



Federation of Small Businesses
The UK's Leading Business Organisation



The Global Defence and Security Industry – Why Small Businesses Matter

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Contents

About the authors	2
Introduction	3
Why small businesses are important to the MoD and the wider defence and security industry	5
The role of government and in particular the MoD	8
Spare parts and the definition of what is 'genuine'	20
Exporting	23
An effective voice for small businesses	26
Conclusion	29
Benefits of joining the FSB	30

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Introduction

The Federation of Small Businesses (FSB) is the UK's leading business organisation. It exists to protect and promote the interests of the self-employed and all those who run their own business. The FSB is non-party political, and with over 200,000 members, it is also the largest organisation representing small businesses in the UK.

Small and medium-sized enterprises (SMEs) make up 99.8 per cent of all businesses in the UK, and make a huge contribution to the UK economy. They contribute 51 per cent of the GDP and employ 67 per cent of the private sector workforce.¹

The FSB takes an active interest in the defence and security industry because there are over 9,000 SMEs operating in this sector. The UK defence industry alone has more SMEs than the French, German, Italian, Spanish and Norwegian industries combined². The FSB takes an interest in the defence and security industry not just because it is vital to the success of the UK economy, but also because it is obvious that SMEs are not being given the same access to procurement opportunities as the primes³; if they were, 90 per cent of all defence exports would not be won by just the 20 largest UK companies⁴.

The UK's defence and security industry has a wide ranging portfolio from aircraft, warships and armoured fighting vehicles, through communications, radars, propulsion, munitions and support services, to basic equipment such as clothing and on to financial and support activities. Increasingly, UK companies are taking this defence industry expertise into equipment for humanitarian relief, counter-terrorism and peace-keeping activities. And since the terrorist attacks of 11 September 2001, the UK's world expertise in counter-terrorism has come to the fore.

While the fundamental role of the defence and security industry is to supply our own armed forces, exports are vital for its survival. Yet so much of the UK's overseas success is achieved by so few⁵.

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- 1 www.ec.europa.eu/enterprise/policies/sme/files/sme_definition/sme_user_guide_en.pdf
- 2 www.adsgroup.org.uk/images/stories/pdfs/ads-info-leaflet.pdf
- 3 Large defence companies such as BAE Systems
- 4 UKTI
- 5 According to UKTI approximately 90 per cent of defence exports are won by the 20 largest UK companies

Presently the UK is slowly emerging from the greatest financial crisis in living memory; the MoD has been forced to make overall savings in response to spending cuts of eight percent in real terms by 2014-15;⁶ the MoD is currently engaged in implementing the first strategic Defence and Security Review (SDSR) since 1998 – the most significant reform in a generation; and UK armed forces are still heavily committed in Afghanistan. In this context the MoD faces a prolonged period both of rapid change as well as high operational tempo and low priority for additional funding.

This report will set out the vital importance of small businesses to the UK and global defence and security industry. Through the direct experiences of FSB members operating in this industry, this report will detail the specific problems faced by small businesses in this industry. As an organisation, we believe those problems to be:

- The role of government and in particular the MoD
- The definition of 'genuine' parts
- Exporting
- Lack of an effective voice for small businesses.

The last point is of particular relevance, that without an effective voice the FSB is firmly of the opinion that the very real problems currently facing small businesses operating in this sector will only continue.

At no point in this report does the FSB wish to suggest that primes operating in the defence and security sector do a bad job, nor does the FSB wish to suggest that small businesses can provide all the solutions to the Government's defence and security procurement needs. It is important to stress that the FSB wishes to engage with the MoD and others in a spirit of cooperation, because on this issue the FSB is convinced that the interests of the MoD and small businesses are at one. This report will therefore set out a series of detailed recommendations that the MoD and others can take forward.

⁶ http://cdn.hm-treasury.gov.uk/sr2010_chapter2.pdf

Why small businesses are important to the MoD and the wider defence and security industry

The Defence Industrial Strategy (DIS)⁷ outlines the role of SMEs as follows, *“SMEs and supply chain companies are equally valued for their contributions, often characterised by agility, flexibility and innovation. These are exactly the qualities that the MoD requires in order to respond to rapidly changing military needs and to maximise value for money.”*⁸ The Coalition Government has set out their views in a recently published Green paper entitled, *Equipment, Support, and Technology for UK Defence and Security: A Consultation Paper*, in which they state, *“We believe small businesses are often more flexible and responsive, offering imaginative solutions to defence and security requirements.”* There is, however, a belief among small businesses that the MoD either does not recognise or understand the small business community – despite rhetoric to the contrary.

It may be tempting for the MoD to ask, *“Do we need SMEs?”* But as Chris Trout from BMT Defence Services points out – small businesses are important. *“It may be tempting to think that SMEs are not necessary and that the major prime contractors have all the capabilities they need to meet the defence requirement. There are many SMEs who fear this scenario and a small number who have been treated roughly by their primes. However, the truth is, and the major prime contractors would agree, that such a vertically integrated world would deliver inefficiency, risk aversion and poor responsiveness, all to the detriment of military capability. The major primes are aware of their dependence on a thriving SME base and recognise the need to nurture it for their own best interests as well as those of the nation.”*⁹

Not only are small businesses an integral part of the defence and security supply chain but they have consistently proven more flexible, responsive

- 7 www.mod.uk/DefenceInternet/DefenceFor/Business/DefenceIndustrialStrategy
- 8 *SMEs: How To Grow Your Business With The MoD 2009* eBook
- 9 *Operational Sovereignty and the Role of SMEs* by Chris Trout, RUSI Defence Systems, October 2008

and innovative than the more ponderous, cumbersome and process-driven primes. As Rear Admiral Sir Robin Walmsley recently stated, *“Primes are like very large crude carriers. In contrast, SMEs are speedboats and must exploit their superior manoeuvrability and agility.”*¹⁰

Small businesses are also important to the economic prosperity of the UK as a whole. The UK is the second largest defence exporter in the world, an achievement due in no small measure to the creative spirit of its small businesses. These businesses are often a source of deep expertise, particularly in areas of high technology and where there is a need to adapt commercial technologies for military applications. As Chris Trout demonstrates, *“The intellectual – or research-based SME will help overcome a range of obstacles and potentially deliver that all-important technological edge. The design house will so often be the source of innovation when the design department of the major prime will stay with the tried-and-tested low-risk approach.”*¹¹ Centres of technical excellence deserve to be nurtured and incubated. Small businesses provide the fertile ground in which the ideas that will sustain the UK’s competitive position in the future world will germinate. It is important to note that small businesses also support jobs both directly and indirectly. Because they are small, they must buy in expertise and materials to produce their product.

Finally, small businesses are important when it comes to public sector procurement. The Government aims to deliver world-class public services that the UK public demands, and it sees procurement as a key route through which to deliver reform. The role that these businesses can play in the delivery of goods and services to the MoD and others is recognised as follows:

- **Better value for money** – Increased competition among suppliers pushes down procurement costs and small businesses’ lower overheads can also result in lower prices.
- **Better quality of service** – Shorter management chains and focus on specific markets and customers can mean greater flexibility and a more tailored, personal level of service.
- **Innovation** – Small businesses can often respond more quickly to changes in technology and/or develop new products to differentiate themselves from bigger market players.
- **Responsiveness** – It is recognised, even at Secretary of State level¹², that Defence Acquisition is plagued with programme slippage. Small businesses are well placed to deliver rapid commercial propositions.

It is important to remember at this point that not all small businesses are dedicated defence specialists. The FSB has a number of these businesses among its membership. One such member runs a chain of motor factors with bases in South West England and Wales. Their core business is the supply of automotive parts and accessories to trade, retail, public sector and corporate clients, including multi-nationals and NGOs. It just so happens that the spare parts our member sells are also used in military vehicles.

10 UKTI DSO Small Business Forum 3 November 2009

11 *Operational Sovereignty and the Role of SMEs* by Chris Trout, RUSI Defence Systems, October 2008

12 Rt. Hon Dr. Liam Fox MP, Secretary of State for Defence, giving oral evidence to the House of Commons Defence Select Committee, Wednesday 21 July 2010

Businesses whose core work is not defence related, but who could supply the MoD, primes, or engage in defence related exporting, face their own specific problems. They lack information on business and clustering/partnering opportunities and they experience difficulties in making primary defence companies and government aware of their products and services.

The role of government and in particular the MoD

The defence and security market's uniqueness relates to a number of issues: technological level, programme cycle, security of supply, market regulation and industry's relationship with government. The Government dominates the sector through a variety of roles such as regulator, owner, controlling shareholder, funder of research and development (R&D), and as principal customer. Therefore, the Government's attention should be directed to all stakeholders, not only the primes but also to small businesses, which possess the technology and the skills, but lack some of the resources necessary to penetrate the market.

In the current economic climate it is vital that the Government uses all its resources in the most efficient and effective manner to encourage and sustain growth within the UK's small business community. The Government therefore has a vital role to play in facilitating small businesses access to this crucial market.

Research carried out for the FSB¹³ demonstrates that:

- Nearly three quarters of small businesses rarely or never bid for government work.
- Over three quarters of small businesses believe that there are barriers to awareness of government opportunities.
- Over half of small businesses feel that the process of tendering for government contracts requires more time and resource than their business can allow or afford.
- Over half of small businesses expect the proportion of their revenue coming from the private sector to increase in the next two years – but only one in five small businesses expect their revenue from the public sector to increase within the same time period.
- On average, small businesses find the private sector easier to sell to than the public sector – their rate of success in winning private sector contracts is double their rate of success in winning public sector contracts.

13 *Evaluating SME experiences of Government Procurement*, Freshminds Research, October 2008

- Nearly three quarters of small businesses feel that the public sector is more difficult to deliver work to than the private sector, due to a greater amount of formality, a lack of responsiveness or understanding, unrealistic timescales and a belief that many small businesses are just going through the motions when applying for work, knowing they have no opportunity of success.

Whilst the recognised benefits of small businesses (value for money, innovation, quality of service) align well with what the Government sees as important goals within public procurement, most parties agree that there is some distance to travel before these benefits can be fully realised. Some small businesses perceive the barriers in tendering for public procurement contracts to be considerable. However, the benefits that these businesses have to offer in terms of procurement effectiveness together with public and private productivity mean that action should be taken to surmount these barriers.

The current public procurement process places small businesses at a disadvantage

The process of tendering for public contracts can be daunting for small businesses. It can be problematic for these businesses in a number of ways. Small businesses perceive the process as long and complex and can become discouraged from bidding. The cost of this long tendering may be prohibitive. Or, alternatively, small businesses with limited resources might actually find the timescales too tight and struggle to 'keep up' with larger companies. Those new to the public sector market may also have difficulty understanding what is required of them and may not have the skills to construct good quality proposals.

The MoD does not set a good example

Primes often fail to formally recognise the crucial role small businesses play; many do not provide necessary support to SMEs. While the primes could and should do more, the MoD should demonstrate leadership in this area. The MoD should look at what the United States of America's (USA) Department of Defence (DoD) does under their 'Mentor Protégé Programme'¹⁴. This programme provides incentives for DoD tier one contractors to assist small businesses in enhancing their capabilities and increasing the participation of such businesses in government contracts.

Increasing contract sizes reduces opportunities for small businesses

Following the Gershon Review¹⁵, streamlining of procurement procedures in a bid for efficiency has caused contract sizes to become larger. Again, this is problematic for small businesses for a number of reasons. Not only

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14 www.acq.osd.mil/osbp/mentor_protege/

15 www.webarchive.nationalarchives.gov.uk/http://www.hm-treasury.gov.uk/d/efficiency_review120704.pdf

might the size of a contract outstrip the capacity of a small business, the fact that it is above threshold means there is also a larger number of potential competitors, due to advertising. Increasing the size might also carry increases in length, which, if not won by small businesses decreases their future opportunities. This situation is being exacerbated by the current squeeze on the Defence Equipment Programme. In an attempt to maintain profit margins primes are migrating into other areas of defence business that they have hitherto ignored i.e. BAE Systems moving into logistic support.

The current Land Rover contract is priced at £50 million. This is beyond the reach of almost all small businesses. There is however a solution. West Yorkshire Ambulance Service is currently running a competitive tender for most of the ambulance services in the UK. As a single priced contract small businesses would be priced out, but, West Yorkshire Ambulance is breaking the contract into lots, thus making it accessible to these businesses.

Making subcontracting opportunities more visible and ensuring equal terms for subcontractors

In the defence market, subcontracting is often the most important part of a small businesses workload as they can sometimes lack both the economies of scale and scope to develop complete systems. It is therefore crucial to promote transparency and fair competition at the contract and subcontract level.

Risk-averse culture in the civil service

As acknowledged by the now extinct Better Regulation Commission¹⁶, public sector buyers often adopt a 'risk averse attitude'. This means not only will they opt for a bigger name that they have 'heard of' but that there is overreliance on paperwork and an inflexible application of the guidelines disadvantages small businesses.

Greater private sector experience is needed

The MoD is well resourced, in terms of total head-count¹⁷, but relatively few MoD staff have any private sector experience. This shortage of commercial and project management skills has three negative effects: those MoD managers who do have honed commercial skills are often overloaded; programmes are often delayed due to lack of adequately qualified management resource; relatively junior civil servants often find themselves running projects for which they lack the requisite knowledge and skills, resulting in poor decisions and increased costs.

¹⁶ *Government Procurement and Barriers to Small Suppliers*, Better Regulation Commission, 2007

¹⁷ There are 20,000 procurement personnel employed by the MoD: www.channel4.com/programmes/dispatches/articles/how-the-mod-wastes-our-billions-related-links

This can have significant cost impacts for a small business where scarce management and financial resources are committed to projects that are then cancelled, delayed, or awarded without a rigorous tender evaluation process. In one instance, that the FSB is aware of, an Urgent Operational Requirements (UOR) was awarded to a prime without competing tenders even being read. The FSB member involved in this bid had spent £50,000 in expenses preparing their bid only for it not to be read.

Poor MoD procurement practices end up costing the taxpayer more

The FSB has a member that provides MoD organisations with Information Assurance (Information Security) services in support of both procurement exercises and in-service systems support. These services revolve mainly around providing technical security architecture advice, per government guidance from CESG¹⁸/GCHQ¹⁹, and drafting of security policy documentation, again to government standards, policed via the CESG Listed Advisor Scheme (CLAS), itself administered by CESG, the UK National Technical Authority for Information Assurance.

To date, this FSB member has provided those services via an extensive supply chain of up to four or five commercial entities by virtue of MoD's framework agreement mechanisms which precludes small businesses bidding for work directly. This is a very costly way to procure this member's services. Given the current financial circumstances and the MoD's need to cut its budget, is it not time for the MoD to rethink its procurement process in this area?

By delivering Information Assurance services to the MoD via this extended delivery chain, headed-up by 'household names' in consultancy, this FSB member has gained repeat work, often via different supply chains to the one which he initially contracted-through, by virtue of delivering a high standard of service and earning the trust of both MoD procurement managers and Information Assurance practitioners. This FSB member concludes that the only people who seem to benefit from the current MoD procurement model are the 'household named' consultancy companies. This points to the underlying reason which is laziness on the part of the MoD. Once they have got assurance for a 'consultancy' then rather than qualify a new and appropriate company they create a club of preferred suppliers of consultancy services who then become beholden to them for work. This leads to a dependency culture.

Rather than being able to bid for a specific opportunity (where the small business might have highly relevant experience/skills), the framework agreement requires a small business to bid for general

18 www.cesg.gov.uk/

19 www.gchq.gov.uk/

access to the market. This broad range might be out of the expertise or geographical capability of the business. The FSB is concerned that the current financial crisis and the pressure to reduce costs will mean that procurement teams will be understaffed and under resourced. They will be forced to reduce the number of frameworks available with the net result that each framework will be larger in scope, value and complexity. Only the largest primes will have the necessary manpower to fulfil such massive projects – and even they will struggle to find the requisite skills. Small businesses will no longer be able to compete on their own – and any partnerships between such businesses will be likely to fail as their people will not have had experience with such size and complexity previously.

On a wider point, framework agreements confound small businesses, particularly where they act as ‘preferred supplier lists’ (FATS²⁰ framework agreement²¹ is an example of this). A lack of resource within the MoD prevents these frameworks from being offered to SMEs even when they are up for renewal. The FSB is aware of companies trading through ‘preferred list’ suppliers for over three years before they can get on the list themselves.

Member Case Study – FATS3 (Framework Agreement for Technical Support)

One FSB member had held a FATS agreement since it first came out, and has conducted tasks through it on a single action basis (e.g. undertaken work agreed directly with the customer). Their problem is with the competitive use of the agreement, when Defence Equipment and Support (DE&S) send out Invitations to Tender (ITT) on the basis of the Market Knowledge Matrix (MKM). They see hardly any opportunities of this kind, and those they do are often worryingly irrelevant. In addition, many other companies to which they have spoken have had the same experience, because the decision on who to send an ITT is based purely on a ‘black box’ selector attached to the MKM, and:

1. This favours big companies who have ticked all the capability boxes.
2. It also favours companies who have been ‘creative’ with their capabilities.

For example, their company specialises in Whole Life Cost (WLC) modelling, and they know that there are probably only between five and 10 companies in the UK with a serious, deep knowledge of this subject. According to FATS3 there are more than 50!

The result of using the MKM as a ‘black box’ is that strange decisions are made regarding who gets ITTs. This has been borne of conversations with numerous other companies – including some very big names, so this is not just an SME issue.

Less focus on process

Like all large organisations there is a tendency for the MoD to focus on process. The MoD should move away from trying to manage process to contracting for capability e.g. instead of deciding which spare parts to hold and how to deploy them, contracting levels of operational readiness and availability from the private sector. The concept of contracting capability, rather than physical units, has already been successfully applied to AIR and SEA systems.

20 Framework Agreement for Technical Support (FATS)

21 www.ogc.gov.uk/contractsdatabase/list_all_contracts_599.asp

Small businesses lack the capacity to take advantage of opportunities

Small businesses may not have the capacity or expertise to research the opportunities available to them. While opportunities above the EU thresholds have to be advertised in the Official Journal of the European Union, there is no one place for advertising of small contracts.

Supplier requirements exclude small businesses

Public tenders very often require a wide range of professional, technical and economic qualification criteria and references from other contractors. Different public organisations may have different requirements for accreditation so it can be cost-prohibitive for small businesses to obtain all of these. There are also problems at the pre-qualification stage – young companies may not have an extensive track record, they might not be able to provide several years of audited accounts. If contract limits are derived from a percentage of turnover some small businesses will be automatically excluded.

The MoD should use its purchasing power to drive innovation

The FSB would like to see the MoD and the wider government looking to emulate the approach of the USA. The USA has a long-standing set of policies to favour small businesses in public procurement including the Small Business Innovation Research Programme (SBIRP)²² and 'Set Asides'. The USA is generally acknowledged to have a more enterprising culture, which as a result is more encouraging of small businesses.

The SBIRP programme awards over \$2 billion in value across 4,000 contracts to small firms in the USA each year. The value of SBIRP contracts tend to be significantly higher than UK grants with a common contract value of \$850,000 and with no upper limit. Additionally, the value of the SBIRP contracts cover the total funding for the project and companies are permitted to apply for multiple contracts.

Unlike the UK where small businesses are required to go through extensive application processes, the USA government enables small businesses easier access to funding and support. The SBIRP is just one example of how the USA government provides financial support for small businesses to encourage an innovation-friendly culture.

The USA DoD has a range of measures that, whilst not overtly protectionist, ensure the participation of American small businesses in the defence procurement cycle. The USA Small Business Act requires that awards of any size shall be set aside for small business participation when there is

22 www.sbir.gov

Small businesses need to be able to understand the interaction between the MoD's procurement priorities and the latest developments in a range of technologies, and to understand the capability requirements of potential customers

a reasonable expectation that offers will be obtained from at least two small businesses and awards will be made at a fair market price. Where contracts are awarded to a prime set aside obligations cascade down to sub-contractors. Adherence is monitored by the Office of Small Business Programmes (OSBP)²³.

Intellectual Property Rights (IPRs)

Small businesses frequently are the generators of technical innovation, yet this innovative and creative capacity is not always fully exploited, as many of these businesses are not aware of the intellectual property system or the protection it can provide for their inventions, brands and designs. Also, due to their size, small businesses have limited resources to protect, monitor and claim infringements of their IPRs. Does the MoD bear this in mind when dealing with a small businesses intellectual property? If a small business comes up with an idea of how to solve a problem and then subsequently shares that idea with the MoD, will the MoD put that idea straight into the public domain in order to find out who best could put the idea into effect, as has happened previously and how will the originator of the idea be treated subsequently?

Successive governments have pursued policies transferring risks and costs of development to the private sector. Simultaneously, the increasing sophistication of weapons systems has increased the cost of R&D and lengthened lead times, increasing technical and commercial risks. This is placing enormous strain on the cash flow of small businesses. To exacerbate matters small businesses frequently see their Intellectual Property infringed by others, eroding revenues and inhibiting both their ability and appetite to progress further R&D.

Access to information

Information is a key factor in competitive markets, particularly so for small businesses. Due to the specificities of the defence and security sector, accessibility of information is often difficult, whereas at the same time crucial for the industry. To function effectively in the defence sector, small businesses need to be able to understand the interaction between the MoD's procurement priorities and the latest developments in a range of technologies, and to understand the capability requirements of potential customers.

To improve the market awareness of small businesses and ensure access to all the relevant information on business opportunities is key in order to strengthen their future capabilities and to remain innovative. Improved communication and transparency are fundamental for small business involvement; in particular policies that improve small business access

23 www.acq.osd.mil/osbp/

to information regarding long-term requirements and future capabilities allowing them to better target their efforts and facilitate their involvement.

A period of stability is called for

Frequent re-organisations have left many MoD staff demoralised and showing signs of 'change fatigue'. Moreover, appointments can result in senior officers from the wrong service or speciality taking decisions about areas of which they have little specialist knowledge e.g. an RAF officer procuring armoured vehicles or an army officer purchasing frigates. This, combined with frequent staff changes over the life of the programme, with large projects stretching over 10 years, can result in sub-optimal decision-making and a lack of continuity or accountability.

Recommendations:

Public procurement

- **Development of an MoD Quality Charter** – Develop an MoD Service Quality Charter, to build industry's confidence that its efforts will not be wasted. The rules for tender evaluation must be clear, transparent and rigorously applied.
- **Contractors should deal with their subcontractors equally** – The MoD should insist that main contractors deal with their subcontractors on not less favourable IPRs protection terms than those between contracting authorities and main contractor.
- **Simplify and clarify the bidding process** – Existing portals are known to confuse applicants. The MoD needs to move towards simplifying the procurement process from start to finish, both in terms of the administrative burden and the use of acceptable language. Bids are very cumbersome documents that are measured in inches rather than their applicability. In practice this actually results in stifling 'innovative' bids that are always requested but as an addition to a formal bid.
- **Introduce lots** – As MoD contracts become larger they move beyond the reach of many small businesses. Where appropriate the MoD should break larger contracts into lots, thus making them accessible to small businesses.
- **Reduce bureaucracy (compliance demands)** – Efforts to reduce the bureaucracy for small businesses should impact both the time spent to amalgamate information required in bids as well as the level of contractual compliance required by producers, which is often prohibitive for small companies.
- **Make the process more transparent** – Some small businesses still perceive some procurement bias, particularly towards lower cost options. Procurement needs to continue to become more transparent, selecting on the basis of value for money.

- **Provide constructive and clear feedback on lost bids** – It is imperative that the MoD provides small businesses with timely and appropriate feedback as this will improve their future chances of winning bids.
- **Create an approved suppliers list** – Once a small business has been approved for an MoD contract they should be added to an approved suppliers list. This will encourage small businesses to apply for further MoD contracts and will make the procurement process far smoother and cost effective.
- **MoD needs to look to the future** – the MoD tries to micro manage companies and contractors instead of directing, monitoring and controlling them. Large companies when dealing with suppliers have expert teams who can move into a small business that is not delivering and retrain the key staff to deliver. They identify weakness in a few days, resolve issues and move on. The MoD could and should do this.
- **Make delivery terms and conditions more adaptive to the needs of the small business supplier** – Small businesses are often less able to cope with prolonged periods of financial insecurity; simply paying invoices in a timely manner and speeding up the contractual process would benefit many such businesses.
- **Learn from best practice in public procurement from abroad** – The MoD should look to the USA which has a long-standing set of policies to favour SMEs in public procurement including the SBIRP and ‘Set Asides’. The USA is generally acknowledged to have a more enterprising culture, which is as a result more encouraging of small businesses.
- **Introduce positive discrimination** – The MoD should discriminate in favour of Trade Associations and groups of like-minded small businesses (coalitions of interest as UK Trade and Investment (UKTI) refer to them) to encourage small businesses to work together in their vertical sectors and deliver jointly services direct to the Government (rather than through multiple intermediaries fronted by large corporations).
- **Provide a website for all FATS companies** – The Government should provide a website for all FATS companies on which FATS requirements are advertised. Only those companies with an agreement should be able to view the website. This would enable companies to bid for what they want, and – just as importantly – build teams to meet larger or more specialised requirements. By moving to an all-electronic medium, as well, costs might be cut. The MoD may be concerned that a website of this nature would lead to potentially large numbers of companies tendering. This could be resolved by:
 - Announcing how many companies have expressed interest when the deadline has been reached. Just telling bidders this will cut their numbers – if 50 are bidding, then those with little real chance of success can withdraw.
 - An electronic Pre-Qualification Questionnaire emphasising track record. By showing this to the technical authority, a rapid sift could be conducted.
 - Down-selection to around six companies (maximum) for ITT.

There is no doubt that point two could impose a resourcing headache for the MoD, but by making tendering electronic this additional effort might be offset. The outcome will be better for both MoD (most appropriate suppliers and teaming) and industry.

- **Keep trade local** – Almost all MoD procurement is done centrally. The MoD should encourage, where possible, military bases and regional offices to procure services and materials from local businesses. Research by Friends of the Earth has shown that between 50-70 pence of every pound spent with a local business goes back into the local economy²⁴. In North Yorkshire the Garrison Commander procures all beef for the Garrison from local Yorkshire Farmers. He has told the FSB that any local businesses wanting to supply the Garrison are welcome to contact him directly. On a larger scale the SAS is given permission to purchase the best equipment possible to match their needs. They have complete freedom as to where they source equipment. Recently the quartermasters from 21 and 23 SAS reserves purchased 150 items of body armour from Solo International, a small shop in Hereford selling military supplies. They did this because what Solo International sold did a better job and was cheaper than the standard issue kit provided by the MoD.²⁵

Access to information

- **More business-to-business events** – The MoD should also organise more business-to-business events for specific major programmes, to present to small businesses the operational requirements and the milestones, in order to foster as wide a participation as possible and to foster partnering between businesses. The FSB recognises that the MoD does run ‘Industry Days’ at present but they tend to be narrowly publicised.
- **Create ‘communities of interest’** – The MoD to encourage organisations such as UKTI Defence and Security Organisation (UKTI DSO); Aerospace, Defence and Security Industries (ADS) and the Defence Industries Council (DIC) to better represent SMEs through the creation of ‘communities of interest’, disseminating information and assisting contractors to find suitable subcontractors.
- **Provide appropriate support schemes for small businesses** – Guidance documents and ‘Meet the Buyer’ events can be extremely valuable for small businesses in improving their chances of winning a contract.
- **Enhanced small business understanding of MoD priorities** – To facilitate small business understanding of MoD priorities and to help them anticipate the required technological innovations, the MoD is encouraged to organise events on their future procurement priorities.
- **Improve small business access to information on MoD procurement opportunities** – Whilst considerable progress has been made, UKTI DSO being a good example, it is imperative that the MoD and other departments develop one single point of reference for small businesses to find information about bidding opportunities available to them.

24 www.foe.co.uk/resource/action_guides/localfirst_introduction.pdf23/08/2010

25 www.channel4.com/programmes/dispatches/articles/how-the-mod-wastes-our-billions-related-links

MoD staff

- **Greater level of commercial awareness needed within the MoD** – Complement the MoD's commercial skills with experienced staff recruited from the private sector so that the MoD can learn from private sector 'best practice'. This needs to be matched with a greater focus on specialisation ensuring officers appointed to manage programmes have the requisite specialist and technological skills and background knowledge. These officers need to be in post longer, ideally seeing programmes through to completion. The greater the skills and experience that MoD procurement professionals can apply to their jobs, the more likely the process is to be transparent and appropriate.
- **Reduce the workload of MoD staff** – Too many staff at the MoD are overloaded with work, they need to be unloaded so that they can operate effectively and train others.
- **Creation of a new acquisition body within the MoD** – Formation of a specialist acquisition arm within the military to provide career progression, career management, specialisation and continuity.

Innovation and R&D

- **Promote protection of Intellectual Property** – The MoD and other organisations such as UKTI DSO should ensure that information on the Intellectual Property protection is available and distributed to small businesses.
- **Greater partnering with small businesses** – The MoD should be encouraged to partner with small businesses, sharing the costs and benefits or R&D effort. Intellectual Property would be jointly funded and jointly owned, reducing risk, easing cash flow and providing both parties with return on investment and a common interest to protect Intellectual Property generated from infringements.
- **Small businesses need to have confidence in the MoD** – 65 per cent of innovation comes from small businesses. These businesses need to have confidence that if they approach the MoD with an innovative solution to a particular problem that the MoD will not put that idea straight into the public domain in order to find out who best could put the idea into effect without first ensuring that the small business in question has protected their intellectual property.
- **Introduce innovative measures such as performance bonds and contract banding to combat the perceived risk associated with small businesses** – Any reduction of the risks associated with contracting with small businesses would likely result in an increase in procurement from these companies.

Funding

- **Development and pre-production funding** – Cash flow is a recurring challenge for all small businesses, particularly during development, pre-production and mobilisation. Given the long lead times, large investments and risks associated with defence projects, and the

scarcity of capital in a credit market that is extremely risk averse, the MoD should introduce staged payments released against defined pre-production milestones. The MoD should also make greater use of mobilisation payments to finance production set-up. The MoD and wider government must do more to ensure better ending decisions from the banks.

Spare parts and the definition of what is 'genuine'

Unlike the civilian market, supply of spare parts for military vehicles is a 'closed shop' in which the vehicle manufacturer can hide behind security considerations and IPR. Therefore, there is no compulsion at all on the manufacturers to share proprietary data with the independent aftermarket, which in turn means that the MoD effectively has only a single source of supply.

This has two important effects:

1. **Commercial:** As the vehicle manufacturer/importer has a monopoly over the supply of components, the MoD is forced to pay above market prices for parts, many of which are available in the civilian market.
2. **Casualties:** A far more important issue is the inability of major corporations to supply spare parts when they are needed. Due to sheer inertia and a prevailing corporate culture of complacency, members of our armed forces are not receiving the equipment they need with increased casualties as a result.

Vehicle manufacturers (VMs) are in fact vehicle assemblers. They do not manufacture components but rather assemble components manufactured by the Original Equipment Manufacturers (OEMs) many of whom are major companies in their own right. It would be unfair, for example, to suggest that a Gates timing belt is somehow inferior in quality to the Land Rover genuine part, given Gates is the undisputed world leader in drive belt technology. The only 'genuine' thing about a 'genuine' part is the branding on the box. The part itself will have been manufactured by an OEM, often in the same plant, to identical technical specifications to the parts FSB members offer. The suggestion that 'genuine' parts are somehow of superior quality is a fallacy that does not bear objective scrutiny. Yet this is precisely what some VMs do to ensure that they are dominant in both the primary market and the aftermarket.

One FSB member has direct experience of this from his time working for three of the largest vehicle manufacturers in the world. Our member states, *“Whilst working for a major vehicle manufacturer we would import parts from major OEMs like Bosch, to our main hub in Nyköping, south of Stockholm. We would remove the parts from the OEM’s box, re-pack in our own genuine boxes before re-exporting to our distribution centre in Germany having added significant margin. This was before our German distributors and the German dealer added their respective margins. When a consumer in Germany had the audacity to try and fit a Bosch part at his local independent garage we would threaten to invalidate his warranty.”*

At no point in any of this is the FSB suggesting that that the MoD procure cheap imitation or under specified parts. Small businesses in the independent aftermarket will source from highly reputable OEMs with major brands. The parts offered can be backed by Certificates of Origin, Certificates of Conformity, ISO 9001 and ISO 14001 accreditation and any other documentation required. It is therefore unfair for the MoD and/or the primes to suggest that fitting OEM parts would have any adverse impact on reliability or operational efficiency. The FSB would seriously question whether the MoD has any reliable data to support this hypothesis.

Using standard parts from the civilian market in military vehicles

Pinzgauer is an armoured vehicle serving as Vector in British Army service, where MoD has experienced enormous difficulties as a result of its decision to source all spare parts from the prime. These problems could have been avoided as many of the components are standard. The brake callipers, for example, are identical to those fitted on the VW Passat and can therefore quite easily be sourced from numerous SMEs in the independent aftermarket. Once SMEs have access to the IPR they can supply the MoD with whatever they need – but the fact of the matter is that big business and the MoD are currently working together to constrict SMEs’ opportunities, which in turn restricts supply.

Looking in detail at the range of parts and consumables required to service a Challenger Main Battle Tank, most are also standard parts that can be supplied by SMEs in the civilian market. This is not an accident, but sound design engineering. The more one is able to use standard parts from the civilian market the more economical it will be to maintain the vehicle throughout its life.

The current policy of sole sourcing from the primes has often led to chronic supply constraints. In Iraq and Afghanistan, according to the BBC, four out of five Mastiffs were non-operational in 2008 because of the primes inability to supply parts. The FSB is reliably informed that Pinzgauer is still suffering from perpetual supply problems due to another primes apparent inability to support this vehicle yet the MoD is bound by the terms of its contract to this prime and cannot source parts elsewhere.

Large corporations operating in the defence sector need to be compelled to open up and allow the MoD to source parts wherever they are available. These large companies should not be allowed to hide behind claims of national security or IPR. In the civilian market the European Commission has taken increasingly robust action as part of the new Motor Vehicle Block Exemption regulations²⁶ to prevent VMs misusing the warranty and IPR to

26 www.eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:129:0052:0057:EN:PDF

retain after sales business. The FSB was directly involved in negotiating these new regulations. Regrettably this ethos has yet to spread to defence.

Small businesses that wish to supply spare parts to the MoD have received some support, but one or two people working in procurement at the MoD cannot compensate for a system that is heavily weighted towards the largest companies operating in this sector, all of whom do everything in their power to keep small businesses out.

This is an issue – not only because small businesses are losing out to this ‘closed shop’ approach – but because the MoD is having to pay far too much for what is purchased. Nowhere is this more apparent than in the area of spare parts.

Recommendations:

- **Pre-qualification of multiple suppliers** – The MoD to carry out thorough due diligence on a number of potential suppliers to ensure technical ability and quality assurance. By pre-qualifying numerous suppliers and negotiating framework agreements the MoD would not only ensure best price and fitness-for-purpose but also secure plurality of supply – hence operational flexibility.
- **Large companies need to open up** – Large corporations operating in the defence sector need to be compelled to open up and allow the MoD to source parts wherever they are available. These large companies should not be allowed to hide behind claims of national security or IPR.

Exporting

The defence industry, aligned with the growing security market, has become one of the UK's most significant business sectors, with our exports second only, in global terms, to the USA. Yet, as has already been stated, so much of the UK's overseas success is achieved by so few.

Breaking into overseas defence and security markets can be challenging, if not daunting for small businesses, and even for those that persevere and become successful it can be a long, slow process, putting considerable pressure on company resources and other priorities.

Research produced by the European Commission²⁷ highlighted the fact that fewer than one in 10 EU SMEs (8%) reported turnover from exports, which was significantly lower than the respective share of larger enterprises (28%). The main export obstacle for SMEs was the lack of knowledge of foreign markets (13% of exporting SMEs mentioned this as their prime obstacle), followed by import tariffs in destination countries and the lack of capital (both 9%). Further research, again produced by the European Commission, found that the percentage of UK SMEs exporting was below the EU average of 25 per cent. The research also showed that those SMEs actively engaged in the export market reported employment growth of seven per cent, while those focused on local markets grew by only one per cent.

Offset commitments are an obstacle to export, particularly for small businesses. The Government holds significant offset credits from multinationals receiving MoD contracts. Better use of these offset credits could alleviate pressures on small businesses and promote UK defence exports.

Finance is also an issue preventing small businesses from taking full advantage of defence export opportunities. One FSB member attempting to fund a \$2.4 million tender of vehicle parts for UN Development Programme in Kabul has been told by three banks that they must produce an irrevocable letter of credit or tangible security. In the end one bank did offer them an invoice discounting scheme but the fixed cost element just

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²⁷ www.ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-observatory/index_en.htm

to set the facility up was over £30,000 with APRs of over 10 per cent, and even then our member had issues around concentration and onerous bureaucracy.

When you are a small business and not a multinational enterprise you have to cope with the currency risks. For your business prospects devaluation may be as unfavourable as a rise of the exchange rate. You might have to think about getting insurance against this kind of financial risk by forwarding contracts or derivative financial instruments such as options, futures or other frequently very risky businesses involving financial contracts. However, for small businesses, these options are rarely understood by the staff in high street banks.

FSB research shows that UK banks are operating increasingly stringent lending criteria. On top of this, many banks operate blacklists, with many developing countries deemed 'no go areas' irrespective of the client's creditworthiness. These 'black lists' are drawn up based on advice given by the Foreign and Commonwealth Office (FCO). What this means in reality is that many of the markets that UKTI are rightly encouraging small businesses to pursue, are effectively not fundable. As an example, one small business received a purchase order for four Toyota Land Cruisers from a major high street bank's wholly owned subsidiary in the Ivory Coast, only to be told by the same bank in the UK that the deal could not be financed as the Ivory Coast was blacklisted.

Recommendations:

- **Share offset commitments with small businesses** – Establish an Industrial Participation clearing house within the MoD or UKTI to share offset commitments with a percentage set aside for small businesses.
- **Foreign companies to sub-contract to UK small businesses** – Incentivise foreign companies to sub-contract to qualifying UK small businesses.
- **Joined up government** – There should be a more joined up approach within government, with organisations like Foreign and Commonwealth Office (FCO), Department for International Development (DfID), Department for Business Innovation and Skills, UKTI, Business Link and the new Local Enterprise Partnerships promoting defence export opportunities to a wider range of businesses than at present.
- **Closer cooperation with SME representatives** – The MoD and UKTI DOS should work closely with small business organisations like the FSB to disseminate information relating to business opportunities in defence export to a wider range of businesses.
- **Joined up communication between government and banks** – There should be a more joined up approach between UKTI, the FCO, DfID and high street banks so that one arm of government is not encouraging small businesses to pursue business opportunities in a country that another arm of government is advising people not to do business in.

- **Increase knowledge in high street banks** – Staff within high street banks need to have a greater awareness of the specific problems facing small businesses when they seek finance for export work. Commercial bank managers should also be aware of organisations such as UKTI so that they can point small businesses in their direction.
- **UK businesses need a champion** – Breaking into overseas defence and security markets can be challenging, if not daunting for small businesses. These businesses need the help and support of people who have a detailed knowledge of the countries in which they wish to export to. Take Afghanistan as an example; this is a country that UK small businesses could and should be exporting to yet there is no government support in the country. UKTI should therefore establish bases in more countries than at present.

An effective voice for small businesses

There are 4.8 million SMEs in the UK, some of whom will be defence specialists, others will have branched out into the industry, and many more will have no idea that defence is an area that they could or should be working in.

There are a plethora of government bodies and departments that deal with defence and security, UKTI DSO and the MoD are but two. How do they communicate with these small businesses and, more importantly, how do these businesses communicate with government?

Unlike the primes, most small businesses cannot pick up the phone and arrange a meeting with the Secretary of State for Defence, nor can they afford to provide hospitality for ministers or pay the large sums needed to take a stand at one of the major defence events. At the same time the MoD, quite rightly, does not want to have 9,000 SMEs coming to them individually with their problems; so how does a small business engaged in the defence and security sector get their message to the relevant people?

A number of organisations have been established by government and industry to try and answer this question and to act as channels of communication. From the industry side you have ADS and from the Government side you have the Defence Industry Council (DIC). Do these organisations have the true interests of small businesses at heart?

The board of the DIC is made up of the Chief Executive Officers of the largest companies operating in the UK defence and security market today. The sole designated representative of small businesses on this board is actually a company at the medium end of SME. We therefore have a situation where the body set up to act as 'go between' for industry and government cannot, in all seriousness, be said to have the concerns of micro and small businesses at heart.

Like DIC, ADS is dominated by the primes. It is however early days and time will tell how ADS manages to fully represent both primes

and the smallest businesses operating in this sector. With the existing bodies failing to adequately represent the interests of small businesses, the genuine concerns of these businesses are not being heard by the Government, so consequently, the real concerns of small businesses are being ignored by the MoD. Decisions are therefore being taken with big business in mind and small businesses, if they are considered at all, being very much an afterthought.

One government organisation that is an effective advocate for SMEs is UKTI. UKTI DSO and the UKTI DSO Small Business Unit do a huge amount to help small businesses. Through the Small Business Charter smaller businesses have access to a range of advice, information and assistance on selling products and services to overseas defence and security customers. At present, roughly 600 SMEs have signed up to the Charter which is good news. This allows the UKTI DSO Small Business Unit to gain a greater understanding of these businesses and to develop a close, two-way relationship with them. As a result of this close relationship the Small Business Unit is able to ensure that Charter members are made aware of, and are ready to take advantage of, the most appropriate support available pursuant to defence and security export sales. By the end of March 2008, Charter members recorded defence and security export sales in excess of £320 million.

Another example of the good work carried out by the UKTI DSO Small Business Unit is the encouragement of 'communities of interest' or 'clusters of excellence'. These bring together small businesses operating in similar areas under a single umbrella allowing them to pool resources so that they could, for example, take a trade stand at one of the major defence industry events, something that they, as individual small businesses, would have found impossible. These 'communities of interest' also make it easier for the UKTI DSO Small Business Unit to target specific contracts when they come up thus making it easier for these small businesses to bid for work.

'Communities of interest' are, as we have said, a great idea and more should be done to promote and encourage them. The FSB is however concerned that the wider government is either not aware of their existence or is indifferent to them. When news broke of the devastating earthquake in Haiti, the UKTI DSO Small Business Unit contacted DfID to make them aware of one specific 'community of interest' that was made up of small businesses that would be able to supply all sorts of relevant equipment for dealing with a post earthquake environment, DfID responded saying that they had all they needed and that they were not interested.

While the UKTI DSO Small Business Unit provides a wonderful service for small businesses wishing to be involved in defence exports, what support mechanisms and communication channels are there for such businesses that wish to work directly with the MoD?

Recommendations:

- **Genuine small business representation in established bodies** – Small businesses warrant a seat at the 'top table'. The existing representative bodies such as the DIC must open up their membership to genuine small business representatives. If this is not possible then a dedicated channel for small business communication with the MoD should be established.
- **The creation of a UKTI DSO for the domestic market** – The fantastic work that UKTI DSO does for small businesses in the export market needs to be replicated through the relevant organisation for small businesses in the domestic market.
- **Closer cooperation with small business representatives** – UKTI DSO to work more closely with organisations like the FSB to better communicate the great work that they do.
- **Better communication within government** – Departments across government need to be made aware of the 'communities of interest' that have been created by the UKTI DSO Small Business Unit so that when a crisis takes place or a contract comes up for tender the relevant government department knows that there are dedicated groups of specialist small businesses that may be able to help or fulfill a specific contract.

Conclusion

In conclusion, as Richard Paniguan recently stated, *“the role of SMEs in defence and security is vital in ensuring that the UK offers innovative and reliable equipment that supports the UK Armed Forces, our security services, overseas customers and most importantly the UK economy.”*²⁸

It is the FSB’s firmly held view that small businesses have a role to play in defence procurement, and that the current practice of restricting major contracts to the primes is not only artificially increasing taxpayer cost but is negatively impacting operational readiness as objective scrutiny of the Iraq and Afghanistan campaigns clearly demonstrates.

Whilst recognising some of the good work that the Government does, the FSB is firmly of the opinion that small businesses are still placed at a significant disadvantage compared to their prime competitors, if this were not the case approximately 90 per cent of defence exports would not be won by the 20 largest UK companies. In order for this situation to be improved it is vital that the voice of small businesses must be heard by the decision-makers at the MoD and beyond.

In this report the FSB, drawing on the real life experiences of FSB members, has highlighted a number of problems faced by small businesses and has put forward a series of solutions that would not only directly benefit such businesses in the UK, but would also help the MoD save the UK taxpayer money, and most importantly, provide a better level of service for our armed forces personnel. In short, all small businesses are asking for is a fair crack of the whip on a level playing field.

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28 SME Opportunities in Global Defence and Security, RUSI Defence Systems, October 2009

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