

PARTNERING IN UK DEFENCE PROCUREMENT: THE MONOPOLY PERSPECTIVE

Group Captain Andrew S Humphries
Defence Logistics Organisation,
Equipment Support (Air)
Royal Air Force Wyton, Huntingdon, PE28 2EA.
andrew_humphries@bigfoot.com

Dr Richard Wilding
Cranfield Centre For Logistics & Transportation,
Cranfield School of management,
Cranfield University, Cranfield, MK43 0AL
richard.wilding@cranfield.ac.uk

Abstract

After the 1998 Strategic Defence Review the Government reversed its competition policy and now seeks to improve Defence Procurement relationships with industry through partnering. However, at a time when the Defence industries are concentrating and globalising and more and more of the large contracts are being managed under monopoly conditions, substantive relationship improvements are hard to find. This paper offers a Monopoly Relationships Model, which seems to epitomise a predominant view of Defence procurement relationships. It then reviews relationship development within commercial Supply Chain Management (SCM), business-to-business dealings and contracts in order to identify the key success factors. It is proposed that when these success factors are linked to the Monopoly Relationships Model an insight is offered into solving the Defence Procurement problem of operating successful partnerships within sustained monopolies. The paper finally introduces a research programme within the

Defence Logistics Organisation, which aims to test the hypothesis.

Introduction

The relationship between the Ministry of Defence (MoD) and the Defence Industries has historically been problematic. With equipment expenditure of £9,803 million in 1999/00 [1] the MoD has immense power as British industry's largest single customer. It can thus determine the size, structure, conduct, ownership and performance of the industry through pricing, profitability, technical progress and exports. On the other hand, British industry is a major exporter and contributor to the UK's balance of payments and by extending production for foreign sales ensures that the MoD's equipment unit costs are reduced. It also has a key role in developing strategically important technologies such as aero engines. Lastly, the major companies such as British Aerospace Systems, Rolls Royce, VSEL and Royal Ordnance who are virtual domestic monopolies, have considerable opportunity to team with foreign companies to further reduce global competitive forces. Thus the

relationship between the MoD and its main industrial suppliers is dominated by a monopoly market in which each side wields considerable power and where potentially, lack of trust can reduce efficiency and value outcomes. Against this background, in the 1999 Defence White Paper [2] the Government made a clear statement of policy that its *Smart Procurement Initiative* depended heavily on the concept of partnership in order to reap the benefits of competition and collaboration.

This paper first articulates the problem faced by the MoD and its main industrial suppliers in moving away from traditional adversarial relationships whilst facing increasingly monopolistic business dealings. It then proposes a model which describes the relationship environment within a monopoly and which appears to resonate with the current Defence Procurement situation. Next it traces the development of relationships within the Supply Chain, between businesses and contractually and identifies the key success factors that are important to monopolistic business-to-business dealings. It then assesses their implications for Defence Procurement and proposes an approach to solving the business problem.

UK Defence Procurement

Superpower politics, nuclear deterrence and the arms race overshadowed the years of the Cold war until 1989 and the clearly defined threat from the Warsaw Pact provided a period of stability for UK's armed forces [3]. The logistics imperative was high readiness using large stockpiles; cost optimisation was not the first priority. Relationships with industrial suppliers were shaped very much by the political requirement to support domestic companies and promote UK-based R&D and strategic technologies. As a result the British Defence Industry enjoyed good profits through cost-plus development contracts and non-competitive, cost-based contracts for production. However, the MoD was not a demanding customer, value for money was low, quality was poor and contracting relationships lacked trust and were epitomised by costly, cancelled projects such as the Nimrod Airborne Early Warning Aircraft. The geo-political transformation that followed the fall of the Berlin Wall allowed the Government to refocus its Defence expenditure on less costly, low intensity operations and to reap 'peace dividends' from reduced support costs. Thus between 1985 and 1997 spending on equipment reduced by 40%, on R&D by 45% and employment fell by 50%. Half of these job

losses occurred between 1990 and 1995 [4] reflecting the 'shake-out' following the end of the Cold War.

The impact on Defence Industries of reduced spending and the loss of the 'cosy relationship' through increased competition and opening up the market to foreign companies was cataclysmic. The period was characterised by radical downsizing, concentration, and collaboration with other companies and efforts to reduce over-capacity continue to this day. Moreover, the legacy of 'bad feelings' from this era have become fixed in the Defence Industry culture and consequently reduced its capacity to enter into long-term, trusting contractual relationships.

Since 1989 the MoD has been driven relentlessly by operational, financial and political pressures to become smaller, flatter and more flexible by using out-sourcing, rationalisation, redundancies and stock reduction programmes [5]. Unfavourable Public Accounts Committee and National Audit Office reports have driven the pace of change. Measures to increase the number of competitive contracts, to focus on life-cycle costs, to reduce specification rigidity (Cardinal Points Specification), to promote more cost effective operations (Competing for Quality)

and to open up defence activities to external funding (Private Finance Initiative) have been initiated. From 1994, the formation of Multi-Disciplinary Groups brought together formerly disparate teams of engineering, procurement, commercial and finance personnel to improve the in-Service support and initial procurement functions. More recently the *Smart Procurement Initiative* [6] and now *Smart Acquisition* [7], introduced the concept of Integrated Project Teams to further streamline processes – *faster, cheaper, better*.

The concept of Partnering has been acknowledged by the private sector as 'best practice' in managing customer/supplier relationships to provide mutually beneficial results. The MoD consequently believed that partnering would allow it to overcome the adversarial relationships within a Defence market containing few competitors [8]. However, despite clear strategic intentions, practical implementation of partnering arrangements have been slow, patchy and clouded by uncertainty over ways and means. Furthermore, the fundamental differences of aims by both sides appear to make the selection of common objectives difficult and problematic. Overcoming these difficulties is still the business problem faced by the MoD and its main industrial suppliers.

The Monopoly Phenomenon

The manifest adverse effects of monopolistic conditions i.e. where there are few or single buyers and sellers (small numbers), within UK Defence Procurement have been described but a more theoretical approach is necessary to facilitate analysis. Economists believe that monopolies are a short-term, highly undesirable market aberration that would normally be dealt with by government anti-trust regulation or normal market pressures.

Although parties in this situation can complain or leave, often the cost of finding another source of supply can be more expensive than the high costs of managing the situation and as a result they put up with a mutually sub-optimal position until a normal market is reestablished. Furthermore, without the pressure of the market, monopolies tend to be prone to inefficiency, decay and flabbiness because costs are poorly controlled and service quality is low. However, in the stable monopoly situation that prevails in Defence Procurement, the opportunity to escape, even at a cost, is not available and the result is an impasse where neither side has the power or the motivation to improve the relationship. The model at Figure 1 illustrates this self-defeating situation and the factors are explained as follows:

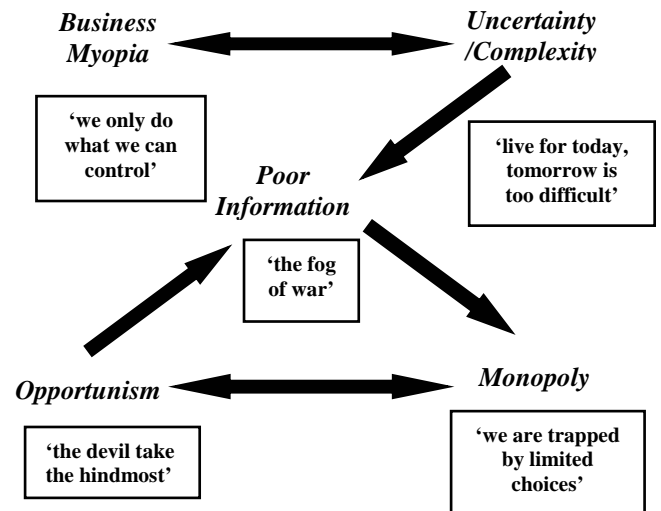


Figure 1. A Model of The Monopoly Relationship

- *Business Myopia*: People have only so much capacity to rationalise what is going on around them and therefore naturally limit their aspirations to the adequate rather than the optimum. This compounds and is compounded by
- *Uncertainty/complexity*: which describes the difficulty people have of making sense of complex current and future events in the post Cold War political and economic climate.
- *Poor Information*: resulting from both *Uncertainty/Complexity* and *Opportunism* and refers to the imbalance caused by selective information disclosures and distortions which are difficult or expensive to verify at the time and which undermine the durability of contract arrangements.
- *Opportunism*: is a self-interested lack of candour or honesty. It can be exhibited

in a number of ways but it is the complete antithesis to the spirit of partnering because it implies seeking advantage at the expense of the other party. In a 'locked-in' monopoly relationship the result is a downward tit-for-tat spiral. It also contributes to reduced information quality where information is deliberately obscured e.g. inflation of cost information.

- *Monopoly*: represents the position where both sides are 'imprisoned' in a business relationship that lacks trust and confidence in the other party's motives. This is epitomised in traditional Defence Procurement where, through tightly controlled profit rewards, industry is not incentivised to deliver reliable equipment. As a result the MoD receives a service which does not give value for money and industry recoups its costs through repair contracts. This situation breeds long term, deeply rooted bad feelings and encourages contractual and operating practices that perpetuate a poor relationship.

Although the author can find no empirical evidence to support this model, it does seem to have face validity because the factors it represents are readily observable in the Defence Procurement today. The paper now

turns to a consideration of the development of business-to-business relationships in the private sector over recent years in order to identify the factors which might allow the MoD and its industrial suppliers to overcome the problems of managing effective relationships under sustained monopolistic conditions.

Drivers for Change

In the last 20 years strong competitive pressures such as scarcity of resources, increased competition, globalisation of markets, faster change and higher customer expectations have forced companies to search for reduced transaction costs and more efficient, agile processes. A number of solutions have been adopted. Firstly, quality systems, such as Total Quality management, have encouraged 'reverse marketing' starting with the customer (demand driven/flexible manufacturing) and moving back to procurement process efficiencies (reduced cycle times and inventory). Secondly, the need to optimise the supply chain has stimulated the use of IS tools and networks and highlighted the importance of supply chain relationships using fewer, key suppliers and co-ordinated processes to build competitive advantage. This competitive advantage includes access to new technologies, information, skills and markets and, increased

capabilities and agility to provide a wider range of products and services. Moreover, these changes have demanded improved management that realises the importance of customer satisfaction, customer retention and relationships to the firm's performance. These competitive and process changes have resulted in organisations migrating from bureaucratic hierarchies to more decentralised structures in search of increased flexibility. In summary, when allied to a concentrating and globalising trend of business, these factors have produced a dramatic shift from domestic, transactional sourcing to a procurement paradigm based upon global, relational sourcing.

Supply Chain Relationships

The business of UK Defence Procurement is essentially the management of the supply chain – the synchronisation of the physical flow of goods from sourcing to consumption. The concept of SCM evolved from logistics, which as both a military and a civil concept was largely concerned with efficient internal planning and operational processes.

Relationships did not feature highly because interfaces with external agencies were largely seen as outside the scope. SCM on the other hand, can be seen as a more all-embracing, proactive view from an industry perspective to

manage the total flow of a distribution channel to the ultimate customer – like a well-balanced and well-practiced relay team. This integrated approach clearly infers the need for closer relationships, including trust, commitment and collaboration between supply chain members. SCM appears to provide a business environment in which firms closely co-operate rather than compete to achieve mutual goals.

Because of the management costs involved, firms select their most critical channels and reduce the number of suppliers in the chain in order to work more closely and effectively with them over the longer term. However, integration of this nature is more than a change of scope. It represents a change in attitude away from the adversarial attitude to one of mutual support and co-operation and provides a real opportunity to focus on customer value rather than transaction costs. Relational, supply chain, business dealings are given a number of labels. Partnering and partnership sourcing are generically demand-led, integrated, inter-company relationships based on collaboration. They are long-termed and focussed on complex, joint problem solving. They are tailored business arrangement based on mutual trust, commitment, openness, shared risks and rewards that leverage the skills of each partner

to achieve competitive performance not achieved by individual partners. Co-makership also describes a seamless end-to-end pipeline between the supplier and the customer and emphasises high quality processes and open information flows. More simply, partnering is an arrangement where suppliers and customers are inextricably linked.

Trust is seen as an essential component of successful relationships. Although a complex term, it can be defined as a cyclical process of making commitments, following them through and communicating the results. It is also fragile needing rapid, clear communication mechanisms to prevent local problems from endangering the relationship. But, it is just as important to build up a culture of 'do as you say,' sensitivity, dedication and goodwill. More specifically at the individual level it is important to maintain standards of honesty and integrity. More generally, a significant change in attitude at the organisational and personal levels is essential to the success of closer supply chain relationships.

In concluding this section it is important not to underestimate the practical difficulties in making supply chain-partnering work. Most managers and academics are fully aware of the principles of SCM partnering however, so

often the espoused values do not meet the theory in use. Despite the availability of modern information systems, successfully implemented examples are few. The main obstacle is motivating chain members and company staff by communicating a clear vision of the benefits to be achieved in an environment of great complexity and uncertainty. The key advice is to use intelligently the many tools that SCM provides and concentrate on exercising leadership to achieve simple objectives.

Business Relationships

As organisations have migrated from bureaucratic hierarchies to more flexible and decentralised structures and buyer-seller relationships have become less adversarial, the role of marketing within the firm has changed. Initially the managerial emphasis was on discrete transactions, planning, control and profit maximisation and the aim was to *preclude killing and stealing*. It thrived in large organisations in the 1970s and 80s and usually operated in an adversarial mode. Next came the theory of Industrial Networks which saw pairs of firms in closely linked relationships forming focal, value-added partnerships and, together with a secondary network of other firms, managing the flow of goods and services around a specific market opportunity. This

offered a first insight into the complexity of business relationships and a realisation that they could be other than adversarial.

Next, a Marriage Analogy saw building and sustaining customer and infrastructure relationships as requiring similar relationship qualities to those in marriage. Here, a firm achieved reduced uncertainty, managed dependence, exchange efficiency and social satisfaction without recourse to law to settle disputes. Current thinking reflects the view that all marketing activities are directed towards establishing, developing and maintaining successful relational exchanges. It involves designing and negotiating strategic partnerships with vendors and technology partners through which the firm deploys its distinctive competencies to serve market opportunities. The quintessential manifestation of New or Relational Marketing is Key Account Management (KAM) and here, the strategic importance of relationship-building and maintenance is recognised by the appointment of senior managers to provide high level expertise and management to this key task.

Best practice clearly underlines the importance of trust and commitment, co-operation, co-ordination, collaboration (C³ Behaviour) long-

term orientation, interdependence, power, creative conflict, adaptation and finally communication to building and maintaining successful business-to-business relationships. Culture changes are also required. There is a need to develop a corporate culture where companies can operate in a climate of trust and openness. This might be accomplished by changing the reward systems, which reinforce the behaviours that generate trust, mutual goals and adaption but, the difficulty of changing the mindsets of staff should not be underestimated. Finally, although the importance of rich interpersonal relationships to the growth of trust is sometimes advocated, it is more pragmatic to view these relationships as business partnerships where close personal relationships are not essential and where enlightened self-interest operates such that both parties press hard for advantage but stay within their trust compact. In the final analysis, business relationships depend on a clear understanding of each party's needs and the maintenance of an agreed framework within which to prosecute shared objectives.

Contract Relationships

The governing component of economic exchange between firms is the 'contract' and an understanding of the relational opportunities that this provides is a key factor within this

paper. Essentially there is a spectrum between 2 extremes: the untrusting contract laden with detailed provisions and the 'word is my bond' variety resting on the broadest contractual framework.

The original doctrine of the price mechanism as the key determinant of business survival was overtaken by search for realism in economic thinking. The human and monetary costs of transactions have always governed whether it was cheaper to do the work in-house or to buy the good or service in the open market. However, as business deals become more extended and the costs of resolving disputes in the courts rise, a range of contracting options are used to cope with both the length and depth of business transactions. There is therefore, a richer perspective of business exchanges than the simple make or buy approach.

The traditional or classical purpose of a firm was to economise on the cost of transactions including negotiating and enforcing contracts and internal control and management overheads (governance). The incorporation of human factors into the equation only aimed to demonstrate their limitations (focus on self-interest and opportunism) in complex markets and the importance of institutional controls.

Furthermore, it was believed that where these controls were inadequate, market failure would result and lead to monopoly; a highly undesirable but short-lived phenomenon. Classical contracting also included a range of contracting options to be matched to the depth and frequency of business transactions and the extent to which each side invested in the relationship. This was in reluctant recognition that it was impossible to legislate for every possible contingency. But, it is clear that efficiency, credibility and reputation based upon calculativeness were considered the secrets of successful business relations rather than altruistic concepts such as trust.

A monochrome view of the economic organisation as an efficiency-driven, market or hierarchy containing calculative, self-interested employees who must be watched and controlled obviously does not fit with current, more socially constructed approaches. It is now believed that employees are more likely to associate with the goals of the firm and to be innovative if they are inspired by higher moral values and if there is trust, then co-operation will be reciprocated. The famous example is the hand-shake agreement between the CEOs of Coca-Cola and McDonalds for the exclusive supply of soft drinks.

Contract and economic writers conclude that there is a spectrum of economic relationships that range between in-house production and the spot market and that these are governed by contracts of varying complexity. Where either party has disproportionate power then the benefits will be unbalanced and the incentive to break out of an unsatisfactory condition and move towards the open market will be strong. However, because in Defence Procurement a stable monopoly has been established for the main contracts, the result has been a mutual reduction in power, a lack of incentive to co-operate and the creation of an adversarial relationship without the freedom to look to the market for alternatives. It is obvious that adversarial competition should be abandoned and collaboration based on long-term, trusting relationships should be established. But, this philosophy runs counter to established commercial practices within Defence Procurement where the oft expressed desire to transfer risks rather than manage them jointly and to emasculate performance through red-tape is well-known.

Conclusions & Implications for Defence Procurement

This paper first identified the Defence Procurement business problem and then identified a theoretical framework that appears to provide a view of the relationship

environment found within the monopolistic, Defence Procurement situation. It then considered the development and nature of SCM, examined the practical aspects of implementation and finally identified the relational factors that are essential for success. The paper then turned to generic business relationships and traced the development from transactional to relational orientation before identifying the behavioural factors that are important to the success of business-to-business relationships. A further review then examined contracting developments for evidence of relational and monopoly business dealings. The paper concludes that from a relational perspective there are clearly almost identical business drivers that persuaded the UK Ministry of defence and the commercial world to develop closer relationships between partners. However, although a considerable amount of best practice advice is available, it ignores sustained monopoly market business. Nevertheless, it does describe a complex suite of relationship variables that provide an insight to the improvement of relationships within Defence Procurement and monopolistic environments when matched to the Monopoly Relationships Model in Figure 1. An example of how this might be possible is shown in Figure 2 where possible best practice

'antidotes' are juxtaposed against each corresponding adverse factor.

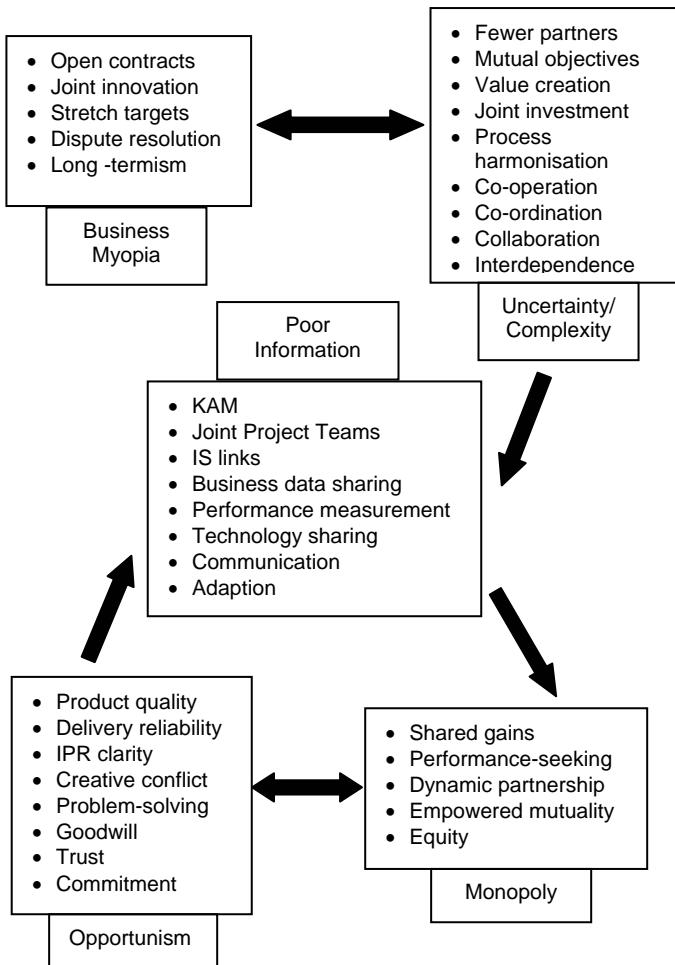


Figure 2. Potential Success Factors

Business myopia may be reversed by enabling mutual creativity through approaches such as open contracts, joint innovation, applying stretch targets, ensuring disputes are resolved quickly and fairly and finally by taking a long-term view of the relationship.

Uncertainty/Complexity may be overcome by building relationship stability and creating a framework for successful business. Working more closely with fewer partners, pursuing mutual objectives through value creation, joint

investment and harmonised processes and, through C³ behaviour building interdependence. Creating a communication environment optimised for success can defeat poor information. This involves implementing multiple communication links at all level between firms including KAM, IS (especially e-commerce), sharing business and design data, objective performance measurement and responding quickly to the needs of your partner. Opportunism is a dangerous effect that is quite difficult to reverse and requires measures to strengthen the relationship by creating a reliable business infrastructure. A focus on the quality of the relationship outputs is key as is clarity over the boundaries of the relationship. A creative approach to conflict and problem solving helps to sustain impetus and finally the building of goodwill, trust and commitment by incrementally building on achievements creates a virtuous circle. Lastly, the monopoly syndrome might be overturned by incentivising a quality relationship where the gains are both shared and highly rewarding. Both sides feel empowered to strive dynamically for the mutual good and above all true equity in the relationship overcomes any power imbalance.

A Problem-Solving Approach

As a conceptual framework Figure 2 provides an opportunity to carry out a research strategy to determine which combination of business relational success factors are effective at reversing the unsatisfactory output of the Monopoly Relationships Model within Defence Procurement. There are currently many Integrated Project Teams within the Defence Logistics Organisation, which manage monopolistic contracts with Defence Industries. The research intends to capture data from the staff on each side about the quality of the business relationship. It is hoped to that it will be possible to identify best and worst practices and therefore the key factors that bring relationship success and, at the end of the day, to help Defence Procurement managers improve the performance of their business.

References

1. DASA. (1999) UK Defence Statistics 1999. MoD/HMSO, Norwich.
2. Cm 4446. (1999) The Defence White Paper. Directorate of Policy Planning, The Stationery Office.
3. JWP 0-01. (1997) British Defence Doctrine. HMSO, London.
4. Same as Reference 1.
5. Same as Reference 2.
6. HC 138-1. (1998) The Strategic Defence Review - Report. Eighth Report from the Defence Committee - Session 1997-98 Stationery Office, London.
7. Hansard. (2000) Column 423. House of

Commons Daily Debates (26 Oct) Publications on the Internet, London.

8. MoD/CBI. (1988) Partnering Arrangements Between The Ministry of Defence and its Suppliers. Creative, London.