

Summary: Intervention & Options

Department /Agency: Ministry of Defence	Title: Impact Assessment of a Public Policy Exclusion Order to support a Submarine Enterprise Collaborative Agreement	
Stage: Final	Version: Final	Date: 25 June 2008
Related Publications: Defence Industrial Strategy (DIS) dated 15 December 2005, and MoD's Response to SECA Consultation		

Available to view or download at:

<http://www.mod.uk/DefenceInternet/AboutDefence/CorporatePublications/ConsultationsandCommunications/PublicConsultations/>

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What is the problem under consideration? Why is government intervention necessary?

The UK Government's decision on the future deterrent has reinforced the assessment that there is an enduring long-term requirement for nuclear submarines. The Defence Industrial Strategy (DIS) explains the intent to build and maintain the Royal Navy's submarine flotilla on a through-life basis achieving best value for money whilst protecting vital UK industrial capabilities. To achieve this, MoD wants to fully explore the potential benefits of collaboration with the main Industry players - the submarine divisions of BAE Systems (BAES), Rolls-Royce and Babcock Marine. This requires the exchange of commercially sensitive information. To ensure there is no infringement of UK competition laws a Public Policy Exclusion Order excluding the arrangements from the Competition Act 1998 is required.

What are the policy objectives and the intended effects?

The UK MoD is seeking to sustain unique skills and resources within the UK submarine industrial base and to establish a sustainable and affordable Submarine Enterprise. In order to achieve these objectives it is proposed to enter a collaborative agreement with the main Industry players. The Collaboration members will be required to work very closely together in order for the collaboration to operate optimally and this will require the parties to share commercially sensitive information about their businesses and the supply chain (subject to confidentiality obligations). The PPEO will enable this to occur.

What policy options have been considered? Please justify any preferred option.

Three options have been considered as follows: (1) The creation of a single industrial entity (as envisaged by DIS); (2) Optimising the existing commercial approach through improved bilateral arrangements with the three main players and; (3) Forming a collaboration between MoD and the three main industrial players. Option (3) is the preferred option because collaboration has the most potential to deliver the required outputs at best value for money by assigning clear roles and responsibilities thus enabling a holistic approach to design, build and support, minimising duplication and maximising utilisation of skills and facilities.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? The Public Policy Exclusion Order would be formally reviewed after 3 years. The Submarine Enterprise Collaborative Agreement will be reviewed annually against jointly agreed cost and benefit performance targets.

Ministerial Sign-off For final proposal/Implementation Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

[Original Signed by Des Browne]

Date: 29 June 2008

Summary: Analysis & Evidence

Policy Option:	Description: Public Policy Exclusion Order to support Submarine Enterprise Collaborative Agreement
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups'	
	One-off (Transition)	Yrs	One-off and average annual costs of running the operation (borne by both MoD and Industry)
	£ 7M	3	
	Average Annual Cost (excluding one-off)	The Costs are based on current expenditure. At the present time it is not possible to provide a PV assessment of the savings. All Costs remain indicative at this stage and will be subject to further refinement as the programme matures post PPEO.	
£ 1M	Total Cost (PV)	£ See comment above	
<p>Other key non-monetised costs by 'main affected groups'</p> <p>Commercial arrangements will need to be put in place that will result in an element of savings being gain shared with Industry, these have yet to be determined.</p> <p>There will be costs associated with the overall rationalisation of the Enterprise, eg redundancy/ redeployment; these have yet to be determined.</p> <p>The current levels of competition between the parties to SECA (Industry Tier 1s) within the Submarine Enterprise is small. The savings through competitions in these areas will therefore also be small but they will be lost by establishing SECA.</p> <p>The indirect effects into other markets are very small indeed.</p>			

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups'	
	One-off	Yrs	With a PPEO enabled SECA in place, MoD believe there is potential for a reduction in nuclear submarines 'cost of ownership' as shown This amounts to between 4% and 15% of the Tier 1 scope of the SECA boundary (approx £900M PA, price basis @ FY 07/08 Economic Conditions, based on a 'snapshot' of SECA boundary).
	£ NA		
	Average Annual Benefit (excluding one-off)	The Benefits are based on current expenditure (annualised). At the present time it is not possible to provide a PV assessment of the savings. All Benefits remain indicative at this stage and will be subject to further refinement as the programme matures post PPEO.	
£ 32M – 132M	*Total Benefit (PV)	£ See comment above	
<p>Other key non-monetised benefits by 'main affected groups' Benefits currently identified have been monetised.</p>			

Key Assumptions/Sensitivities/Risks

The PPEO is the enabler that will provide the means to further quantify the Collaboration benefit. A formal MoD business case will be required to be approved before Collaboration is formalised.

Price Base Year 07/08	Time Period Years 0	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £
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What is the geographic coverage of the policy/option?	United Kingdom
On what date will the policy be implemented?	September 2008

Which organisation(s) will enforce the policy?		Ministry of Defence		
What is the total annual cost of enforcement for these organisations?		£ TBC		
Does enforcement comply with Hampton principles?		Yes/No		
Will implementation go beyond minimum EU requirements?		No		
What is the value of the proposed offsetting measure per year?		£ 0		
What is the value of changes in greenhouse gas emissions?		£ Negligible		
Will the proposal have a significant impact on competition?		Tier 1 – Yes Tiers 2 and 3 - No		
Annual cost (£-£) per organisation (excluding one-off)	Micro £0	Small £0	Medium £0	Large £0
Are any of these organisations exempt?	Yes/No	Yes/No	N/A	N/A
Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)		
Increase	£ N/A	Decrease	£ N/A	Net £ N/A

Key: Annual costs and benefits: Constant Prices (Net) Present Value

IMPACT ASSESSMENT

COMPETITION ACT 1998 (PUBLIC POLICY EXCLUSION) ORDER [XXX]

As consulted on from 12 February to 6 May 2008.

1 INTRODUCTION

1.1 The UK Ministry of Defence (MoD) is in the process of improving the way in which it procures, maintains and disposes of nuclear submarines. It is proposed that the MoD will enter into a Submarine Enterprise Collaborative Agreement (“Collaborative Agreement”) with the Tier 1 suppliers: the submarine divisions of BAE Systems (BAES), Rolls-Royce and Babcock Marine. The Agreement will recognise the unique capability of the Tier 1 suppliers in the areas of: designing and building a nuclear submarine and integrating its equipment and systems; providing and managing repair, maintenance and support; designing and building the nuclear reactor; and managing the removal of the reactor, its fuel and other radioactive material. The collaboration members will be required to work together very closely in order for the Collaboration to operate optimally and this will require the parties to share commercially sensitive information about their businesses and the supply chain (subject to confidentiality obligations). In order for the Collaboration to operate in this way without infringing UK competition laws it will require an Order excluding the arrangements from the Competition Act 1998 in the form of a statutory instrument (called a Public Policy Exclusion Order (PPEO)). It is the making of this statutory instrument that requires this Impact Assessment.

1.2 This Impact Assessment is structured as follows:

- Section 1 provides the background and rationale for government intervention including the case for change, an overview of the submarine market and the need for Industry restructuring.
- Section 2 provides a brief review of the outcome of the public Consultation conducted with Industry.
- Section 3 contains a cost and benefits analysis of the options being considered by MoD based on the available evidence and initial quantitative assessment.
- Section 4 contains Specific Impact Tests with special attention paid to the impact on Competition and Small Firms.
- Section 5 presents an assessment of the affected groups and sectors.
- Section 6 provides an overview of how the MoD anticipates implementing, delivering and monitoring both a PPEO and a Collaborative Agreement.
- Section 7 sets out the Conclusions and Recommendations.

Background and Rationale for Government Intervention

1.3 The MoD's Defence Industrial Strategy (DIS), published in December 2005, affirmed the need to retain a sovereign capability to deliver, operate and maintain nuclear submarines. While this provided a clear statement of intent, the DIS also recognised the need for a significant reduction in through-life costs otherwise the Royal Navy's submarine programme is likely to become unaffordable as hull numbers reduce and the relative cost of the fixed overhead increases. Given the recent commitment to a successor for the Vanguard Class submarines to maintain the nation's nuclear deterrent, this is clearly unacceptable. This is the basis for Government intervention.

1.4 Key issues currently facing the UK submarine market can be summarised as follows:

- Force levels for the UK nuclear submarine flotilla will have declined from 21 hulls in 1990 to 12 by 2008. HMS ASTUTE, rolled out for launch in June 2007, was the first UK submarine launched since HMS VENGEANCE in 1998, and the first Fleet submarine since HMS TRIUMPH in 1990. Despite the reducing number of submarines there has not been a proportionate reduction in overheads because complex and costly build and support facilities must be maintained.
- The British submarine market is dominated by three monopoly suppliers each with responsibility for different aspects of the business, who historically have not worked together to reduce the overall cost of the Enterprise. There is inherent inefficiency in this lack of integration and separation of responsibilities.
- The new Astute Class contains a reactor core that will last the full 25 year life of the submarine thus significantly reducing the workload for the support facilities at Devonport which conducts the refuelling of the current flotilla.
- The renewed emphasis on through-life cost and capability management has forced a dramatic shift in industry and MoD behaviour in order to secure both industrial sustainability (ie security of supply) and the future of the submarine as a key sovereign capability.
- The challenges arising from dismantling of submarines which have left naval service and determining a solution for the storage of Intermediate Level Waste.

National Security and Retaining UK Sovereign Capability

1.5 Nuclear submarines form a key part of the UK's defence. Submarines (currently the Vanguard Class) host the Trident missile system, which is the independent strategic nuclear deterrent. Fleet submarines (currently Swiftsure and Trafalgar Classes, to be replaced by Astute Class) provide protection to Trident; undertake strike operations using cruise missiles; and provide force protection for the other maritime assets. They also conduct intelligence gathering operations and special forces insertion. The nuclear power plant enables these military capabilities to be hosted on a platform that can operate unsupported globally and can remain submerged for extended periods. The capability provided by nuclear submarines is therefore unique and of vital importance to national defence.

1.6 It is essential to national security that the UK has absolute confidence in the capability, performance and safety of its submarines. The DIS specifically identified the need to retain UK capability in this area. In particular it states:

“... for the foreseeable future the UK will retain all of those capabilities unique to submarines and their Nuclear Steam Raising Plant (NSRP), to enable their design, development, build, support, operation and decommissioning” (paragraph B2.18)

“The UK’s fleet of nuclear powered submarines requires a specialist subset of skills within the maritime industry.....it is essential that the UK retains the capability safely to deliver, operate and maintain these platforms, without significant reliance on unpredictable offshore expertise. This delivery spans from conceptual design through to disposal” (paragraph B2.26)

“The ability to manage Nuclear Steam Raising Plant throughout its life-cycle (...) is a strategic capability that must be retained on-shore. (...) An irreducible minimum level of associated facilities, intellectual resource and supporting technologies must be provided within the UK or under arrangements that guarantee UK control and safe ownership” (paragraph B2.28)

1.7 The complexity of operation and support associated with nuclear submarines means that it is not possible to simply buy from abroad and then operate nationally. A sovereign capability must therefore be maintained across key aspects of the submarine Enterprise. Not to do so would result in the loss of operational independence demanded by current UK Defence policy and would undermine UK national security.

The Nuclear Submarine Market

1.8 The submarine market can be sub-divided into three “tiers” as follows:

Tier 1

1.9 At Tier 1 the market is characterised by monopoly-monopsony relationships between MoD and these three suppliers.

- BAES Submarine Solutions, an operating division of BAE Systems, is responsible for designing and building of nuclear submarines and integrating their equipment and systems. Based in Barrow-in-Furness, the yard, owned by BAES, is the only facility in the UK capable of designing, building and integrating nuclear submarines.
- Babcock Marine is primarily responsible for delivering support of nuclear submarines. They own and operate Devonport Royal Dockyard managing many of the services provided by the Naval Base, such as engineering support to ships and submarines, facilities management and berthing. Devonport contains the only facilities in the UK able to conduct de-fuel and refuel operations for nuclear submarines. Due to nuclear safety considerations, Babcock Marine will manage the removal of the reactor, its fuel, and other radioactive material.
- Rolls-Royce Submarines designs, part builds and supports the Nuclear Steam Raising Plant (NSRP), (the reactor, which is the most significant platform system within the submarine in terms of cost). For reasons of investment, security and practicality Rolls-Royce Submarines, based in Derby, is the sole contractor for the design, equipment procurement, ongoing technical support and author of NSRP Safety Justifications. Rolls-Royce Submarines’ role is articulated in the 1958 US-UK Mutual Defence Agreement which is a unique UK/US treaty that places clear obligations on the UK.

Tier 2: Critical suppliers of sovereign capability and key suppliers

1.10 Tier 2 is broadly defined as those suppliers identified as essential to the delivery of submarine capability, including those required to maintain an indigenous UK industrial capability. This includes members of the BAES-led Astute Key Suppliers Forum (Alstom; L3 Communications; McTaggart Scott; Sheffield Forgemasters Engineering; Thales; Ultra Electronics; Weir, Strachan and Henshaw; Wellman Defence; York), who together with MoD and the prime contractor (BAES) are responsible for the majority (75%) of Astute's materiel spend, and who exert considerable influence on through-life cost. Tier 2 also includes suppliers (such as Qinetiq and BMT) who have a significant part to play in current and future submarines and are crucial to providing innovation and challenge.

Tier 3: The wider supply base

1.11 Tier 3 covers a wide-ranging supplier base that includes markets within, and related to, the submarine market. Tier 3 comprises a wide-range of suppliers that directly support Tier 1, Tier 2 and MoD across the totality of the Submarine Enterprise.

The need for Industry restructuring

1.12 Current trends indicate that the cost of the current planned submarine programme is likely to become unaffordable without action by MoD and Industry. The declining order rate and piecemeal approach to ordering is detrimentally affecting industrial sustainability. There is also the challenge of maintaining a broadly static level of availability from a reducing number of hulls and the need to continue to satisfy the demands of necessary, but exacting, safety and regulatory standards.

1.13 These factors contribute to an assessment of the current situation as unsustainable and in view of the huge pressure on the future programme the DIS concluded that "*industry restructuring and consolidation is likely to be a key feature of any improvement programme and fundamental to creating a viable and sustainable business to meet anticipated steady-state demand*" (DIS, paragraph B2.48).

1.14 The DIS also identified the need to work with Industry in order to be able to deliver an effective, sustainable and affordable submarine programme, which retains key sovereign capabilities. In particular, paragraph B2.47 of the DIS states that:

The UK will need to buy (...) submarines for the foreseeable future, but the clear trend is for fewer, more capable platforms, with longer operational lives and increased opportunity for regular upgrades in response to new technologies and threats. The ability to do so will depend upon us working together with industry to address the fundamental issues of affordability and productivity.

DIS stated that a "*single industrial entity for the full lifecycle of the submarine flotilla*" provided the best solution for the Submarine Enterprise.

Market Analysis

1.15 Independent analysis of the Submarine Enterprise supply chain confirms that it is dominated by the Tier 1 suppliers, with low levels of competition for MoD spend as a result of the historic reduction in demand for new submarines and the reduction in size of the submarine Fleet. The specialised nature of submarine build and support also restricts the degree to which work can be competitively procured.

1.16 The independent analysis also suggests that there are opportunities to improve value for money, but competition is not always the best route; the unique nature of the Submarine Enterprise implies that in many cases MoD and its direct suppliers will need to work collaboratively to sustain a viable supply chain in the UK and should seek to derive innovative ways of reducing costs where competition is not possible or beneficial.

2 CONSULTATION

2.1 The MoD's work to determine the most effective solution to deliver the Government's DIS intentions is already underway. A dedicated SECA Team has been established by the MoD to assess the options for success within the Submarine Enterprise, particularly to develop the concepts that would underpin any Collaborative Agreement.

Within Government

2.2 This team has already consulted widely within the MoD and with key stakeholders in the Department for Business, Enterprise and Regulatory Reform (BERR), Office of Fair Trading (OFT) and HM Treasury (HMT).

Wider Consultation

2.3 The next step for the MoD SECA team was to undertake formal wider Consultation with the industrial base. This Consultation was undertaken between 12 February and 6 May. Comments and views on the Consultation Document and Impact Assessment (Consultation Draft) were invited from all companies (Tiers 1, 2 and 3) and organisations within the submarine and related markets, some of whom would be directly impacted by the adoption of a PPEO and collaboration.

Tier 1

2.4 The SECA team is in ongoing contact with the Tier 1 companies who have agreed the principles that would enable collaborative working and the potential benefits.

Tier 2

2.5 A letter was sent to each of these companies informing them that Consultation was underway, and pointing them to the direction of the SECA Impact Assessment (Consultation Draft). MoD also offered meetings on a one to one basis.

Tier 3

2.6 In view of the larger number of Tier 3 companies, engagement was conducted through the relevant Trade Associations, the Defence Manufacturers Association (DMA), the principal trade association for the submarine industry, and the British Naval Equipment Association (BNEA). The MoD SECA team, in conjunction with the DMA, conducted an Industry Day to which all the DMA members were invited as part of the Consultation process. In addition, prior to Consultation but with the aim of reaching as many companies as possible, the MoD presented on its intentions at BNEA Conferences.

Government response to issues raised during Consultation

2.7 Many of the respondents to the Consultation accepted and agreed with the MoD's

strategy as a logical way to implement improvements. However some areas of concern were raised, in particular the scope of Tier 1 work; competition and sustainability within the supply chain; ensuring innovation; and governance arrangements.

2.8 The comments received and issues raised were helpful in that they enabled the MoD to:

- a. Clarify its intent to exploit competition where appropriate, while recognising the importance of sustainability in this specialist market.
- b. Explain how it intends to actively engage with the wider supplier base and provide programme visibility.
- c. Delineate the scope of SECA to cover the Tier 1 suppliers' areas of capability that will enable effective collaboration.
- d. Minimise the risk of vertical integration by ensuring visibility of supply chain decision making.
- e. Explain its role in the evolving governance arrangements, including the need to control the influence of the Tier 1 companies.

2.9 The MoD Response to SECA Consultation Document provides detailed responses to points that were raised by industry, and can be found on the MoD website:

<http://www.mod.uk/DefenceInternet/AboutDefence/CorporatePublications/ConsultationsandCommunications/PublicConsultations>

along with this Impact Assessment and MoD's original Consultation documentation. See also paragraph 4.5 regarding the scope of the PPEO.

3 OPTIONS REVIEW (Including Benefits and Costs)

Background

3.1 Prior to the publication of the DIS, the MoD worked with companies in the submarine sector (including Tier 1s) under the umbrella of a project known as Submarine Acquisition Modernisation (SAM). The aim of SAM was to explore ways to reduce cost of ownership, improve platform availability and industrial sustainability. SAM undertook cost/benefit and options analysis that looked at the most suitable and practicable industrial construct to deliver an affordable, sustainable and efficient submarine industrial base. This study represents the most recent comprehensive analysis that looked across the totality of the Submarine Enterprise and its core assumptions on potential savings have been used to inform this Impact Assessment. These in turn have been reviewed and updated in light of Industry engagement, lessons learnt on key contracts and initiatives in the submarine sector. The results of this initial analysis are summarised below.

3.2 Three options have been analysed to determine which commercial construct provides the best solution:

- Option 1: Creation of a single industrial entity as envisaged by DIS, through a significant level of Industry transformation;

- Option 2 (Do Minimum): Optimising the existing commercial approach. This would involve the development of improved bilateral arrangements between MoD and the Tier 1 companies; and
- Option 3: Collaboration between MoD and the Tier 1 companies to jointly manage the Submarine Enterprise.

3.3 Section 1 of this Impact Assessment presents the case for change from which the implications are clear if the MoD does not act to address the challenges of affordability, sustainability and efficiency. Option 2, “Do Minimum”, reflects the current baseline in that work is already underway to deliver improvements through optimising the existing bilateral contracts. and therefore “doing nothing” is not an option. Also, in view of the monopoly nature of the Tier 1 suppliers, and the barriers to entry into the market in terms of acquiring the necessary technology and expertise, full and open competition is not regarded as a viable option.

3.4 All options have been subjected to an initial analysis against broad criteria that are seen to be critical determinants for the Enterprise:

- Achievement of Military Capability
- Sustainment of UK Industrial Capability
- Affordability and Value for Money (VfM)
- Through-Life Capability Management
- Market Impact
- Relationships and Behaviours

The summary below highlights the differentiating factors and issues that MoD has identified as key to determining the preferred way forward.

Option 1 - A single industrial entity through a Joint Venture or a Joint Management Company

Description

3.5 This option is considered to directly address the challenge set by DIS of creating a single industrial entity. It was also the preferred option from the SAM study and would involve the creation of a new company by the three main Industry players that would include assets from all parties. The SAM study regarded this option as potentially offering greatest efficiencies with fewer organisational interfaces, and barriers to change. It would also avoid conflicting business strategies, practices and ethos.

Costs and Benefits

3.6 Concerns with this approach focused on having a single dominant entity in the submarine market and its potential impact on the relationships and behaviours at all levels as well as the risk of vertical integration pushing key suppliers out of the market. The view taken was that a single entity should be more efficient in engaging the wider supplier base, since it would facilitate transparency and exploitation of Enterprise data. This option would make it easier to separate out MoD’s customer role, but more difficult to integrate outputs that are currently provided by MoD.

Conclusion

3.7 However all these issues remain theoretical because the circumstances do not currently exist to enable this option to be realised. The unique areas of expertise of each of the Tier 1 companies are sufficiently distinct and of such strategic importance that MoD does not consider creation of a single industrial entity is likely to happen within the current market climate.

3.8 In view of the above Option 1 is considered non-viable and is not considered further.

Option 2 - The Bilateral approach (The Do Minimum Option)

Description

3.9 This option is based on optimising the existing commercial landscape where MoD has individual contracts with each Tier 1 supplier for discrete elements of submarine support (e.g. BAES for new build; Babcock Marine for in-service support; Rolls-Royce for NSRP). Under this approach each Tier 1 supplier is effectively a monopoly supplier with each contract negotiated separately with its own terms and conditions.

3.10 Historically the commercial focus for Industry has been to seek profit through increasing turnover and contract volume. Each company's level of industrial capacity and capability has been driven by the need to meet their own contractual commitments. More recently there have been moves in a number of areas of the Submarine Enterprise to take a more commercially progressive approach to how these bilateral arrangements are managed. This has involved joint working between MoD and Industry to look at the potential to take a more whole-life view and to have Industry's contract performance more directly linked to risk and reward.

Note – total current spend with the Tier 1 companies within the Submarine Enterprise equates to approximately £900M per annum (price basis @ FY 07/08 Economic Conditions).

3.11 These initiatives include:

- A contract between MoD and Rolls-Royce for Flotilla Reactor Plant Support (FRPS) that includes incentives for Rolls-Royce to identify opportunities that will reduce cost in the wider Submarine Enterprise.
- A joint MoD and Industry team looking at the rationalisation of Nuclear Facilities.
- The development of an Enterprise model for the Combat Systems that integrate with the submarine platform.
- A joint MoD and Industry team looking at the Concept Design of the new class of nuclear submarines.
- The development of the Key Suppliers Forum within the Astute programme to realise Enterprise-wide benefits from more effective supply chain management.

Benefits

3.12 The MoD recognises the potential from continuing to pursue these initiatives and optimising the bilateral approach to improve the health of the Submarine Enterprise. However despite the many positive benefits the MoD considers it is not as efficient as Option 3 because it would perpetuate an Industry model where the commercial focus of Tier 1 companies is to work independently to maximise return from their element of the Enterprise providing little incentive to collaborate.

Costs

3.13 Although the bilateral approach has the potential to develop an improved commercial strategy with each company it will not support the overarching commercial environment capable of optimising the submarine enterprise. In particular there will be no restructuring or consolidation across the industry and this will limit any potential Cost of Ownership savings.

3.14 The costs associated with this approach are:

- Duplication and lack of integration across the Enterprise including:
- MoD having to carry the risk of integrating Industry outputs to provide submarine capability
- A sub-optimised and overlapping supply chain as each Tier 1 company focuses on the suppliers that support their area of business rather than efficient management of the whole Submarine Enterprise supply chain.

Conclusion

3.15 While it is possible to make improvements by negotiating the terms of each bilateral contract to support the delivery of benefits across the Enterprise, (as has happened on FRPS) this alone does not facilitate full collaborative benefit and would still leave MoD in sole charge of designing, managing and delivering commercial coherence across the Enterprise and therefore this option is considered more difficult for MoD to manage as effectively as Option 3.

3.16 Option 2 is therefore judged to be sub-optimal when compared to Option 3 but a more viable approach when compared to Option 1.

Option 3 – Collaboration

Description

3.17 This option looks at enhancing and adding to the benefits achievable through Option 2 through a Collaborative Agreement between the customer (MoD) and the Tier 1 companies, as the parties who collectively manage the Submarine Enterprise and who can directly influence its strategic direction. Collaboration is therefore seen as building on existing and future bilateral contracts through an over-arching collaborative framework which enables optimisation across the Enterprise. The intent is to enable development of the most efficient and integrated industrial construct for the Submarine Enterprise capable of delivering value for money on a through-life basis.

3.18 In order to optimise benefits to the Submarine Enterprise Tier 1 suppliers will be required to work together in a unique, collaborative manner that hitherto has not been viable within the constraints of the Competition Act. The Collaboration will require the parties to enter into a multi-party collaboration agreement under which SECA Tier 1 suppliers will be required to pool resources, work together and exchange information (including commercially sensitive information) about their businesses and the supply chain (subject to other confidentiality agreements). The industry parties will also need to enter into bilateral arrangements with other suppliers and between themselves to implement aspects of the collaboration, for example, to facilitate sharing resources and infrastructure (enabling rationalisation) and adopting coherent supply chain strategies.

Benefits

3.19 To support the Benefit and Costs analysis the MoD had previously identified a range of potential benefit opportunities that could only be either delivered, or optimised, by adopting a truly collaborative approach enabled by the sharing of commercially sensitive information. These included the following:

- The rationalisation and optimisation of common facilities and personnel across the Submarine Enterprise.
- A holistic approach to design, build and support - ensuring, for example, that new design takes account of in-service experience.
- Regulatory process rationalisation through the adoption of commercial standards and common processes.
- The establishment of a more strategic approach to managing the supply chain through, for example, the implementation of Category Management techniques across the Submarine Enterprise as an enabler to a self-sustaining and innovative supply chain capable of meeting new build and through-life support needs.
- Joint buying so there is a single, more effective, Submarine Enterprise customer for the supply chain to engage with, thereby reducing inventory and gaining economies of scale.
- A mechanism to facilitate collaborative implementation of the cost reduction opportunities identified through the FRPS contract.
- Encouraging innovation and adoption of new technologies to reduce cost and reliance on expensive bespoke solutions.

3.20 MoD and Industry analysis has confirmed these potential benefits and identified specific improvement opportunities in the areas of: Programme & Performance; People; Infrastructure and facilities; Processes; and Supply Chain. Benefits have been examined to confirm that they can only be delivered through collaboration.

3.21 With a PPEO enabled SECA in place, MoD believe there is potential for a reduction of £32M to £132M in nuclear submarines 'cost of ownership'. This amounts to between 4% and 15% of the Tier 1 scope of the SECA Boundary – approximately £900M per annum (baseline Tier 1 expenditure under 'Option 2' referred to in paragraph 3.10).

3.22 All benefits remain indicative at this stage and will be subject to further refinement as the programme matures post PPEO.

3.23 Industrial sustainability is a key objective of DIS for the Submarine Enterprise and will be a benefit of Collaboration under SECA. The objective of SECA is to sustain the unique skills and resources within the UK submarine industrial base, whilst removing unnecessary duplication and excess capacity, and to establish a sustainable and affordable Submarine Enterprise to design, build, support and dispose of nuclear submarines.

Costs

3.24 Commercial arrangements will need to be put in place that will result in an element of savings being gain shared with Industry; there will also be costs associated with the overall rationalisation of the Enterprise, eg redundancy/redeployment; these have yet to be determined.

3.25 The current levels of competition between the parties to SECA (Industry Tier 1s) within the Submarine Enterprise is small. The savings through competitions in these areas will therefore also be small but they will be lost by establishing SECA.

3.26 With a PPEO enabled SECA in place, there will potentially be negative outcomes in other areas of the submarine enterprise (i.e. Tiers 2 & 3) and in related markets. The Consultation has sought to identify and respond to any such impacts. Market analysis also indicates that current competition is limited. It is concluded that the indirect effects in the submarine and other markets are very small indeed.

Conclusion

3.27 As a consequence of this analysis MoD continues to assert that collaboration is the option most likely to deliver the strategic intent of the DIS. In comparison to the bilateral approach, MoD judges that collaboration is more likely to produce an optimal outcome of delivering an affordable and sustainable Submarine Enterprise on the grounds that it is the most coherent, integrated and efficient means of maximising the value of expertise, resource and facilities across MoD and Industry. Collaboration is also likely to reduce through-life costs with less commercial and programme risk exposure to MoD leading to better support for front line operations. It has the best potential to achieve a healthier, viable and self-sustaining submarine market through a more co-ordinated and effective supply chain strategy.

3.28 However it is recognised that collaboration is not an easy solution for MoD or Industrial parties that have previously focused on their individual elements of the Enterprise and have each maintained the capability to underpin this. A successful Collaborative Agreement will need to provide a solution in which reduced cost and sustained performance for MoD also sees increased shareholder value for Industry. Design of an appropriate incentivisation arrangement will be key, as will the development of an environment in which MoD and Industry are able to work together for mutual benefit, potentially giving up capability and placing greater reliance on each other.

3.29 In addition, by opting for collaboration through a PPEO from Chapter I of the Competition Act 1998 the Tier 1 companies are protected from the threat of competition. In most sectors the view is taken that competition, or the threat of competition, is the most effective way of incentivising firms to operate efficiently and to innovate. MoD is of the view that the risk of excluding Tier 1 companies from competitive pressure is low as there is limited competition between these firms at present. Indeed the maintenance of what competition there is is a major driver toward duplicated facilities and resources. The PPEO is a key enabler in releasing that negative pressure.

3.30 In conclusion the MoD considers that Option 3 has the potential to provide the optimal through-life solution that will deliver a sustainable, affordable and efficient Submarine Enterprise.

4 SPECIFIC IMPACT TESTS

Competition Assessment

4.1 The MoD has consulted the OFT's guidelines "*Completing competition assessments in impact assessments*". According to these guidelines, the purpose of conducting an impact assessment from a competition law viewpoint is to consider whether the proposed regulation prevents, restricts or distorts competition (OFT876, page 7). The MoD requires a PPEO from Chapter I of the Competition Act 1998 because it recognises that the proposed collaboration would prevent, restrict or distort competition. However, the MoD believes that there are

exceptional and compelling reasons of public policy which justify the suspension of the application of the competition regime.

Parties to the Collaboration

4.2 The proposed collaboration would be put into place through a Collaborative Agreement between the MoD and the three Tier 1 suppliers, namely the submarine divisions of BAES, Babcock Marine and Rolls-Royce.

4.3 Details of the Tier 1, Tier 2 and Tier 3 markets are set out above at paragraph 1.8. It is also worth noting that the submarine divisions of BAES, Babcock Marine and Rolls-Royce are the only Tier 1 suppliers in the submarine market. The MoD believes that these Tier 1 suppliers do not face any competition (outside of this group) in the UK in respect of the services that they provide in relation to nuclear submarines. The MoD is the only customer for the Tier 1 suppliers for nuclear submarines.

4.4 When considering related markets and the potential for spill-over effect, it is worth noting the specialist and distinct nature of the submarine market. Initial research demonstrates that “nuclear submarines” is a distinct product market and that the geographic market is national as nuclear submarines are not exported or purchased from abroad for political reasons. The primary related markets are those of Surface Warship Build and Surface Ship Support.

- Surface Warship Build - BAE Systems participates in the UK market for building Surface Warships. Surface Warships are only built in the UK i.e. not off-shore. There is some overlap of skills between submarine and Surface Warship build, but many of the skills (e.g. design and specialist welding) are specific to submarines.
- Surface Warship Support - Babcock Marine participates in the markets for supporting Surface Ships. An Exclusion Order was granted in relation to Surface Ship Support in 2006.

It is not MoD’s intention to cause a contraction or potential distortion in these markets by having a PPEO in place, and the scope of the PPEO will minimise any spill-over effects.

4.5 The other main military and non-military markets that are engaged with and related to the submarine market include: electrical systems, machinery equipment, electronic systems, combat systems and facilities management. Other markets potentially affected are those that relate to materials and facilities under the materials and facilities management part of the Submarine Enterprise. Following the Consultation the scope of the Order has been defined to only cover the Tier 1 suppliers’ unique capabilities that need to be protected in the essential interests of UK security, such as the integration of equipment and systems. Those areas in the supply chain where there is healthy competition, or are outside the scope of the Tier 1 suppliers’ unique capability, are not covered by the Order. In particular:

- provision of equipment and systems is excluded;
- facilities only covered where they are required for nuclear submarines;
- disposal of submarines is excluded, other than managing the removal of the nuclear reactor, nuclear reactor fuel and other radioactive material.

The Infringements

The Chapter I Prohibition

4.6 Section 2 of the Competition Act 1998 states that:

“...agreements between undertakings, decisions by associations of undertakings or concerted practices which

(a) may affect trade within the United Kingdom, and

(b) have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom,

are prohibited unless they are exempt in accordance with the provisions of this Part.”

4.7 In order to implement DIS the proposed Collaboration intends to achieve the following:

- Reduce costs by cutting out unnecessary duplication of facilities and resources;
- Develop innovation and incorporate new technologies;
- Foster joint profit and risk sharing to ensure all parties have an interest in the overall performance of the Collaboration;
- Engage in joint buying; and
- Ensure that the UK industrial and skills base is sufficient to sustain all components of the life cycle of nuclear submarines.

4.8 To allow the Collaboration to achieve the aims set out above and get optimum results, it must engage in practices which will infringe Section 2 of the Competition Act 1998. Further details are set out below. For the sake of completeness, details about information exchange between non-competitors which does not infringe competition law are included.

Information Exchange

4.9 In the majority of areas covered by the proposed Collaboration, the parties are not in competition with each other and their areas of activity are complementary. In those areas the Collaboration is unlikely to prevent, restrict or distort competition between the parties as the exchange of information between non-competitors does not raise competition concerns.

4.10 It is proposed that there will be information sharing between the Collaboration parties across the following areas: designing and building a nuclear submarine and integrating its equipment and systems; providing and managing repair, maintenance and support; designing and building the nuclear reactor; and managing the removal of the reactor, its fuel and other radioactive material.

4.11 The MoD regards the exchange of information as fundamental to ensuring that there is genuine collaboration between the parties. It is necessary to enable the parties jointly to identify costs and to deliver collaborative opportunities to the MoD. It also operates to build

trust between the parties. The exchange of information will include commercially sensitive information such as the parties' internal costs, planning, strategy and skills. The exchange of commercially sensitive information falls within the Chapter I Prohibition where it is liable to restrict competition between the parties. This applies in those areas of the Collaboration where the parties are actual or potential competitors. The MoD is of the view that such infringements should be excluded from the application of the Competition Act under paragraph 7 of Schedule 3 of the Act.

Elimination of Potential Competition

4.12 There is scope for potential competition between BAES, Babcock Marine and Rolls-Royce in some areas of activity. Within these areas the effect of the Collaboration will be to eliminate that competition because the purpose of the Collaboration is to ensure that the Collaboration parties' pool resources and work together. This results in an infringement of the Chapter I Prohibition of the Competition Act 1998. The MoD is of the view that such infringements should be excluded from the application of the Competition Act 1998 under paragraph 7 of Schedule 3 of the Act.

The Chapter II Prohibition

4.13 Section 18 of the Competition Act 1998 states that:

“(1) ... any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.

(2) Conduct may, in particular, constitute such an abuse if it consists in –

(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions”

4.14 MoD has carefully considered whether there is a need for an exclusion from Chapter II of the Competition Act 1998 in conjunction with the OFT. It is intended that the Collaboration will seek to engage in joint buying arrangements to enable the Collaboration parties to procure goods and services more cost effectively and assist in achieving the Collaboration's aims. Chapter II of the Competition Act 1998 prohibits one or more undertaking(s) in a dominant position from imposing unfair trading conditions, or discriminating between suppliers. It would not be the intention of the Collaboration parties to impose unfair conditions or for the parties to the Collaboration to abuse their dominant positions either individually or jointly. On the basis that the continued applicability of the Chapter II prohibition will operate to ensure that there are protections in place to guard against the possibility of an abuse of dominance, the MoD is not seeking an exclusion from Chapter II of the Competition Act 1998.

Public Policy Exclusion for Chapter I

4.15 Paragraph 7 of Schedule 3 of the Competition Act 1998 provides that:

“(1) If the Secretary of State is satisfied that there are exceptional and compelling reasons of public policy why the Chapter I prohibition ought not to apply to –

(a) a particular agreement, or

(b) any agreement of a particular description,

he may by order exclude the agreement, or agreements of that description, from the Chapter I prohibition.

4.16 It is the MoD's understanding that the need to protect national security has in the past been considered an "*exceptional and compelling reason of public policy*" as required by paragraph 7 of Schedule 3 (see the Competition Act 1998 (Public Policy Exclusion) Order 2006, SI 605 and the Competition Act 1998 (Public Policy Exclusion) Order 2007, SI 1896. On this point, it may also be of relevance to refer to Section 42 of the Enterprise Act, which deals with the intervention of the Secretary of State in certain public interest cases. Section 42(3) provides that a public interest consideration is a consideration which is specified in Section 58. This section specifies "*the interests of national security*" as a public interest consideration and goes on to say that national security includes "*public security*", as defined in Article 21(4) of the EC Merger Regulation. Article 21(4) states that public security shall be regarded as a "*legitimate interest*" which Member States may take appropriate measures to protect.

4.17 The MoD is of the view that the anti-competitive practices identified above in relation to the Chapter I Prohibition qualify for a public policy exclusion on the grounds of national security. The relevant essential security interest here is the maintenance of an independent nuclear submarine fleet. Nuclear submarines are connected with the production of or trade in arms, munitions and war material and the Collaboration is a measure necessary for the protection of the essential interests of UK security because without it there will not be the necessary cost savings, which would mean that there would need to be cut backs in the planned current submarine programme. It is likely that this would result in the UK no longer having a sovereign industrial and skills base to design, build and support nuclear submarines. The need to preserve UK sovereign capabilities and technologies is considered essential for the protection of national security. This objective was highlighted in the Ministerial Foreword to the DIS which states: "*In this Strategy, we consider carefully which industrial capabilities we need to retain in the UK to ensure that we can continue to operate our equipment in the way we choose to maintain appropriate sovereignty and thereby protect our national security*" (emphasis added).

Small Firms Impact Tests

4.18 There are a large number of Small Medium Enterprises (SMEs) providing support to the Submarine Enterprise either direct to MoD; direct to a Tier 1 supplier; or as part of the wider supply chain.

4.19 In broad terms suppliers will be either:

- Specialist or niche within a specific market segment managed as a key supplier so as to maintain a sustainable sovereign capability; or
- part of a more competitive aspect of the submarine market; or
- part of a related competitive market that also provides support to the delivery of submarine capability.

4.20 The Collaboration recognises that a primary source of successful innovation lies within the supply chain which can often expose the best new technologies; innovative ways of delivering capabilities and business processes (including how to address business cultural issues). The promotion of SMEs will be one of the issues addressed by the Submarine Enterprise Supply Chain Council (SESCC), details of which can be found in the Consultation Response Document.

4.21 The MoD's intention is for the Collaboration to engage in dialogue with the wider Industrial Base about the shape of the future submarine programme including future opportunities to bid for work, and the potential for introducing new technology and innovation. The aim is to compete as many requirements as possible taking into consideration the demands of IPR and the need to retain and support key sovereign capabilities.

4.22 The success of the Collaboration will be measured in part by the health of the submarine supply chain - how it secures sovereign capability; encourages, identifies and exploits innovation; and provides a fair deal for SMEs as it seeks best value.

4.23 The MoD intends that the Collaboration will result in competitive opportunities for suppliers of products and services to the first tier. In part this is due to an intention during the Concept and Design phases to reduce the current heavy reliance on bespoke inputs and to have greater scope for use of Commercial off the Shelf (COTS) and Military Off the Shelf (MOTS) equipment and materials. This will support adopting a through-life approach on an Enterprise-wide basis where innovation is encouraged and managed through the effective insertion of new technology to improve the performance and value of submarine capability.

5 AFFECTED SECTORS AND GROUPS

5.1 The main affected sectors and groups are the Tier 1 suppliers and the supply chain.

Tier 1 Suppliers

5.2 Subject to the demonstration of VfM the use of the preferred option will mean that Tier 1 companies will work in collaboration with MoD for the long-term benefit of the Submarine Enterprise.

Supply Chain

5.3 As already identified the supply chain consists of a wide grouping across Tiers 2 and 3 covering sub-system suppliers to material suppliers whose views have been sought during the Consultation process, and MoD's response to their concerns is summarised in its Consultation Response. However an overriding objective of the implementation of collaboration is to ensure a self-sustaining and viable supply chain capable of supporting both new build and through-life support demands of the Submarine Enterprise. Greater certainty over the future of the Enterprise, the use of category management techniques and increased transparency will combine to support this objective.

6 IMPLEMENTATION AND DELIVERY

Introduction

6.1 This Section provides an overview of how the MoD anticipates monitoring both the PPEO and Collaboration.

Monitoring

6.2 Any Collaborative Agreement between MoD and the Tier 1 companies will be monitored against a range of criteria that will focus on VfM through assessing delivery of operational capability, sustainability, programme affordability and industry viability, including the sustainment of sovereign capabilities in the submarine sector.

6.3 Prior to the signing of any Collaborative Agreement the MoD and Industry's willingness and ability to work on a collaborative basis will be rigorously assessed, primarily through a set of

Confidence Building Measures (CBM). These will be a combination of hard programme deliverables (Business Case approvals; Contracts signed; etc) and behavioural issues that will assess the effectiveness and enduring potential of the joint working of the Industrial partners, and MoD, as well as internal organisational coherence for all Collaboration parties. It is envisaged that these CBMs, and their evolution, will form the basis of any Collaborative Agreement's Performance Measurement regime.

6.4 VfM - The MoD is aware that any procurement route it wishes to use must provide demonstrable VfM through the life of any arrangement agreed with Industry. While the specific mechanisms will need to be developed the MoD recognises the need for a suite of incentives that will drive transformation and efficiency at the Enterprise/Sector level and also for individual initiatives, contracts and projects.

6.5 Military Capability - Delivery against this objective will be measured at both project and sector level. Each project or initiative will be subject to rigorous scrutiny under the terms of the Collaborative Agreement consistent with the highest standards demanded by the MoD scrutiny process, including post project evaluation.

6.6 Industrial Capabilities - The MoD will periodically review the requirements for UK sovereignty through the DIS and Defence Technology Strategy (DTS) and, in conjunction with its overarching view of UK submarine capability, will actively manage any changes (through mechanisms on the Collaborative Agreement).

Implementation and delivery plan

6.7 Information Exchange - Once a PPEO takes effect, exchange of commercially sensitive data can take place, but this data will be restricted to that necessary for the objectives of the Collaboration i.e. no more restrictive of competition than necessary. Furthermore, the exchange of information will be ring fenced to the entities within each party that work on nuclear submarines.

6.8 MoD Internal Approvals - A Collaborative Agreement will be subject to internal MoD approval and agreement by the respective boards of the Industry partners. It will clearly articulate the means by which the Agreement parties will work collaboratively across the totality of the Submarine Enterprise programme articulating how this will be achieved commercially. The Collaboration parties will agree the precise measures and mechanisms that will drive the Collaborative Agreement including a programme of targets/milestones and a review process, which is envisaged will include a comprehensive annual review covering all key business, programme and commercial drivers within the Submarine Enterprise. It is envisaged that the Collaboration parties will agree Annual Targets based on the key outputs of the Submarine Enterprise and this will be directly linked to the Collaborative Agreement incentivisation mechanism.

6.9 Exit strategy - In the event that the MoD is not granted a PPEO it will still have to address the industrial issues described in DIS. In this context the MoD would adopt Option 2 to take sole lead negotiating bilaterally with the Tier 1 suppliers to attempt to drive through transformation and rationalisation at the sector level and across the totality of the Submarine Enterprise. Similarly should the collaborative approach not deliver the anticipated benefits the MoD would fall back to optimised bilateral arrangements.

6.10 Post Implementation Review - The PPEO will be formally reviewed after 3 years. The review will be led by MoD, but will involve an independent assessment. The Submarine Enterprise Collaborative Agreement will be reviewed annually against jointly agreed cost and benefit performance targets.

7 CONCLUSIONS AND RECOMMENDATIONS

7.1 In addressing the needs of the Submarine Enterprise the DIS identified the need to address the challenges of affordability and sustainability. In seeking to address these challenges the MoD has considered the following three options:

Option 1: Creation of a single industrial entity as envisaged by DIS, through a significant level of Industrial transformation

7.2 This option has many potential benefits of coherence and transparency that could make this the preferred option, including directly meeting the demands of DIS. However these remain theoretical due to the prevailing market conditions of three Tier 1 companies who wish to maintain their unique market status within the Submarine Enterprise. On this basis this option is not being taken forward.

Option 2: Optimising the existing commercial approach. Development of improved bilateral arrangements between MoD with the Tier 1 companies

7.3 This option would require the MoD to continue to negotiate and contract bilaterally with the three Tier 1 companies. It is considered a positive option with the potential for the delivery of significant benefit but is regarded as sub-optimal compared to Option 3. It would not provide a balanced or commercially coherent solution for the Submarine Enterprise because it would result in a series of separate but necessarily linked arrangements which MoD would have to integrate to provide submarine outputs. On this basis the option is judged to be sub-optimal, but as noted at paragraph 6.9 above it represents the MoD's fall-back position should Option 3 fail.

Option 3: Collaboration between MoD and the Tier 1 companies to jointly manage the Submarine Enterprise

7.4 This approach has the potential to deliver the most coherent and effective working arrangements between MoD and Industry by implementing a Collaborative Arrangement that enables access to benefit across the Enterprise over and above that that can be achieved under Option 2. The preferred option has the most potential to deliver the required outputs at best value for money by assigning clear roles and responsibilities thus enabling a holistic support to design, build and support, minimising duplication and maximising utilisation of skills and facilities.

7.5 In order to deliver the MoD's recommended option (collaboration) it is judged that an exclusion from Chapter I of the Competition Act 1998 is required. It is MoD's view that there are exceptional and compelling public policy reasons, namely national security, for such an exclusion to be granted.

Recommendations

7.6 The DIS specifically identified the need to retain UK capability in relation to nuclear submarines and recommended that it is the nature of the relationship with Industry that will help guarantee this capability. Subject to a formal MoD business case being submitted, MoD therefore judges that collaboration with the three Tier 1 companies offers the potential for the most cost effective, sustainable and affordable solution for the Submarine Enterprise. In order to achieve these objectives the following specific recommendations are made.

- MoD enter into a Collaborative Agreement with the Tier 1 suppliers. Subject to a formal MoD business case being submitted, the MoD judges that collaboration with the three Tier 1 companies offers the potential for the most cost effective, sustainable and affordable solution for the Submarine Enterprise.
- Collaboration will require the Tier 1 suppliers to work very closely together in order for the Collaboration to operate optimally and this will require the parties to share commercially sensitive information about their businesses and the supply chain (subject to confidentiality obligations).
- To enable effective collaboration it will be necessary to implement a PPEO that will allow MOD to achieve its policy aims of effective collaboration, while applying effective mechanisms to address the concerns identified during Consultation. In order for the Tier 1 companies to work together with MoD, and Tier 1 companies to share commercially sensitive data, a PPEO from Chapter I of the Competition Act 1998 is needed. The PPEO is therefore the enabler that will provide the means to quantify and deliver collaborative benefit.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes

No Annexes are attached to this Impact Assessment