger point has become too narrow.

(e) whether the requirement to categorise a contract as a risk contract at the outset (thereby making it eligible for the risk rate of profit regardless of the stage at which a price is actually agreed) encourages delayed pricing in certain circumstances.

(f) whether any limitations in the manpower resources (either of numbers or experience levels) available to either side act as obstacles to early pricing.

(g) the extent to which changes in general circumstances in the economy or in the industrial outlook can act to encourage or discourage prompt pricing.

13. Because of the intricacies of the subject, a thorough review is likely to prove more constructive than one that is rushed.

TERMS OF REFERENCE

Having regard to the need to:

- remunerate non-competitive Government contracts on a basis which overall is fair to both taxpayer and contractor
- maximise the incentive to efficiency and encourage technical competence in the performance of Government non-competitive contracts
- minimise consistent with propriety the administrative cost of the arrangements for remunerating non-competitive Government contracts
- ensure appropriate long term security of supply of defence equipment, taking account of changing requirements and economic conditions;

to review the present application of the arrangements established under the 1968 Agreement, considering in particular

- the principle and practical application of comparability, including the extent to which the target rate of return of these contracts should reflect changes in economic factors and the rate of profitability of other sectors of British industry
- the appropriate definition of the rate of profit, including the balance between remunerating capital and cost
- the extent to which risk contracts should not only attract a higher rate of profit than non-risk contracts, but should differentiate if at all for varying degrees of risk
- the obstacles to earlier pricing of various kinds of contracts
- whether having regard to the purposes for which they were intended the post-costing arrangements should be modified;

to make recommendations.

RESTRICTED

Trade

Ref. A02267

PRIME MINISTER

Open-ended Contracts

(E(80) 45)

BACKGROUND

The background to this paper is set out in E(80) 45, which covers the more detailed paper prepared by the Cabinet Office in consultation with the Departments mainly concerned.

HANDLING

2. You might begin by inviting colleagues to focus on the four questions listed in paragraph 5 of my covering note - the first of which seeks specific endorsement of the conclusions in paragraph 12 of the note by officials. As the Treasury is in the lead on procurement policy you might invite the Chancellor of the Exchequer to open the discussion, and then work through the conclusions of the note by officials (paragraphs 12a.-d.) followed by the outstanding conclusions of the covering note (paragraphs 5.2-4).

3. The following main questions arise:-

(a) Should the present flexible arrangements continue?

Paragraphs 12a. and b. of the detailed paper conclude that, given the great variety of circumstances in Government contracts, Departments should continue to have discretion over the inclusion of break clauses in their contracts. This is likely to be endorsed. The main question then is the extent to which Ministers should delegate, both in their own Departments and in the nationalised industries for which they are responsible, discretion to approve any open-ended contracts.

(b) What should be the Departmental arrangements?

Paragraph 5.2 of my cover note raises the question of whether the present arrangements should be reinforced by a general instruction applying to all Departments that no open-ended contracts should be concluded without the

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express agreement of the Minister. The alternative - suggested in paragraph 12c. of the more detailed paper - is for each Departmental Minister to decide whether he needs to be consulted on any specific categories of contract and to approve the general arrangements applying to his own Department. In view of the very different kinds of Government contract Ministers may prefer to endorse the latter proposal. As it is, the keen interest traditionally shown by the Public Accounts Committee in Government contracts gives Departments a sharp incentive to exercise great care in this area.

(c) What should be the arrangements for the nationalised industries? If it were decided that Ministers should personally approve all open-ended contracts in their own Department it is for consideration whether a direction or instruction to similar effect should be given to nationalised industries. Departments doubt whether a formal direction could be given under existing statutory powers. Ministers may, in any event, prefer to leave such decisions to the commercial judgment of the management. If so, an alternative - 12d. of the more detailed paper - would be for each Minister to write to his Chairmen to give guidance and to follow this up with discussion. Either of these approaches could be reinforced by reminding the industries that their External Financing Limits would not be amended to take account of losses arising from open-ended contracts. If Ministers do decide to make an approach to the industries it would be better if the guidance took a common form and applied to all the industries, rather than leaving it to the discretion of individual sponsor Ministers. The Chancellor of the Exchequer might be invited to arrange for the Treasury to co-ordinate the preparation of a draft letter of guidance, or of formal instructions if that were the preferred course.

CONCLUSIONS

4. You will wish to record the conclusions on the following:-

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(i) Whether the Committee endorses the present degree of flexibility and discretion - paragraph 12a. and b.

(ii) Whether each Departmental Minister should determine the contractual arrangements, and degree of delegation, for his own Department <u>or</u> whether it should be the general rule that no open-ended contracts should be concluded without the express agreement of a Minister.

(iii) Whether for the nationalised industries:

(a) the arrangements should be left to the commercial judgment of the management, as now, with perhaps some informal advice from Ministers on the importance of this issue; <u>or</u>

(b) this approach should be reinforced by a letter of guidance to each Chairman; <u>or</u>

(c) whether there should be instructions to each industry that no open-ended contracts should be concluded without the express agreement of the sponsoring Minister; <u>and</u>

(d) whether (b) or (c) should be reinforced by advising the industries that losses arising from open-ended contracts concluded without Ministerial agreement would not be taken into account in determining their External Financing Limits.

5. If guidance or instructions are to be given to the nationalised industries you might invite the Chancellor of the Exchequer to arrange for the Treasury to co-ordinate the preparation of a letter, or instructions.

RTA

ROBERT ARMSTRONG

<u>3rd June, 1980</u>

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Trade

SIR ROBERT ARMSTRONG

Open-Ended Contracts

The Prime Minister has now read your minute of 7 May on the above subject (ref. A02108). She is content for you to circulate the note attached to your minute of 2 May to E Committee with a view to discussion. But this is subject to the following point.

She would like the note to consider the possibility that nationalised industries should be warned that any losses arising from open-ended contracts will not be taken into account in fixing EFL's.

T. P. LANKESTER

14 May 1980

PRIME MINISTER

Your query on Open-Ended Contracts.

I have asked the Treasury whether they can warn nationalised industries that any losses arising from open-ended contracts will not be taken into account in fixing EFL's. They say - "yes in principle". But they are not sure how this would be implemented in practice. Presumably, nationalised industries would have to notify their sponsoring departments of every open-ended contract they enter into, and these would then be individually monitored. Some Ministers may argue that this would involve too much detailed intervention, and that subject to meeting their rate of return targets, it is better left to individual industries to decide on the costs/benefits of such contracts.

I suggest this particular point should be discussed in E: there is no immediate urgency since we are several months off deciding on the EFL's for next year.

If you agree, I will ensure that the point is covered in the paper to E.

Agreed MT

R.

12 May 1980

Prime Minister

You said you disagreed with the line proposed by Robert Armstrong on this. Since it is a matter which affects a number of Departments, I think it is right to have a discussion in E - as proposed in para 4 below. Agree? TL 8/5

1

Ref. A02106

MR. LANKESTER

Open-Ended Contracts

Thank you for your minute of 6th May.

2. I note that the Prime Minister does not agree with the conclusion that we should not try to lay down additional detailed guidance from the centre, and would like to see Departments and nationalised industries instructed not to sign any open-ended contracts with no provision for termination, save with Ministerial agreement.

3. In the case of nationalised industries such an instruction would constitute an unprecedented degree of Government intervention in the commercial responsibilities of the industries, and I think that we should have to consider whether strengthened guidance should take some rather different form. I do not think that we can really take this matter further without collective Ministerial discussion, at which Ministers in charge of large contracting Departments and Departments responsible for nationalised industries are present. This was originally raised in OD, but I think that, on the point of principle now in question, E would be a more appropriate Committee.

4. I propose therefore to make the note attached to my minute of 2nd May a note by officials, and circulate it to E under cover of a note by the Secretary of the Cabinet, indicating that the Prime Minister considers that the matter should be discussed by Ministers, with a view to deciding whether more positive guidance or instruction is required.

RA

(Robert Armstrong)

7th May, 1980

Before doing so please enquire from the Treasury whether they can warn N.I.s that any losses or charges arising from open-ended contracts will not be taken into account in fixing E.F.L.'s. [illegible]

vb

Lord PS

SIR ROBERT ARMSTRONG

Open-ended Contracts

The Prime Minister has considered your minute of 2 May (ref. A02084) on the above subject. She has asked me to say that she does not agree with your conclusion that we should not try to "lay down additional detailed guidance from the centre". Her view is that Departments and nationalised industries should be instructed that they should not sign any open-ended contracts with no provision for termination, and that exceptions should be cleared with Ministers.

TPL

6 May 1980

RESTRICTED

Ref. A02084

PRIME MINISTER

Open-Ended Contracts

On 21st February, following the invasion of Afghanistan, OD accepted a recommendation by the Secretary of State for Energy that a contract by the CEGB for the supply of enriched uranium from the Soviet Union should be allowed to continue. They agreed that to do otherwise would have involved substantial extra costs in obtaining the supplies from elsewhere (OD(80) 5th Meeting, Minute 3, conclusion 2).

2. The Committee instructed me, however, to consider how guidance should be given to Government Departments and nationalised industries about the undesirability of entering into open-ended contracts with no provision for termination. I attach a fuller note which has been prepared in consultation with the Departments mainly concerned. As far as Government Departments are concerned, it appears that standard break clauses are commonly used, though practice varies to some extent, depending on the circumstances of the contract in question. In the case of nationalised industries, it seems that the practice varies, but that the use of break or termination clauses is less common. This is the sort of issue which Governments have usually left to the commercial judgment of each industry. One very relevant point is that to impose a break clause in cases where this does not exist at present could often involve additional costs to the public authority concerned, to pay for the benefits it would get. It follows that a decision whether to introduce such a clause is not always clear cut, and has to be considered case by case.

3. In the light of this, I advise against any general decision to lay down additional detailed guidance from the centre. I recommend, however, that individual Ministers should consider whether they wish to review further the practice in their own Departments, and whether to offer any informal guidance to their nationalised industries, and whether to bring up the special problem of international contracts at the next convenient meeting with the chairmen of the nationalised industries they sponsor.

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4. If you are content with this, I will send copies of my note to all members of the Cabinet and the Minister of Transport, with an indication that you have seen it and are content with its recommendations, subject to any comments or suggestions they may have.

RGA

(Robert Armstrong)

2nd May, 1980

Open-Ended Contracts

Note by the Secretary of the Cabinet

1. On 21 February, when Ministers discussed possible sanctions against the Soviet Union following the invasion of Afghanistan (OD(80) 5th Meeting, Minute 3, conclusion 2) they considered a contract placed by the Central Electricity Generating Board (CEGB) for the provision of enriched uranium for British nuclear power stations. Although Ministers agreed that the contract should be allowed to continue, they were unhappy about the open-ended nature of this contract, which made it difficult to discontinue it, even in the circumstances of the Afghanistan invasion. I was instructed 'to consider how guidance should be given to Departments and nationalised industries about the undesirability of entering into open-ended contracts with no provision for termination'.

2. All the main purchasing and sponsor Departments and the Treasury have been consulted. The Treasury is in the lead on procurement policy.

3. The CEGB contract was described in OD(80) 12, which was before Ministers in February. The main reason for entering into the contract, apart from diversifying the sources of enriched uranium, was that the Soviet Union offered the cheapest supply. Other countries, including West Germany, have similar contracts which are being continued. The CEGB's contract is not totally open-ended: it is for a period of ten years. It did not include a break clause, because in their view their interests were adequately protected by the contract's force majeure clause. Moreover the inclusion of such a clause could have increased the risk to the security of their uranium supplies from the Soviet Union, since the latter might then have insisted that the break clause should be reciprocal. It is perhaps fair to say that this was a particular and rather special kind of international contract which gave rise to particular problems; but there are of course other such contracts which could in certain circumstances give rise to similar problems.

4. What seems to be at issue in this instance is a contract with no provision for unilateral termination by the United Kingdom public authority concerned. The Ministerial instruction has been interpreted as relating to contracts of this kind.

GOVERNMENT DEPARTMENTS

5. The Standard Conditions of Government Contracts for Stores Purchases (GC/Stores/1) contain a break clause (S C 56) for use in supplies contracts other than those of minor value or relatively brief duration where its inclusion is unnecessary. Similar powers of termination are included in works contracts, viz Condition 44 of the General Conditions of Government Contracts for Building and Civil Engineering Works (CG/Works/1). The use of these standard conditions is not mandatory. Each contracting Department must decide, and be prepared to defend, the precise terms which it incorporates in any contract. Departmental Accounting Officers are open to examination by the Public Accounts Committee in the event of something going wrong.

6. A copy of SC 56 is annexed. It will be seen that termination is at some cost to the Government as it necessarily provides for at least some compensation to be payable to the contractor. Each case must be considered on its merits; there are situations in which it would be inappropriate to include break clauses. The most obvious arises from the fact that it takes two to make a contract: if the other party will not accept such a provision, and there is no alternative source of supply, the Government has no option. Should the Government insist on a break clause in contracts where such a clause is not normally used, the contractor may seek to insure himself against premature termination by increasing his price.

7. Departmental practice varies, as does the nature of contracts placed. Most contain the relevant standard condition. Civil engineering and related contracts, for example roads, usually follow the standard commercial forms, which do not have break clauses because the contract is for specified work. Some other Departments, such as HMSO, have special arrangements appropriate to the type of contract placed by them. The Central Computer and Telecommunications Agency makes little use of a break clause because the nature of the business, often the acquisition of standard proprietary equipment, makes it unnecessary. Northern Ireland Departments in general do not use break clauses because their contracts are for specified periods or quantities.

Scottish Departments use a simplified version in many cases. All Departments are fully aware of the need to avoid any risk to public money through inadequate contracting provisions. There is a long history of scrutiny and comment by the Public Accounts Committee on Government contract procedures and conditions.

8. International collaborative procurement is a special case, and invariably calls for Ministerial consideration. When making such arrangements MOD customarily makes provision to enable withdrawal for reasons of national convenience (as do the other parties).

NATIONALISED INDUSTRIES

9. We do not have full information about the practice of nationalised industries, but it is clear that practice varies. For example, the Departments of Trade and Industry have reported that break clauses are unlikely to be included as a general rule by the nationalised industries they sponsor. The British Steel Corporation does not have a break clause in its conditions of sale, although there is provision for termination on the buyer's default or insolvency; nor (normally) do British Airways in their aircraft orders, the Civil Aviation Authority or the British Airports Authority. The nationalised transport industries normally require break clauses for longer contracts or have special arrangements for examining those with unusual features. The nationalised energy industries do not generally include break clauses, though the National Coal Board includes a break clause in its standard conditions for mining works and the CEGB has, rarely, included break clauses in contracts under pressure from contractors for a review mechanism covering circumstances of severe hardship. The British Gas Corporation can be expected to include a break clause in any future contract for imported liquefied natural gas, if the seller reserves the right to periodic price review. A standard condition in the British National Oil Corporation's sale contracts is that they are interruptible at the Secretary of State's direction.

10. Departments do not think that it would be right to issue a general direction (which has legal force) to a nationalised industry, and doubt indeed whether their existing statutory powers would permit this. There would be less difficulty about giving informal guidance to the industries, whether through

a Ministerial letter or in some less formal manner at a meeting with the Chairman. In giving such guidance, the Government will have to be careful not to contradict its own policy of non-interference in management decisions. The use of unilateral rights to terminate a contract, other than for reasons of the other party's default or insolvency, is rare in commercial practice. In many cases the break clause would have to be reciprocal, which might well be disadvantageous. There are of course special considerations applying to some Government contracts, particularly in the defence field, which justify the special powers but it is questionable whether such considerations necessarily apply to public sector contracts generally. Indeed, to include such powers in every public sector contract could, as mentioned above, lead to contractors including additional provision in their prices against what would, in a very large part of public contracting, be regarded as a new and unquantified risk. If Ministers still feel, having considered this report, that some guidance should be given, that guidance could take the form of a letter from the appropriate Minister to each of the Chairmen seeking an assurance that his contractual procedures contain adequate safeguards, including arrangements to ensure that consideration is given to incorporating on contracts, where appropriate, provision for break or termination by the nationalised industry concerned.

LOCAL AUTHORITIES AND THE NATIONAL HEALTH SERVICE AUTHORITIES

11. We have not inquired closely into the contracting practices of local authorities. In general, it appears that local authorities do not include break clauses, except on contractor's default. Most of the National Health Service Authorities' purchases of goods are made under so-called running contracts which effectively provide an opportunity for discontinuance with the completion of each order placed. The Authorities are thought likely to include provisions for mutual termination by notice in their contracts for services.

RECOMMENDATIONS

12. As a result of the enquiries that have been made, I make the following recommendations:-

(a) It will not always be appropriate to include break clauses in Government contracts, and there should not be an invariable rule requiring their use in all contracts.

(b) Existing practice, which allows for the inclusion of break clauses at the discretion of Departments, should continue.

(c) It is for each departmental Minister to consider whether there are specific categories of contracts entered into by his Department on which he needs to be consulted, and to approve whatever contractual arrangements best suit his own departmental activities.

(d) No statutory 'general direction' should be given to the nationalised industries, but each Minister responsible for a nationalised industry should consider whether to give guidance to the Chairman by letter in the form suggested at the end of paragraph 10 above, and should take the opportunity to mention the problem, and explain the special circumstances of international contracts, at his next convenient meeting with the Chairman.

56. Break.—(1) The Authority shall in addition to his power under any other of these Conditions, have power to determine the Contract at any time by giving to the Contractor written notice, to expire at the end of such period as may be specified in the Contract as the appropriate period for a notice to determine the Contract under this Condition or, if no period be specified, at the end of two weeks, and upon the expiration of the notice the Contract shall be determined without prejudice to the rights of the parties accrued to the date of determination but subject to the operation of the following provisions of this Condition.

(2) In the event of such notice being given the Authority shall at any time before the expiration of the notice be entitled to exercise and shall as soon as may be reasonably practicable within that period exercise such of the following powers as he considers expedient:—

(*a*) to direct the Contractor, where production has not been commenced, to refrain from commencing production;

(*b*) to direct the Contractor to complete in accordance with the Contract all or any of the Articles, or any part or component thereof in course of manufacture at the expiration of the notice and to deliver the same at such time or times as may be mutually agreed on, or, in default of agreement, at the time or times provided by the Contract. All Articles delivered by the Contractor in accordance with such directions and accepted shall be paid for at a fair and reasonable price;

(*c*) to direct that the Contractor shall as soon as may be reasonably practicable after the receipt of such notice:—

(i) take such steps as will ensure that the production rate of the Articles and parts and components thereof is reduced as rapidly as possible;

(ii) as far as possible consistent with sub-paragraph (i) of this paragraph concentrate work on the completion of parts and components already in a partly manufactured state;

(iii) determine on the best possible terms such sub-contracts and orders for materials and parts and components bought out in a partly manufactured or wholly manufactured state as have not been completed, observing in this connection any direction given under paragraph (*b*) and sub-paragraphs (i) and (ii) of this paragraph as far as may be possible.

(3) In the event of such notice being given:—

(*a*) the Authority shall take over from the Contractor at a fair and reasonable price all unused and undamaged materials, bought-out parts and components and articles in course of manufacture in the possession of the Contractor at the expiration of the notice and properly provided by or supplied to the Contractor for the performance of the Contract except such materials, bought-out parts and components and articles in course of manufacture as the Contractor shall, with the concurrence of the Authority, elect to retain;

(*b*) the Contractor shall prepare and deliver to the Authority within an agreed period, or in default of agreement within such period as the Authority may specify, a list of all such unused and undamaged materials, bought-out parts and components and articles in course of manufacture liable to be taken over by or previously belonging to the Authority and shall deliver such materials and things in accordance with the directions of the Authority who shall pay to the Contractor fair and reasonable handling and delivery charges incurred in complying with such directions;

(*c*) the Authority shall indemnify the Contractor against any commitments, liabilities or expenditure which are reasonably and properly chargeable by the Contractor in connection with the Contract to the extent to which the said commitments, liabilities or expenditure would otherwise represent an unavoidable loss by the Contractor by reason of the determination of the Contract:

Provided that in the event of the Contractor not having observed any direction given to him under Clause (2) of this Condition the Authority shall not under this Clause pay any sums in excess of those which the Authority would have paid had the Contractor observed that direction.

(4) If in any particular case hardship to the Contractor should arise from the operation of this Condition it shall be open to the Contractor to refer

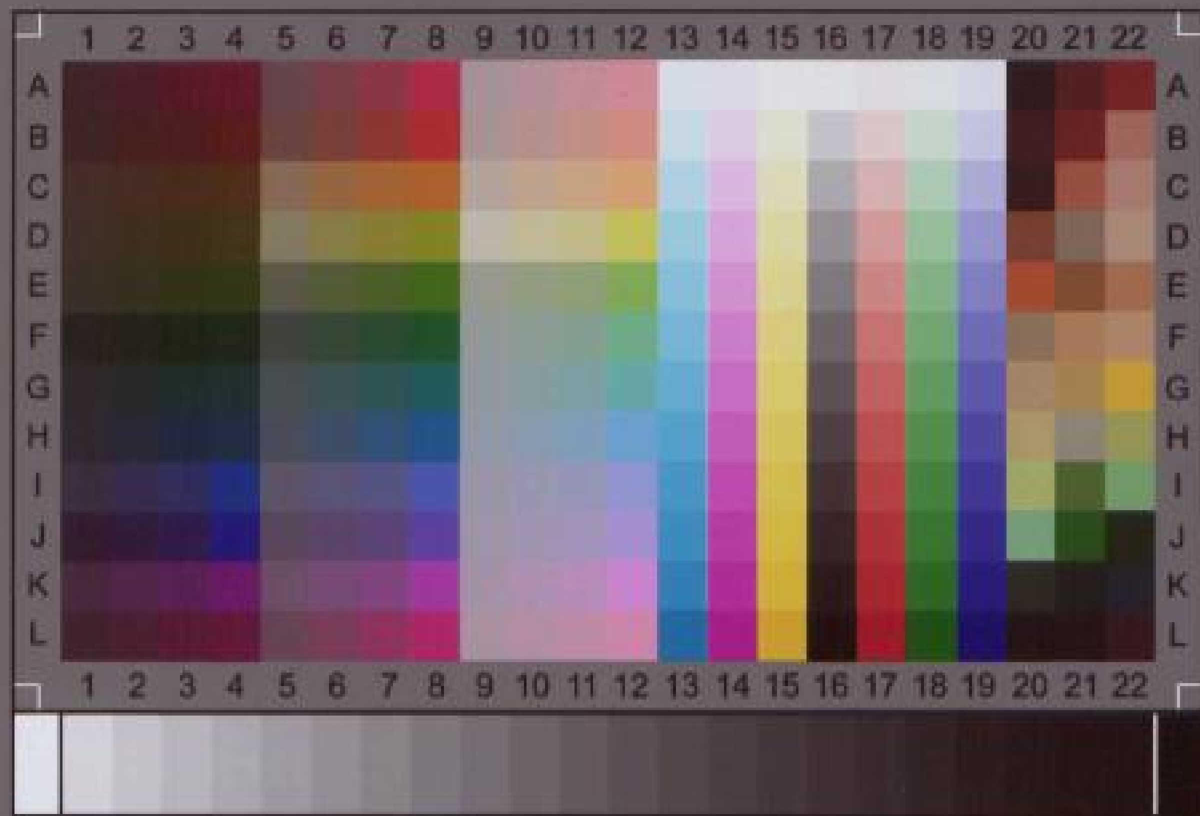
the circumstances to the Authority who, on being satisfied that such hardship exists shall make such allowance, if any, as in his opinion is reasonable and the decision of the Authority on any matter or thing arising out of this Clause shall be final and conclusive.

(5) The Authority shall not in any case be liable to pay under the provisions of the Condition any sum which, when taken together with any sums paid or due or becoming due to the Contractor under the Contract, shall exceed the total price of the Articles payable under the Contract.

(6) The Contractor shall in any sub-contract or order the value of which is £10,000 or over made or placed by him with any one sub-contractor or supplier in connection with or for the purpose of the Contract take power to determine such sub-contract or order in the event of the determination of the Contract by the Authority under this Condition upon the terms of Clauses (1) to (5) of this Condition save only that:—

(*a*) the name of the Contractor shall be substituted for the Authority throughout except in Clause (3) paragraph (*a*) where it last occurs and in Clause (4); and

(*b*) the period of the notice of determination shall be such period as may be specified in the Contract as the appropriate period for a notice to determine a sub-contract or order under this Condition, or, if no period be specified, two weeks.



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