

Review of Single Source Pricing Regulations

A Summary of Public Consultation Responses

March 2012

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An independent report by Lord Currie of Marylebone

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Introduction

1. Single source procurement has accounted for around 43% of Ministry of Defence (MOD) total procurement over the last 5 years¹. Current arrangements for single source procurement have been in place for over 40 years and it is clear that they are no longer fit for purpose. However the particular nature of the defence market means we will still have to place some large non-competitive contracts for military equipment, where there are a limited number of suppliers or where we need to protect our operational advantage or freedom of action.
2. It is essential that the arrangements for single source procurement ensure Value for Money for the UK taxpayer in today's commercial and economic environment.
3. Consequently on 26 January 2011 the Minister for Defence Equipment, Support and Technology asked Lord Currie of Marylebone to produce an independent report containing proposals for the creation of a framework for modern, fit for purpose commercial arrangements for single source contracts.
4. Lord Currie delivered his Review of Single Source Pricing Regulations² on 10 October 2011 and within this context the Government undertook a public consultation.
5. Lord Currie's recommendations focus on achieving greater transparency of costs and strengthening industry's incentives to be efficient. The benefits that could potentially be gained from implementing the recommendations in the report include:
 - A more open relationship between MOD and defence industry
 - Greater support for Small and Medium Enterprises
 - Greater transparency over the costs industry attempt to pass on to the MOD
6. Lord Currie's review is part of a wider defence transformation agenda and, as detailed in National Security Through Technology: Technology, Equipment and Support for UK Defence and Security³, MOD will, wherever possible, seek to fulfil the UK's defence and security requirements through open competition in the domestic and global market.

Consultation proposal

7. Lord Currie's independent report set out 9 Key Recommendations and 14 Ancillary Recommendations, reproduced in full at Annex A, designed to deliver Value for Money to the taxpayer, foster a culture of efficiency within the defence industry and provide a fair return for industry.
8. Public views were invited on these recommendations and more widely on the general content of the report.

1. UK Defence Statistics 2011, Table 1.15, MOD
2. http://www.mod.uk/NR/rdonlyres/894BD700-CE90-43AD-AD52-A94E681AC86B/0/review_single_source_pricing_regs.pdf
3. <http://www.mod.uk/NR/rdonlyres/4EA96021-0B99-43C0-B65E-CDF3A9EEF2E9/0/cm8278.pdf>

Consultation process

9. The consultation was open from 10 October 2011 until 3 February 2012 (17 weeks). The consultation document (the report) was available on the website www.defenceconsultations.org.uk and responses could be made directly on the website (visible to all), by email, via trade bodies or by post.
10. Hard copies of the report were delivered to major single source providers, to trade bodies, across Government, to MOD staffs and to industry stakeholders (such as the Confederation of British Industry, AIDIS⁴, the Review Board for Government Contracts and the Joint Review Board Advisory Committee). In addition the Department's top 10 (by value of business) single source suppliers and contractors with any current single source contracts over £50 million in value were invited to discuss the report with the MOD team that is taking forward Lord Currie's report.
11. As might be expected, due to the specific nature of the report, responses to the consultation were generally limited to those parties with an interest in the arrangements. While individual aspects of the consultation website received a total of 846 views, a total of 22 written responses were received (via the consultation website, letter and email), 19 of which were from defence industry, or defence industry trade bodies, the remaining being from interested members of the public. A list of the organisations who responded is at Annex B.

Summary of Responses

12. While respondents generally accepted that there was a requirement for a review of current single source arrangements, views were divided on Lord Currie's recommendations. Most respondents provided comment on those recommendations of particular interest to them; few commented on all aspects of the review. A table showing the level of response by topic is at Annex C.
13. The general theme emerging from the public consultation was the need to provide further definition of all Lord Currie's recommendations and the desire to involve industry and wider stakeholders in more detailed discussion on any proposed changes to existing arrangements (see paragraph 56).
14. Key recommendations 1 – 5 and 7 and ancillary recommendations 2 and 9 generated the highest volume of comment. These recommendations focussed on the need for improved reporting requirements, the use of 'risk free' profit rates as the basis of negotiation, the improvement of MOD's skills base and the introduction of an independent body to implement and manage Lord Currie's recommendations. The remaining recommendations received limited responses commonly of a specialist nature by those closest to the current arrangements.
15. A summary of comments received from the public consultation, by key and ancillary recommendations is shown below.

4. AIDIS – Aerospace, Defence and Security Trade Association

Key Recommendation 1: Open book accounting.

16. Most respondents accepted the principle behind this recommendation. Indeed many of our larger contractors stated that they already provided significant information and welcomed the continued use of Equality of Information rights under existing DEFCON 648/648A arrangements. However, some commented that these existing arrangements already give MOD access to information, and contested that additional data was therefore unnecessary. Some respondents stated that, if implemented, the requirement may be too onerous on contractors without delivering a defined benefit.
17. The majority of respondents commented that the term 'Open Book' required fuller definition than contained in the Review and recommended that further guidance was needed on what 'Open Book' might mean in practical terms.

Key Recommendation 2: All contracts above a threshold value of £50 million should be reported on regularly by the contractor.

18. Respondents were almost equally divided in either accepting or rejecting this recommendation. Concern was raised regarding the cost of providing the required information and the confidentiality of that information once provided.
19. Those who were concerned recognised the potential cost of providing standardised format reports which could require a new system to be developed by industry, if the required reports did not map onto their current systems. In addition some expressed concern that too much data would be requested and MOD would not have the right skills sets to adequately analyse what is being asked for.
20. Respondents were concerned that commercial confidentiality may be at risk if their data was subject to the Freedom of Information Act 2000⁵ once passed to the MOD (or any other public body). If provided, contractors expressed the need to know what the information would be used for to ensure it did not damage commercial advantage or breach their confidentiality rights.
21. Some commented that the rationale for setting the threshold at £50 million needed explanation and any threshold set would need to be reviewed on a regular basis.
22. Some expressed concern that annual certification with Board approval indicated a lack of trust between MOD and suppliers.

Key Recommendation 3: DEFCON 648A should be modified.

23. A minority welcomed this recommendation and respondents clearly recognised that profit can incentivise efficiency.
24. While most respondents wished to see DEFCON 648A withdrawn in entirety, as it may be

5. <http://www.legislation.gov.uk/ukpga/2000/36/contents>

viewed as a barrier to efficiency due to the financial treatment of efficiency gains, some thought the sharing arrangement could be amended, but using a different basis from that shown in the Review.

Key Recommendation 4: An Overhead Report should be submitted annually.

25. Similar to Key Recommendation 2, respondents commented that MOD already has existing access to overhead data, there were concerns regarding the cost of providing this information and the confidentiality of information once provided. Some commented that it was accepted that MOD needed reassurance that overhead costs were reasonable.
26. Respondents asked for further definition to understand what the information would be used for.

Key Recommendation 5: The implicit starting point for the contract profit allowance should be a 'risk free' profit rate.

27. Most respondents agreed that profit and risk needs to be better aligned, but it was also recognised how difficult this was in a single source environment hence previous attempts to remedy this situation had not been successful. However, respondents did not accept that the 'risk free' rate should be the starting point for profit allowance and noted that industry should be able to make a fair return on investment.
28. Most respondents favoured the continuation of existing comparability principles shown in Section 3 of the Government Profit Formula and its Associated Arrangements⁶.

Key Recommendation 6: The SSRO (Single Source Regulations Office) should provide an independent review of the realism of budgets.

29. Respondent's views were mixed on this recommendation.
30. It was generally accepted that MOD could improve its budgetary process and MOD should set efficiency targets, but this should be across the board rather than on single source contracts alone.
31. Some respondents commented that MOD should retain budget management rather than delegate it to an advisory body; others thought it would be a good idea for an independent view on MOD's budgets.
32. Most respondents recognised the need for 'realism' in MOD's budgetary process, but raised concern that this may introduce delay into MOD procurement procedures.

6. Government Profit Formula and Its Associated Arrangements – May 2011 version - http://www.mod.uk/NR/rdonlyres/A2A77893-F532-4B53-847B-DFA0D73AD5BE/0/gpf_assoc_arrangements_May2011.pdf

Key Recommendation 7: The Review Board should be replaced by the SSRO.

33. Respondents raised several themes on the creation of a SSRO – funding, governance, independence and legislation.
34. Almost all respondents rejected the proposal of funding a SSRO through a 0.10% levy on profit.
35. Respondents recognised the role played by the current Review Board for Government Contracts, especially in their arbitration role, and some considered that this role could be expanded, rather than create a new body. Respondents expressed the need to retain a form of arbitration procedure, either through the continuation of the Review Board or another body.
36. The requirement for the SSRO to be independent from MOD was noted and some respondents challenged the ability of the SSRO as envisaged by Lord Currie to provide the appropriate level of independent assurance and to adequately protect their commercial information.
37. This recommendation included the creation of a Code of Conduct to implement Lord Currie’s recommendations; respondents accepted this as the most practical method of implementation. Legislation was viewed as likely to be inflexible and inappropriate in the circumstances.

Key Recommendation 8: Single Source contracts in excess of £5 million in value but less than £50 million should be exempt from a number of Single Source Pricing Regulations reporting requirements.

38. This recommendation prompted little comment and was usually considered in conjunction with Ancillary Recommendation 9 (see paragraph 49); respondents supported reduced reporting requirements for lower value contracts. Although some suggested that the thresholds required explanation and should be subject to regular review.

Key Recommendation 9: Contractors with single source contracts totalling above £100m in value should produce an annual statement on their contracting with SMEs.

39. While this recommendation did not receive significant comment, respondents recognised Government policy on increasing SME participation in public procurement and accepted the need to monitor the use of SMEs in their supply chains. Most respondents commented on the benefits SMEs brought to their business. Some felt that this may be better recorded on a contract-by-contract basis rather than via an annual statement.

Ancillary Recommendation 1: The current adjustment to the profit allowance for intercompany trading should be removed.

40. Respondents were generally silent on this ancillary recommendation.

Ancillary Recommendation 2: The GACs should include the general provision that costs charged to the MOD should be both reasonable and appropriate.

41. Responses regarding this ancillary recommendation views were conflicting, either seeing this as consistent with the spirit of existing arrangements or at odds with the current 'exception' basis of cost reporting.

Ancillary Recommendation 3: We recommend that the MOD should establish clear rules on the permitted commercial constructs.

42. This ancillary recommendation was accepted as sound, although some respondents considered the use of DEFCONs limited the opportunity to create good commercial constructs.

Ancillary Recommendation 4: TCIF should be fixed to a 50/50 share between the MOD and contractors.

43. The limited responses to this recommendation accepted that a 50/50 share was a reasonable starting point to commence negotiation from, provided it could be flexed in recognition of varying scenarios and circumstances.

Ancillary Recommendation 5: Review of the commercial construct.

44. Respondents were concerned that an independent review of commercial constructs may add time (and hence cost) to the procurement process.

Ancillary Recommendation 6: MOD should reconsider its policy on not using cost-plus contracts.

45. This recommendation was accepted by the few respondents who commented.

Ancillary Recommendation 7: Long term capacity and capability contracts should be used sparingly.

46. Respondents recognised existing long term and capability contracts and commented that they usually included efficiency targets and went on to question how Lord Currie's Review would impact on these arrangements, that may have many years left to run.
47. In general respondents considered that individual requirements dictated which commercial arrangements were appropriate.

Ancillary Recommendation 8: The open book and Equality of Information provisions recommended in Part 1 should extend to rates agreements.

48. Respondents accepted this as a natural extension to existing Equality of Information arrangements.

Ancillary Recommendation 9: If the MOD wishes to retain the current single source overhead recovery approach, it should continue strengthening the CAAS resource engaged in rates agreements and TCIF reconciliations.

49. Most respondents commented on this ancillary recommendation, seeing it as an avenue to welcome enhancement not only of MOD's CAAS resources but also to seek enhancement of MOD commercial, procurement and project management expertise. Wider upskilling of MOD (or SSRO) staff was viewed positively by all respondents.

Ancillary Recommendation 10: Large contracts should be subject to independent commercial due diligence and legal review prior to contract signing.

50. While this ancillary recommendation was not widely commented on, it was accepted as being sensible by those who did.

Ancillary Recommendation 11: Any technical change (or batch of changes) above a certain materiality level is subject to a separate investment appraisal.

51. Recognised by respondents as most likely being a matter of internal MOD policy, it was accepted as good business practice.

Ancillary Recommendation 12: For single source contracts below £5m in value, a simplified flat-rate level of profit should be applied.

52. While welcomed as potentially being beneficial to SMEs, respondents noted that there may be instances when a contractor's portfolio consists of many low value contracts. The question was whether this flat rate would apply to the whole portfolio.

Ancillary Recommendation 13: SSPR requirements should be flowed down from the first tier to the second tier of single source contractors.

53. Accepted by respondents, with the caveat that second tier contractors may need appropriate protection should there be a dispute between MOD and their prime contractors.

Ancillary Recommendation 14: As in the French system, export potential should be formally considered as part of the MOD capability requirement specification process.

54. Those that did respond to this ancillary recommendation accepted that MOD could consider exportability at the capability specification stage, but this may require capability trade-offs. Comparison with the French system may be inappropriate due to the estimated respective ranking in global defence export markets (where UK is a world leader).

Next steps

55. Lord Currie of Marylebone is grateful for all responses to the consultation. Lord Currie would like to thank everyone for submitting their views.
56. The MOD will now consider Lord Currie's review and the results of the public consultation. This will be followed by further engagement with industry and wider stakeholders on which aspects of the independent review will be taken forward for implementation.
57. This engagement will contribute towards creating MOD's future single source policy and arrangements, which we plan to publish along with an implementation plan in 2013.

Annex A – List of Lord Currie’s Key and Ancillary Recommendations

Key Recommendations

Key Recommendation 1: Open book accounting should be mandated on all single source contracts as a supplement to the Equality of Information provisions that exist under the current single source arrangements.

Key Recommendation 2: All contracts above a threshold value of £50m should be reported on regularly by the contractor, using a standardised format, with annual certification by the contractor’s Board.

Key Recommendation 3: DEFCON 648A should be modified from what is currently an overly protective regime to one that more strongly encourages contractors to reduce their cost base. We propose that the current 5% threshold, above which MOD receives automatic sharing, should be increased to 10% or 15%. We also recommend that the 75% MOD sharing arrangement might be better set at a lower percentage, such as 50%. We welcome views on these options, and alternatives, in the consultation phase.

Key Recommendation 4: An Overhead Report should be submitted annually by all contractors with aggregate single source contracts in excess of £100m total value. The report should have two distinct sections - Forward Planning, detailing planned overhead expenditure that will impact the prices of single source contracts; and Overhead Recovery, detailing under/over recovery of overheads on single source work during the reporting period.

Key Recommendation 5: The implicit starting point for the contract profit allowance should be a ‘risk free’ profit rate. Commercial leads should have to justify any movement away from the ‘risk free’ rate using an assessment of the contractor’s risk. The MOD should develop guidance for commercial negotiators to follow in assessing the extent of the allowance that should be added for risk in the profit allowance.

Key Recommendation 6: The SSRO should provide an independent review of the realism of budgets allocated to single source contracts to provide assurance to the MOD that single source contracts are in financial control.

Key Recommendation 7: The Review Board should be replaced by a Single Source Regulations Office (SSRO) with a remit to scrutinise single source defence procurement. The SSRO would define and maintain a framework that encourages efficiency and value for money in MOD single source procurement. It should be an independent Non- Departmental Public Body, sponsored by the MOD. After appropriate consultation, the SSRO should draw up a code of conduct and an associated special condition for inclusion within MOD single source contracts, and should monitor compliance by both industry and the MOD. It should have appropriate information gathering powers to enable it to assess the efficiency of contractors. It should also be charged with assessing whether the MOD is conducting its single source procurement so as to promote value for money for the taxpayer.

Key Recommendation 8: Single source contracts in excess of £5m in value but less than £50m should be exempt from a number of SSPR reporting requirements, for example, Quarterly Contract Reports. Below £5m, no specific SSPR reporting should be required, minimising the administrative burden for SMEs.

Key Recommendation 9: Contractors with single source contracts totalling above £100m in value should produce an annual statement on their contracting with SMEs. It should explain how relationships with SMEs are managed and the processes that the prime contractors have in place to support and foster SMEs in their role as subcontractors.

Ancillary Recommendations

Recommendation 1: The current adjustment to the profit allowance for intercompany trading should be removed, and contractors should be required to record costs charged to the MOD at their original cost to the group.

Recommendation 2: The GACs should include the general provision that costs charged to the MOD should be both reasonable and appropriate. This should be included in the contractors' annual Board certification (Key Recommendation 2).

Recommendation 3: There are clear situations where certain constructs are not appropriate. There is limited guidance on this in MOD commercial policy. We recommend that the MOD should establish clear rules on the permitted commercial constructs in various situations, and that for large contracts the chosen model should be independently reviewed prior to contract signing.

Recommendation 4: TCIF should be fixed to a 50/50 share between the MOD and contractors, mitigating the misuse of TCIF to meet unrealistic budgetary constraints, and balancing the incentivisation of efficiency with the benefit of value for money for the taxpayer.

Recommendation 5: Review of the commercial construct, and the quantification of the risk that the MOD takes on, should be included in the independent commercial due diligence.

Recommendation 6: In the specific area of concept, assessment, and design contracts, the MOD should reconsider its policy on not using cost-plus contracts. Use of cost-plus should be coupled with strong MOD oversight, supported by appropriate provisions in the contract, to ensure quality and mitigate the risk of waste.

Recommendation 7: Long term capacity and capability contracts should be used sparingly and be under particularly close scrutiny. They should only be entered into if a strong case can be made that the strategic capability requirement will remain under all likely future scenarios for the full duration of the arrangement.

Recommendation 8: The open book and Equality of Information provisions recommended in Part 1 should extend to rates agreements.

Recommendation 9: If the MOD wishes to retain the current single source overhead recovery approach, it should continue strengthening the CAAS resource engaged in rates agreements and TCIF reconciliations.

Recommendation 10: Large contracts should be subject to independent commercial due diligence and legal review prior to contract signing. There should also be an evaluation of the

financial risk taken on by the MOD. The MOD should ensure that a realistic provision for this risk has been made within the department's budget.

Recommendation 11: Any technical change (or batch of changes) above a certain materiality level is subject to a separate investment appraisal, regardless of whether or not the project is still within its overall approval threshold.

Recommendation 12: For single source contracts below £5m in value, a simplified flat-rate level of profit should be applied.

Recommendation 13: SSPR requirements should be flowed down from the first tier to the second tier of single source contractors.

Recommendation 14: As in the French system, export potential should be formally considered as part of the MOD capability requirement specification process.

Annex B – Who Responded

The defenceconsultations.org website received 846 views. Responses were predominately from defence suppliers and defence industry trade bodies:

AgustaWestland (a Finmeccanica SpA company)

Babcock International Group

BAE Systems

Confederation of British Industry

Hewlett Packard Enterprise Services, Defence & Security UK

Intellect (trade body)

Interested members of the public

Joint Review Board Advisory Committee

Lockheed Martin UK

Marshall of Cambridge Aerospace

Microsoft

PricewaterhouseCoopers

QinetiQ Group plc

Raytheon (via Intellect)

Review Board for Government Contracts

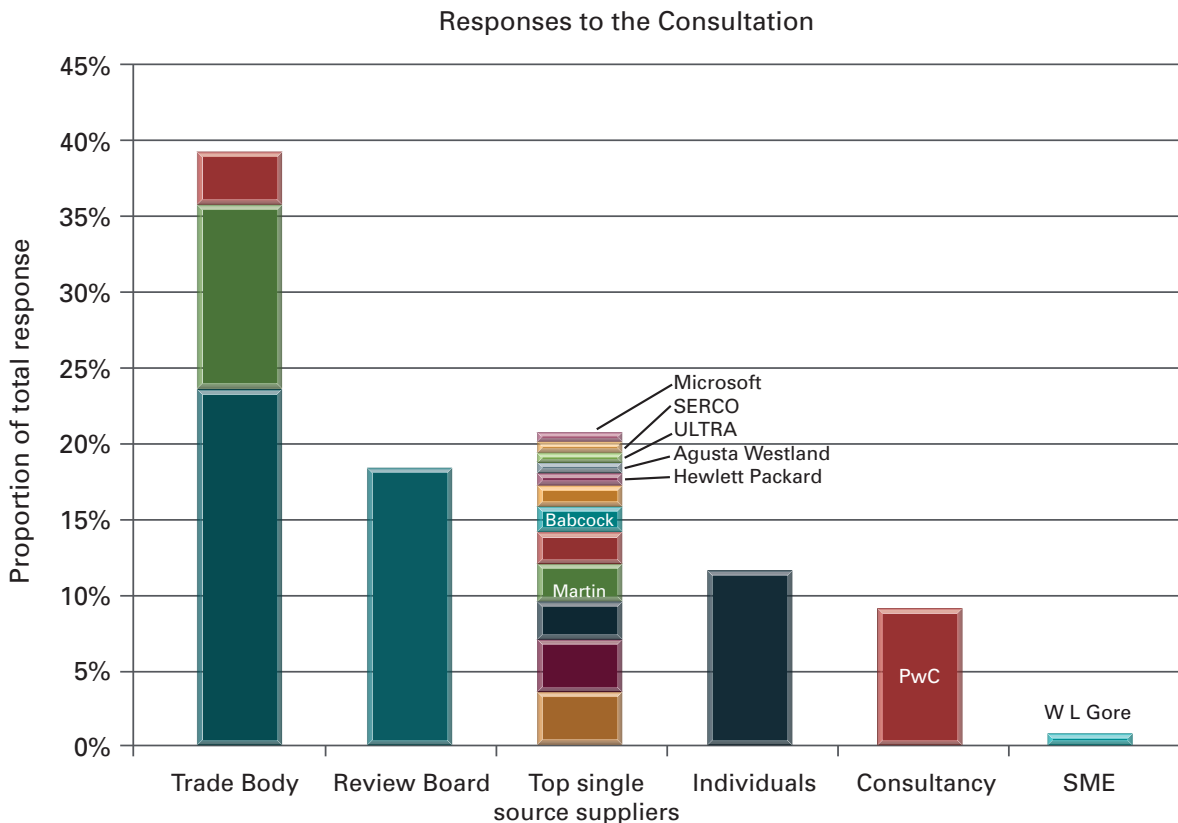
Rolls-Royce

SERCO Defence, Science and Nuclear

Thales UK

Ultra Electronics

W L Gore & Associates



Annex C – Table Showing Level of Response by Topic

Comment by topic	% Of total response
Key Recommendation 7: The Review Board should be replaced by the SSRO	23.0%
Key Recommendation 5: The implicit starting point for the contract profit allowance should be a 'risk free' profit rate	14.0%
Key Recommendation 2: All contracts above a threshold value of £50 million should be reported on regularly by the contractor	11.4%
Key Recommendation 1: Open book accounting	9.2%
Ancillary Recommendation 9: If the MOD wishes to retain the current single source overhead recovery approach, it should continue strengthening the CAAS resource engaged in rates agreements and TCIF reconciliations.	7.5%
Key Recommendation 3: DEFCON 648A should be modified.	6.6%
Transition	6.0%
Key Recommendation 4: An Overhead Report should be submitted annually.	3.3%
AR 1&2: Maintenance of existing framework	3.4%
Key Recommendation 9: Contractors with single source contracts totalling above £100m in value should produce an annual statement on their contracting with SMEs	2.7%
Ancillary Recommendation 3: We recommend that the MOD should establish clear rules on the permitted commercial constructs	1.7%
Key Recommendation 6: The SSRO (Single Source Regulations Office) should provide an independent review of the realism of budgets.	1.7%
Scope of SSPRs	1.6%
Ancillary Recommendation 11: Any technical change (or batch of changes) above a certain materiality level is subject to a separate investment appraisal.	1.4%
Key Recommendation 8: Single Source contracts in excess of £5 million in value but less than £50 million should be exempt from a number of Single Source Pricing Regulations reporting requirements	1.3%
Ancillary Recommendation 7: Long term capacity and capability contracts should be used sparingly.	1.3%

Comment by topic	% Of total response
Ancillary Recommendation 8: The open book and Equality of Information provisions recommended in Part 1 should extend to rates agreements	0.8%
Ancillary Recommendation 5: Review of the commercial construct	0.9%
Ancillary Recommendation 4: TCIF should be fixed to a 50/50 share between the MOD and contractors.	0.8%
Ancillary Recommendation 6: MOD should reconsider its policy on not using cost-plus contracts	0.5%
Ancillary Recommendation 10: Large contracts should be subject to independent commercial due diligence and legal review prior to contract signing.	0.5%
Ancillary Recommendation 14: As in the French system, export potential should be formally considered as part of the MOD capability requirement specification process	0.4%

