



House of Commons

Committee of Public Accounts

Ministry of Defence: The construction of nuclear submarine facilities at Devonport

**Thirty-seventh Report of
Session 2002–03**



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*Report, together with formal minutes,
oral and written evidence*

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The Committee of Public Accounts

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Summary

In 1998 the Ministry of Defence (the Department) assured the Committee of Public Accounts that it was confident of delivering the project for the construction of nuclear submarine facilities at Devonport at the target cost of £576 million. Since then there have been very large cost overruns; and in August 2002 costs were estimated to total £933 million. The Department will meet nearly all of this, paying £890 million in total, £314 million more than its previous assurances to the Committee. By its own admission the Department has partly funded poor performance by Devonport Management Limited (DML), the prime contractor, met the cost increases resulting from nuclear safety regulation, and borne the cost of all other risks originally transferred to DML. Any further increases in the project's costs will be funded by DML but recovered from the Department via the submarine refit programme as an overhead charge.

The Department considered that the prime contract transferred the majority of risks to DML. In practice, however, the Department retained significant risks. It shared the design risk, as well as responsibility for satisfying the nuclear regulators. Because of the importance of the facilities to the UK's strategic nuclear deterrent, the Department could not accept any slippage. DML had limited funds and had negotiated a £35 million maximum liability and, if DML were to breach the contract, the Department would have had to bear the cost of completing the facilities—a risk highlighted by the Committee in 1998. Despite all these factors, the Department originally took a 'hands off' approach to the management of the project.

On the basis of a Report by the Comptroller and Auditor General we took evidence from the Department, the Nuclear Installations Inspectorate, and DML on 7 April.¹ We considered the need for the main parties to work together; whether the Department's attitude to risk transfer was realistic; and the risk of further increases in the final cost to the taxpayer.

We draw the following main conclusions from our examination.

- The main parties to this project did not come together early enough to engage on those issues which were key to its successful implementation. The Department, DML, and the nuclear regulator began work on the project four years before contract signature. Despite this, work on the detailed design, safety cases and construction did not progress smoothly. The parties failed to establish in advance how the civil nuclear regulatory regime would apply, and what the role and responsibilities of each would be. As a result, there were unforeseen additional requirements and design and construction work had to be redone at significant cost.
- The Department's attitude to risk transfer was unrealistic. As it considered that it had transferred the great majority of risk to DML, it took a hands-off approach to

¹ C&AG's Report, Ministry of Defence: *The construction of nuclear submarine facilities at Devonport*, (HC 90, Session 2002–03)

the project's management. In certain areas, however, risks were shared with the Department retaining significant design and nuclear responsibilities. The true extent of any transfer had also been limited by DML's maximum liability, and there were higher-level risks which the Department could not transfer, such as the impact on the United Kingdom's strategic nuclear deterrent if the facilities were late. Before entering into a contract, departments should undertake risk assessments which cover not only the risk allocation explicitly set out in the contract but also those higher-level risks which lie outside it. Contracts should contain the necessary monitoring and control mechanisms to enable departments to manage effectively those risks they retain.

- From a situation where DML supposedly bore the majority of risk, the Department now bears virtually all risk itself. It has agreed to meet the great majority of the cost increase to date, and has, in effect, assumed liability for any further cost overruns as it has placed no limits on DML's capitalisation of additional costs. The Department will also contract separately for the final phase of the project. It will need to exert tight control over the remainder of the project to avoid further increases in the cost to the taxpayer.

1 The need for the main parties to work together

1. There were a number of factors on this project which made it imperative for all main parties to work closely together from the start. For example, the Department faced considerable time pressures. There was an immovable completion date as the new facilities had to be ready for the first of the nuclear ballistic submarines, HMS Vanguard, to enter dock in February 2002. Failure to meet this date would have impacted on the effectiveness of the United Kingdom's strategic nuclear deterrent.² Despite this, the contract was not let until 1997, even though the decision to build the facilities at Devonport had been taken in 1993.³ As a result there was a risk that increased costs might be incurred recovering from any delays. The Department acknowledged that it should have tried to let the contract earlier.⁴

2. The project was also technically challenging. The regulatory regime governing the project required the new facilities to be designed, built and operated to exacting modern safety standards. These standards had first been published by the Nuclear Installations Inspectorate in the late 1970s and early 1980s and last revised in 1992.⁵ The Department had run other large nuclear projects at Faslane and Rosyth prior to this one and these had experienced significant cost overruns of between 70 and 90%, mainly as a result of the work necessary to satisfy nuclear safety requirements. These projects were neither as large nor as complex as Devonport.⁶

3. To reduce the possibility of delays and cost overruns, the Department funded some preparatory nuclear safety case work prior to contract award, enabling DML to submit its first preliminary safety report to the Nuclear Installations Inspectorate in 1994. In line with one of the lessons from the Trident Works Programme the Department had also employed its own independent nuclear advisers, Allott & Lomax, at a cost of £14 million, to produce a risk register. Despite these efforts, subsequent work on the detailed design, safety cases and construction did not progress smoothly. The Nuclear Installation Inspectorate considered that the next set of safety cases, submitted by DML in late 1998, were inadequate and it withheld its approval for the start of the construction of the Vanguard facilities.⁷

4. In order to maintain the project's progress, DML had begun construction work. Consequently, when the Nuclear Installations Inspectorate found deficiencies in the safety cases, DML had to undertake expensive reworking, sometimes involving the design and construction of additional requirements. For example, DML's original plans included the construction of a low level refuelling facility. In response to the

2 C&AG's Report, paras 6, 1.8; Qq 1, 13, 177

3 8th Report from the Committee of Public Accounts, *Ministry of Defence: Sales of the Royal Dockyards* (HC 96, Session 1998–99) paras 50, 52

4 Q 13

5 C&AG's Report, para 1.7 and Figure 5; Qq 9, 147

6 C&AG's Report, para 3.18

7 *ibid*, para 2.20; Qq 148–149, 178, 180, 202–203; Ev 25

Inspectorate's concerns in 1994 about the risk of ships colliding with the facility, DML included in its 1998 safety case designs for the construction of a crash barrier.⁸

5. The design of the facilities was evolving at the same time as they were being constructed and one lesson is that it would have been better to complete the design and the safety case up front before committing to construction. The Department has adopted such an approach for the final phase, the upgrade of the Submarine Refit Complex, and is taking a similar approach on other major defence contracts.⁹

6. The project's time pressures added to the cost increases.¹⁰ Both the Department and DML needed to have the facilities completed on time and to the right standards. The Department was concerned to maintain the effectiveness of the nuclear deterrent (paragraph 1), while DML was eager to generate income from submarine refitting and refuelling, worth about £250 million a year.¹¹ Consequently, DML may have implemented higher cost solutions in response to the regulators' queries in order to save time.¹² The Department rejected, however, the suggestion that their joint interest led to a cosy relationship whereby the project was bailed out by the taxpayer.¹³

7. All the main parties pointed to a number of novel features (**Figure 1**). The nuclear safety standards themselves were clear and were in force before the project began and had not changed during the project (paragraph 2). But difficulties arose in finding engineering solutions which met these standards and this proved much more complicated than any of the parties originally envisaged. The Department admitted that it would have been better if it had engaged earlier in the actual process of applying the nuclear regulatory standards.¹⁴

Figure 1: Novel features of the project¹⁵

- The project was very large and it was the first time that DML had handled a project of this size.
- The project was extremely complex, involving nearly every engineering discipline: civil engineering, mechanical engineering and process chemical engineering. The new facilities were to be constructed on a brownfield site on docks which were originally built in 1904.
- The project involved the first application of civil nuclear regulatory standards to the development of a major defence system where the licensee was not the Department but a civil operator.
- This was the first major nuclear construction project where there was dual regulation with the Nuclear Installations Inspectorate and the Department's own regulator, the Chairman of the Naval Nuclear Regulatory Panel, working together.

8 C&AG's Report, para 2.24; Qq 151, 201, 234; Ev 23–24

9 C&AG's Report, paras 14, 1.18, 2.24; Qq 11, 13, 53–54, 265

10 Q 1

11 C&AG's Report, para 1.8; Qq 43, 64

12 C&AG's Report, paras 12, 2.24

13 Q 156

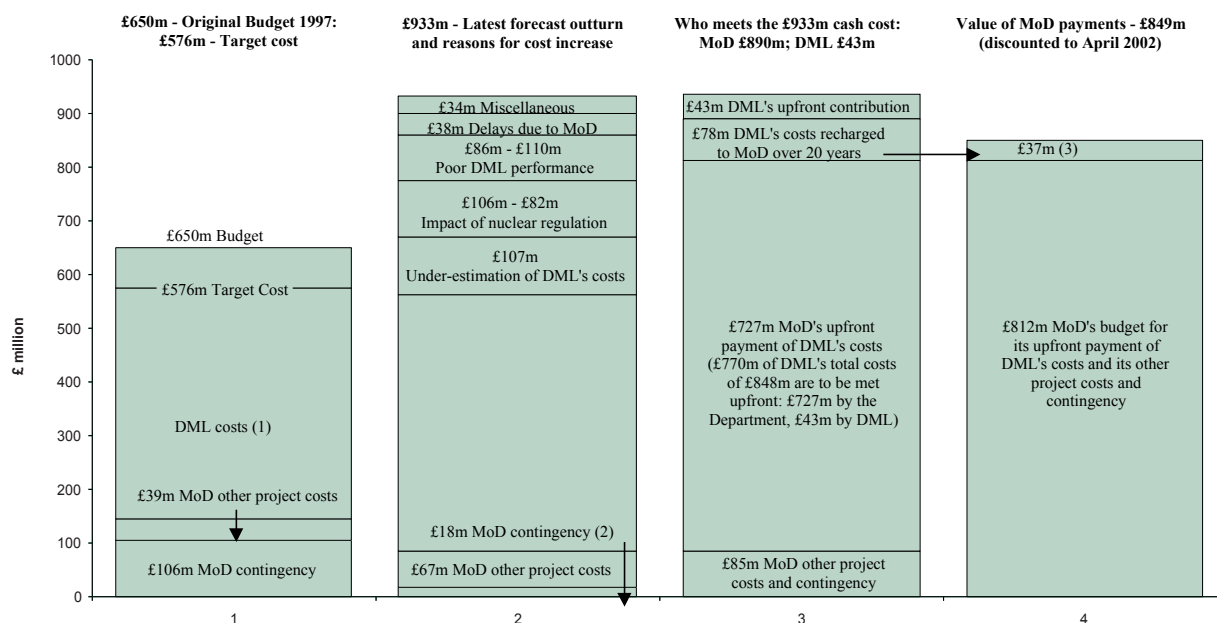
14 C&AG's Report, Figure 5; Qq 1, 9–10, 109, 114, 145–147, 235, 262–263, 267

15 Qq 1–2, 36, 146, 206, 262, 266

8. The Nuclear Installations Inspectorate's usual approach to regulation is to deal only with the nuclear licensee for a site and had consequently dealt mainly with DML. It declined attempts by the Department at working level to engage directly with it on the project. In response to the problems encountered with the safety cases submitted by DML in late 1998 (paragraph 3), the Inspectorate changed its approach and agreed that it, the Department and DML should work more closely together to solve the problems. This new approach was agreed in June 1999, some 18 months after the contract was let. The Inspectorate admitted that it would have been better if it had adopted this approach earlier.¹⁶

9. The problems in meeting nuclear safety standards resulted in a significant increase in the cost of the project, although the Department and DML disagreed as to the exact size. The Department estimated the cost impact of these problems at between £82 million and £106 million (**Figure 2**), and that the regulatory problems contributed to the £107 million under-estimation of DML's sub-contracting costs. Poor performance by DML and its subcontractors also had a significant impact on the costs of the project, resulting in increases of between £86 million and £110 million.¹⁷ DML disagreed and estimated that its mismanagement caused extra costs of only £20 million. In its opinion, the fundamental cost driver was the need to meet nuclear regulatory requirements.¹⁸

Figure 2: The costs of the project and who meets these, as at December 2002



Notes:

1. DML was entitled to a maximum price of £505 million. If its costs reached this level, it received zero profit. If it delivered the facilities for the target cost of £394 million, it was entitled to profit and project management costs of £37 million.
2. The Department's original estimates included contingencies of £106 million. The Department used £88 million of this towards the increase in the cost of the project, leaving £18 million to meet the risks remaining on the project.
3. Allowing for annual inflation of 2.5% and using a discount rate of 6%, the payment by the Department of £78 million over 20 years is equivalent to £37 million at April 2002.

Source: Data from the C&AG's Report

16 C&AG's Report, paras 2.21; Qq 36, 203, 268–269, 271

17 C&AG's Report, para 2.25 and Figure 1; Qq 35–36

18 C&AG's Report, paras 12, 2.26–2.27; Qq 36, 40–41

2 A realistic attitude to risk transfer

10. In 1997 the Department awarded a Prime Contract for the delivery of the submarine facilities to DML. This was in line with the lessons learned on the Trident Works Programme where it had contracted with a number of different firms itself. Under the contract there was to be a significant transfer of risk to DML.¹⁹ The Department subsequently took a hands-off approach to the management of the project as it considered that, as DML had accepted significant risks under the contract, DML should be left to manage these without undue interference by itself. Such interference could result in risk being transferred back to the Department.²⁰

11. Prior to contract award, there had been a 60% increase in the estimated cost of the project.²¹ The Department considered that the payment arrangements in the contract protected it from further cost increases. It would pay at most a maximum price of £505 million and DML would be liable for all costs above that maximum. DML also had an incentive to deliver the facilities below this price as it was only then that it started to earn a profit on the contract (**Figure 2**).²²

12. Such a view, however, was unrealistic as there were factors which limited the amount of risk actually transferred to DML. For example, certain risks were shared, with the Department retaining significant design and nuclear responsibilities. The contract allowed the maximum price payable to DML to be increased should extra costs arise in these areas of the Department's responsibility. On this project, DML argued that the majority of the cost increases were of this type.²³

13. There was also a risk that, even if the extra costs arising should have been borne by DML, DML would not have been able to meet these costs itself as it lacked the necessary financial capacity. It only had available to fund such increases its net assets, valued at £60 million in June 2002, and a parent company guarantee of £35 million from its major shareholder. As part of the contract negotiations, the Department agreed a £35 million limit on DML's liability, which effectively limited the amount of risk transferred to DML. There was always the possibility that, should significant problems arise, DML might choose not to honour the contract and thus limit its losses to £35 million. In this situation, the Department would have had to bear the cost of completing the facilities—a risk highlighted by our predecessor Committee. The Department was massively exposed as the actual cost of the project was 27 times this liability.²⁴

14. The Department retained higher-level risks which it could not transfer. Because of the importance of these facilities to the maintenance of the effectiveness of the United Kingdom's strategic nuclear deterrent, the Department could not accept the contract's

19 Qq 10, 48, 196, 212

20 Qq 10, 93

21 8th Report from the Committee of Public Accounts, *Ministry of Defence: Sales of the Royal Dockyards* (HC 96, Session 1998–99), para 6 (xv)

22 C&AG's Report, para 2.5 and Figure 10; Qq 211, 226, 230, 251

23 C&AG's Report, paras 3.10–3.13

24 *ibid*, paras 3.20–3.21; 8th Report from the Committee of Public Accounts, *Ministry of Defence: Sales of the Royal Dockyards* (HC 96, Session 1998–99), para 6 (xvi); Qq 16, 18–20, 23, 28, 197

failure and the resulting late delivery of the facilities. If DML were to fail, the Department would be left with the responsibility of putting in place alternative arrangements for completing the facilities and of managing the impact of DML's failure on its defence activities. There were no realistic alternative arrangements which could be put in place in the timescale required. At the end of the day, the Department was always going to have to pay for the facilities and thus bear the ultimate risk of their completion.²⁵

15. Prior to the award of the contract the Department had had concerns about DML's ability to manage a project of this kind. The Department, however, had little option but to contract DML as DML was the licensee for the site. Also, one lesson from the Trident Works programme was that the contract for the facilities' construction should be placed with their users. Appointing a different construction contractor would have added to the project's complications. The Department had gained more confidence about DML's ability prior to contract award when Brown and Root became part of DML's team on the project.²⁶

16. The Department's hands-off approach meant that it was not well placed to act when things went wrong. For example, the Department had no contractual right to information on DML's cost forecasts. Under the prime contract it was for DML to complete the work as cheaply as it could in order to make a profit. For the first 18 months after 1997 DML provided the Department with cost spent data rather than cost forecast data. The Department only became aware of cost increases when DML began to submit a series of claims in 1999. At that point there were detailed discussions between the Department and DML and joint cost studies to identify the extent of DML's forecast costs. These revealed during 2000 that DML's costs were rising month on month, from £585 million in February 2000 to £730 million in December 2000, a 25% increase.²⁷ The Department is now taking a more hands-on approach to the project's management and exercising close scrutiny.²⁸

17. Construction projects in central government, but not in defence, are now subject to the Gateway Review Process, under which a team from the Office of Government Commerce carries out a series of reviews during a project at key stages. There is no guarantee that, if this Process had been applied on this project, the cost overruns would have been avoided. However, experience to date has shown that Gateway Reviews have benefited the projects involved. The Department is currently piloting the use of the Office of Government Commerce to conduct Gateway Reviews on ten equipment acquisition projects.²⁹

25 C&AG's Report, paras 3.19, 3.23–3.24; Qq 14–15, 26, 212

26 C&AG's Report, para 2.15; Qq 16, 27, 91, 102–104

27 C&AG's Report, paras 3.3–3.4, 3.6 and Figure 12; Qq 49–51, 94, 191–193, 251–252, 256

28 Qq 10, 53

29 C&AG's Report, para 25

3 The revised allocation of risk

18. In December 2001 the Department signed a revised contract with DML. Under the terms of this the Department has agreed to meet most of the increases in DML's costs (Figure 3).

Figure 3: Terms of the revised contract³⁰

- The Department will meet £727 million of DML's costs below £770 million, DML £43 million (Figure 2).
- DML's costs above £770 million will be met by DML in the first instance. It will then, under the 1997 agreement for the dockyard's sale, capitalise these costs, recovering them from the Department over 20 years as overheads as part of its charges for submarine refit work. The Department's latest estimate of these payments over 20 years is £49 million.
- There is no limit on the costs above £770 million which can be capitalised.
- DML will not receive any fee. It had been entitled, under the original contract, to a profit which could have been as much as £30 million.
- The Department and DML have waived their rights to claim against each other for negligent behaviour and poor workmanship or management.

19. The Department placed no limit on the costs above £770 million which DML can capitalise. It believed that the capitalisation arrangement was sufficient incentive for DML to contain its costs. Firstly, the Department has to agree that the costs incurred by DML are legitimate. Secondly, DML will have to borrow money in order to meet these additional costs itself in the first instance. It will therefore be less able to raise money for other purposes, inhibiting its flexibility. DML also has to meet the financing costs of this extra borrowing.³¹

20. The Department had little alternative to negotiating a new contract. If it had sought to enforce the original contract at law and won, it would have been a pyrrhic victory. There would have been massive dislocation of the work as DML would have been put out of business and the Department would have had to arrange for a new contractor to complete the facilities and refit the submarines. It was by no means certain, however, that the Department would win as the legal position was disputed. If DML had won, the Department would have still ended up paying and there would have been dislocation associated with legal action.³² The Department did not use other alternative methods for resolving the problems on the contract, such as arbitration or adjudication, as these methods could have been lengthy and there was no guarantee of success.³³

21. The Department's current project budget of £812 million only covers the £727 million upfront payment of DML's costs that the Department will make, in addition to

³⁰ C&AG's Report, paras 3.28–3.29, 3.33, 3.37; Qq 11, 32, 36, 64, 93, 175–176

³¹ Qq 11, 32, 63, 65

³² Qq 7, 29, 156–157, 261

³³ C&AG's Report, para 3.9; Q 167

its own costs of £85 million (**Figure 2**). The budget does not include DML's costs over £770 million which will be capitalised. Consequently, there is a risk that the Department will pay less attention to controlling these capitalised costs as they will be paid by the Department over twenty years, and not as the facilities are completed.³⁴

22. The final cost of the project is still uncertain. The Department was confident that the project would cost less than £940 million, £920 million on its most likely estimate plus or minus £20 million. The Department has, however, given the Committee assurances about this project in the past which have proved misplaced. In addition, the estimate of £940 million excluded the cost of the project's final phase, Phase 3—the upgrade of the Submarine Refit Complex.³⁵ Although the Department has included provision for this phase in its current project budget of £812 million, the final scope of the work has yet to be determined.³⁶

23. Both the Department and DML gave the Committee assurances that all the facilities needed for the refit of HMS Vanguard would be ready on time. There was only one safety case left related to power range testing. Defuelling had already commenced and refuelling was expected to start in June 2003.³⁷ One facility, the final part of the Primary Circuit Decontamination building, will not be completed until December 2003, after HMS Vanguard's refit but in time for that of the second Vanguard class submarine in 2004. The late completion of this final part was only acceptable because HMS Vanguard had low radiation levels. These low levels enabled DML to use an alternative method, involving the use of lead shielding, for the refit work. This alternative method will not be possible on the next submarine which requires a fully-functioning Primary Circuit Decontamination building.³⁸

34 C&AG's Report, para 3.34

35 Qq 1, 11, 62, 80, 85, 89–90

36 C&AG's Report, paras 2.6, 2.10

37 Qq 59–60, 63

38 C&AG's Report, para 1.20

Conclusions and recommendations

The need for the main parties to work together

1. The project had an immovable completion date and it was essential that the implications of the nuclear regulatory regime were fully understood by all. The major parties did not engage quickly enough and the project did not progress smoothly, resulting in delay and extra costs. The Department had the vital role in ensuring that all key stakeholders understood each other's requirements and it should have got the main parties to work together from the start. In future departments should engage quickly with all key parties and explicitly agree roles and responsibilities, setting these out in a memorandum of understanding.
2. The Department's experience on other nuclear projects should have alerted it to the risk of significant cost increases on this project arising from the need to meet nuclear safety standards. Despite using expensive advisers, the Department did not establish in advance how the regulatory regime and the nuclear standards would apply in detail to this project. The Department should have established much more precisely what the practical application of these standards entailed.

A realistic attitude to risk transfer

3. There was a strong possibility that risks might return to the Department if significant problems arose. There had been a large increase in cost prior to contract award, and the Department had had doubts about DML's capabilities DML did subsequently perform poorly in some respects. In addition, DML did not have the financial capacity to meet large cost overruns and had limited its liability under the contract – a fact we highlighted in 1998. The Department failed to recognise these risks and presumed that the prime contract transferred significant risk to DML, a fundamental mistake. Before placing contracts, departments should consider explicitly the probability and impact of those risks that might return to them.
4. In carrying out their risk evaluation and in formulating their approach to contracting, departments should seek the views of an external expert, such as the Office of Government Commerce under the Gateway Review process. The Department is piloting these Reviews in its equipment acquisition projects and should, as a first step, extend the pilot to include all new major construction projects.
5. Departments need to take a more sophisticated approach when deciding on the degree of their supervision of a project. Management approaches include: a hands-off approach, but with appropriate monitoring mechanisms; a partnering approach whereby parties work closely together; and the department taking over the project. In this case the Department adopted a hands-off approach but, given the risks it retained, a partnering approach would have been better. It would then have had a better understanding of the risks, more information on the problems faced and their impact on costs, and a greater role in deciding the actions taken to

tackle these problems. Where projects are of critical importance and high risk, departments should consider a partnering approach and develop a joint understanding of risk allocation with their contractors.

The revised allocation of risk

6. The novel arrangement whereby DML charges its costs over £770 million to the Department over 20 years lies outside usual project approval and monitoring controls. It also means that the contract is on a cost pass-through basis, with the Department effectively assuming liability for further cost overruns. The Department should therefore exert tight control over DML's costs. It should include these excess costs in its project budget and establish monitoring arrangements that enable it to disallow costs which are unreasonable, and to demand corrective action. As other departments and contractors might want to enter into similar arrangements, the Department should conduct a review of lessons learnt from this mechanism.
7. The Department is confident that the cost of the main work will not exceed £940 million, but this estimate excludes the cost of the project's final phase. The Department's current budget of £812 million includes a provision for this final phase but it is not yet clear whether this provision will be sufficient. The Department should revise its budget to include the firm cost of this phase, when known, together with the capitalised sums charged by DML for the earlier phases, so that there is clear accountability for the project. The Department should also implement lessons learnt from the earlier phases: the requirement for the main parties to work together; the need to complete design and safety cases before construction; and adopting partnering.

Formal minutes

Monday 30 June 2003

Members present:

Mr Edward Leigh, in the Chair

Mr Ian Davidson

Geraint Davies

Mr Nick Gibb

Mr Brian Jenkins

Mr George Osborne

Mr David Rendel

Jon Trickett

Mr Alan Williams

The Committee deliberated.

Draft Report (Ministry of Defence: The construction of nuclear submarine facilities at Devonport), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 23 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Thirty-seventh Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

Adjourned until Wednesday 2 July at 3.30 pm

Witnesses

Monday 7 April 2003

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Sir Kevin Tebbit KCB CMG, Ministry of Defence, **Mr John Coles**, Warship Support Agency, **Mr Laurence Williams**, Nuclear Safety Directorate, **Mr Jim Furness**, Health and Safety Executive, **Mr Anthony Pryor CBE**, and **Mr Dennis Gilbert CBE**, Devonport Royal Dockyard Ltd

Ev 1

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