EXPLANATORY MEMORANDUM TO

THE SINGLE SOURCE CONTRACT REGULATIONS

2014 No. [XXXX]

1. This explanatory memorandum has been prepared by the Ministry of Defence and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 Part 2 of the Defence Reform Act 2014 ("the Act") makes provision for contracts entered into by the Secretary of State for Defence for procuring goods, works, or services for defence purposes where the award of the contract is not the result of a competitive process ("qualifying defence contracts") and equivalent provision for certain sub-contracts of those qualifying defence contracts ("qualifying sub-contracts"). Part 2 is largely enabling, so rather than setting out the provisions which are to apply, it requires or enables those provisions to be made in regulations. The content of the regulations are described in more detail in Section 7.7 to 7.23.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 These regulations are the first to be made using the powers in Part 2 of the Act. In line with a recommendation made by the Delegated Powers and Regulatory Reform Committee (DPRRC)[1], these regulations are subject to a first-time affirmative procedure. Subsequent regulations may be made by negative procedure unless they relate to the definition of qualifying defence contracts (made under section 14 of the Act) or the maximum civil penalty amounts (section 33), which are always affirmative.

4. Legislative Context

4.1 EU law requires most government contracts to be procured via an open process that involves publicly advertising the fact the contract is available for tender, and then a competitive process to select a contractor (the detail is set out in the Public Contract regulations 2006 and the Defence and Security Public Contracts Regulations 2011). However, there is an exemption for measures which a Member State considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war materiel. Such "single source" procurement is also allowed where there is only one possible contractor, such as for the maintenance of specialist equipment where only one contractor has the engineering capability or the intellectual property rights.

4.2 Single source procurement suffers from a market failure as the contractor can set a price without fear of being under-cut by a competitor. The lack of an alternative contractor also undermines commercial leverage when negotiating a price; choosing not to use a contractor means that the essential capability they provide will not be available to our Armed Forces. Value for money is thus at risk on what is a substantial proportion of Ministry of Defence equipment

[1] In its report on the Defence Reform Bill (Seventeenth Report of Session, 2013-2014, published on 20 December 2013).

expenditure. Part 2 of the Act provides a regulatory framework for these contracts, in particular, providing pricing rules and minimum transparency provisions. It also provides for a regulator, the Single Source Regulations Office (SSRO), which, amongst other duties, will keep the Act and these regulations under review, periodically recommending changes to the Secretary of State.

4.3 Substantial parts of the regulatory framework are set out in these regulations rather than the Act itself. This is to allow detailed aspects of the framework to be kept current. For example, the regulations specify standardised cost reports which will help identify where prices may be at odds with historic information from comparable projects. To be most useful, these reports must reflect the nature of what is being procured as well as current commercial approaches (such as use of multi-year contracts vs. annual contracts). As this changes, as it invariably will over many years, the reporting requirements will need to be updated.

4.4 Parliamentary debates on Part 2 were largely focussed on the independence of the SSRO, the application of the framework to international contactors, and how industry's cost information will be kept suitably confidential.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 Philip Dunne, Minister for Defence Equipment, Support and Technology, has made the following statement regarding Human Rights:

"In my view, the provisions of the Single Source Contract Regulations 2014 are compatible with the Convention rights."

7. Policy background

Introduction

7.1 Single source procurement of equipment and support occurs where the MOD is unable to source its requirements through open competition. This is most common where only a single contractor has the ability or rights to perform the work or for national security purposes, such as ensuring our Armed Forces are not overly dependent upon a supply chain beyond UK influence. The value of single source contracts is high, typically accounting for £6Bn per annum, and is likely to remain significant in the future. Single source procurement is concentrated in a relatively limited number of high value contracts with a small number of contractors. Around 100 existing single source contracts account for the vast majority of the value, and over 90% are placed with ten major single source contractors.

7.2 In the absence of an alternative contractor, value for money (VFM) is at risk. Contractors can price without fear of being undercut by their competitors, so they are not subject to normal market pricing pressures. Furthermore, because we require the military capability they provide, contactors can be confident of follow-on work even if costs are high or performance poor. The volume of single source procurement, together with the risk to VFM inherent in this approach, means assuring VFM in single source procurement is of great importance to both the MOD and the taxpayer.

7.3 Single source procurement is not new and nor are the problems associated with it. Since 1968 the MOD have operated a single source procurement framework known as the "Yellow Book"[2]. This was agreed between the Treasury and the Confederation of British Industry following two high-profile cases involving contractors achieving super-profit by double charging for their costs. It sets the profit rate to use on single source contracts and provides limited protections in the event of over-pricing by contractors. Although originally a cross-government approach, the MOD has been the sole user for many years.

7.4 The Yellow Book was designed to reflect defence procurement in the 1960s. Changes in the industrial landscape (e.g. fewer, larger, more international defence contractors), reducing state ownership and expertise in the manufacture and maintenance of defence equipment, increased complexity of defence equipment, and new procurement approaches have rendered it less and less effective. For example, it is a non-legally binding "gentlemen's agreement" which must be negotiated into contracts, which means it can be easily circumvented. It addresses only the profit and overhead costs which together account for less than half of a price of a typical contract. These problems are compounded by a change process that relies on the consensus of both parties, effectively blocking any change to the Yellow Book, if one party feels disadvantaged by the proposal.

7.5 In 2011, Lord Currie was commissioned to review the MOD's single source pricing arrangements. His report[3] recommended a "fundamental recasting" of the Yellow Book, with much stronger protections against mis-pricing and open book and transparency provisions that would allow the MOD oversight of contractor costs. Following a public consultation, Ministers concluded a statutory regime was required, resulting in Part 2 of the Act.

7.6 Two alternatives to a statutory approach were considered. First, a negotiated approach where pricing protections and transparency provisions could be negotiated into contractual terms on a contract-by-contract basis. This could result in substantial variations between contracts, undermining some of the benefits of standardised reporting, and limited adherence as contractors could either demand concessions in exchange for these provisions or simply refuse them outright. The lack of an alternative contractor would then place the MOD in a difficult situation. A second approach would require contractors to sign up to a framework agreement that would set standard terms that would need to be applied to single source contracts. Attempts to agree such a framework were made in the detailed engagement following publication of Lord Currie's report but difficulties in getting agreement on the details of the framework suggested that making a substantial change on the basis of voluntary agreement would be very problematic. Furthermore, lessons learnt from the Yellow Book itself, namely the difficulty of making any changes using a consensual approach, suggested that any voluntary adherence would decline over time and that it would be very difficult to keep the framework current.

Summary of the Regulations

7.7 The regulations contain pricing and transparency provisions for qualifying defence contracts and qualifying sub-contracts. There is a compliance regime that allows the MOD to impose civil penalties if the transparency requirements are not complied with. The SSRO can make binding determinations on matters relating to pricing, and has the power to amend prices if the rules have not been followed. To protect the confidentiality of sensitive information that the

[2] More formally known as the Government Profit Formula and its Associated Arrangements (GPFAA) published annually by the Review Board for Government Contracts (an advisory non-Departmental Public Body).
[3] Review of Single Source Pricing Regulations, by Lord Currie of Marylebone, published October 2011.

MOD will receive under the transparency provisions, the Act creates a criminal offence for unauthorised disclosure, and the regulations define the information this applies to. The arrangements also flow down to the single source supply chain and the regulations clarify how this works.

7.8 Due to the technical and specialist nature of these regulations, the rest of section 7 of this document provides some additional policy background on specific Parts of the regulations.

Part 1 - General

7.9 This Part defines terms used throughout the regulations, sets out the meaning of "defence purposes" and sets out how to determine the value of a contract. "Defence purposes" has been defined such that any single source contracts to which the Secretary of State for Defence is party may be a qualifying defence contract. This allows for simplicity, so both parties will always be aware that they are signing a qualifying defence contract. The value of the contract (separate from the price payable under the contract) is important because the framework does not apply to contracts below £5m and some of the reporting requirements and compliance regime vary by value. The regulation which sets out how to determine the value of a contract is complex to take account of possible ways of avoiding the framework as well as technical matters such as use of multiple currencies.

Part 2 – Qualifying defence contracts

7.10 This sets the minimum value for a contract to be subject to the regulations. It also defines contracts which will be automatically excluded from the framework, such as government-to-government arrangements and international cooperative programmes. In these cases, transparency and a fair price remain a desired outcome but using UK domestic law to require foreign governments to reveal their costs would be inappropriate. Contracts for land and buildings are also excluded as this is a competitive sector with market benchmarks and quantity surveyors that ensure a fair price.

7.11 This Part also defines a competitive procurement process (contracts which are competitively procured will not be single source) under two scenarios: stand-alone contracts, and "framework" contracts. A common approach to procurement is to sign a framework contract that sets out standard terms and conditions that then apply to any call-off contracts made under that framework. For example, a framework contract may set out daily rates, dispute resolution procedures, and intellectual property right provisions. A contract under a framework agreement may be considered competitively priced if the rates were agreed under a competitive process or if the framework allows for more than one contractor to tender for a call-off contract.

Part 3 – Pricing of contracts

7.12 The Act states that contracts must be priced using a simple formula, namely the allowable costs plus a profit rate (set as a percentage of these costs). This formula can be applied to a variety of types of contract. For a fixed price contract, the allowable costs will be estimated and agreed prior to being incurred. It is sometimes preferable, for example where there is huge uncertainty, to agree to pay a contractor their actual costs plus a profit. In this case, the allowable costs will be actual costs, not estimates. Or it may result in better value for money to choose a compromise between these two approaches, where a target price is agreed and any cost over-runs or under-runs are shared between the parties. This Part defines how the formula should be used for a variety of different contractual models, and on contract amendment.

7.13 The Act requires the profit rate to be determined by following six steps, resulting in a fair and reasonable profit that depends on the particulars of the contract (for example high risk contracts attract a higher return). This Part provides further detail on how to apply these steps. For contractors with whom the MOD has a large number of smaller qualifying defence contracts, the Part allows for a single rate to be agreed for three of these steps for a portfolio of contracts rather than having to calculate them separately for each one. This Part also provides further detail on how this applies.

7.14 One of the pricing protections in the Act is the final price adjustment, which allows excessive profits (or losses) on fixed price contracts to be shared, rather than falling entirely on the contractor or the MOD. This Part sets out a process for this sharing. This Part also enables the SSRO to determine whether the right profit rate has been set or the right allowable costs included, and to adjust the price of a contract accordingly. It sets out the matters to which the SSRO must have regard in making such determinations; this provides clarity to MOD and industry, helping to reduce the risk of unexpected price changes following an SSRO determination.

Parts 4 to 7 – Records, Reports on contracts, overheads etc, and restrictions

7.15 These Parts require single source contractors to keep records and give the MOD access to them for audit purposes, and to provide a suite of standardised reports to the MOD and the SSRO. These Parts define those records and reports, what they need to include, and when they are required. Seven of the reports relate directly to qualifying defence contracts (Part 5). These are:

a) Contract Pricing Statement – the audit trail of pricing assumptions;
b) Contract Reporting Plan – setting out which reports are required and by when;
c) Contract Notification Report – the price split by standard cost categories, to help compare costs by project and contractor on a like-for-like basis;
d) Quarterly Contract Report – to support contract management and give early warning of failing contracts (only for contracts above £50m);
e) Interim Contact Report – actual and forecast costs split by standard cost categories to understand risk and variance from initial estimates;
f) Contract Completion Report – a final statement of outturn costs split by standard cost categories that will form the basis of defence benchmarks; and
g) Contract Cost Statement – a cost certificate which may be required for particular reasons, such as establishing cost over-run or under-run sharing.

7.16 Part 6 defines which reports required by suppliers and which are not limited to specific contracts. Most of these are to provide transparency of costs which are incurred to provide goods, services, or facilities that are used in the delivery of multiple contracts (for example, head office costs, IT infrastructure costs, and new facilities). These costs typically account for 30-40% of the total price of a contract. To ensure the price only includes a fair amount of these costs, it is necessary to understand both that the costs themselves are fair and reasonable, and also that the attribution of these costs to different contracts is fair and reasonable. Contractors account for these ‘indirect’ costs by splitting their company into ‘business units’, which are elements of one (or more) legal entity for which separate financial statements are prepared.

7.17 A common way in which these indirect costs are apportioned is to divide them by a unit of measure, most commonly labour hours. This gives an hourly rate which can be multiplied by the number of hours on a given contract to give that contract’s share of indirect costs. The MOD regularly agrees these rates with contractors for each business unit. To ensure transparency, there are six reports relating to the setting of these rates:

a) Actual rates claim report – a contractor's claim of actual costs for a business unit's rate(s);
b) QBU actual costs analysis report – a business unit's costs split by standard categories allowing comparison between contractors and business units;
c) Estimated rates claim report and QBU estimated costs analysis report – the same as the above two reports, but for estimated (future) costs (not actual costs);
d) Estimated rates agreement pricing statement – the audit trail of assumptions used in those estimated rates;
e) Rates comparison report – a comparison between actual indirect costs incurred and those charged through contracts, to ensure no systematic over- or under-recovery of indirect costs.

7.18 There are two reports which are neither contract nor business unit specific, but are corporate-wide. The small or medium enterprises report allows MOD to monitor the use of small to medium sized enterprises (SMEs) while the strategic industry capacity report is designed to ensure that, for contractor facilities and staff which depend on MOD single source work, the future costs and capabilities are matched against MOD's future requirements. For example, we may be paying for a factory that can produce 50 aircraft a year when we only need 15-20 a year.

7.19 Part 7 disapplies some of the transparency requirements under Parts 4 to 6 where compliance would lead to a breach of a statutory prohibition or restriction, or an obligation of confidentiality.

Parts 8 and 9 – Compliance and SSRO: opinions and determinations

7.20 Part 8 gives the detail for the compliance regime contained in the Act. It sets out infringements related to transparency that can lead to the imposition of a financial penalty, the time limits before compliance and penalty notices may be given, and the maximum civil penalties for different infringements (which also vary with the value of the contract).

7.21 If there is doubt over how to determine a price in accordance with the Act, either party make ask the SSRO for an opinion prior to agreeing a price. Part 9 sets out details of this process, such as time periods and matters to which the SSRO must have regard in giving opinions or making determinations.

Part 10 – Restrictions on disclosing information

7.22 The Act makes unauthorised disclosure of confidential contractor information obtained under Part 2 of the Act a criminal offence; Part 10 specifies what information will be subject to this protection.

Part 11 – Qualifying sub-contracts

7.23 It is common for a single source contractor to outsource aspects of the delivery to sub-contractors. These sub-contracts are often also single source as there is only one sub-contractor that can provide the necessary capability. The problems of single source procurement are just as present in this scenario. To ensure value for money on single source sub-contracts, the Act allows for the framework to flow down to single source sub-contracts. This flow-down can continue down multiple levels as the sub-contractor may further sub-contract. For the Act and regulations to apply, however, there must be an unbroken chain of single source contracting. This Part sets the minimum threshold (£25m), which has been set to ensure the flow-down is manageable. It sets out other requirements for a sub-contract to be a qualifying sub-contract, including what a competitive

sub-contracting process is, and when and by whom the assessment of whether a sub-contract is a qualifying sub-contract is to be made. This Part also sets out the process by which a prospective sub-contractor may appeal an assessment, and when a sub-contract may cease to be a qualifying sub-contract.

7.24 The Act provides (at section 30(1)) that Part 2 of the Act and the regulations apply to qualifying sub-contracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors). So any provision in relation to a qualifying defence contract must also be read as a provision in relation to a qualifying sub-contract but this does not work in a purely like-for-like fashion. For example, it is unreasonable to force a sub-contractor to provide commercially sensitive cost information to another contractor but they will be able to provide it to the MOD. On the other hand, it is the primary contractor who must agree the price with the sub-contractor, not the MOD. The Act allows the regulations to make appropriate modifications to ensure that this flow-down works properly..

8. Consultation outcome

8.1 As part of his review (Jan 2011-Oct 2012) Lord Currie engaged with the MOD, with OGDs, with interested parties, and with the defence industry. This was followed by a formal public consultation process (Oct 2011 to Feb 2012) which resulted in the publication of "A Summary of Public Consultation Responses" (Mar 2012)[4]. From Apr 2012 to May 2014, as primary legislation was developed, the MOD consulted extensively with interested parties, the major UK defence contractors, as well as OGDs (notably HMT, Cabinet Office, BIS, and Ministry of Justice) on the proposed reform. The NAO was also consulted and was supportive of the changes.

8.2 Consultation with industry was achieved through regular meetings of a newly created senior level sub-group of the Defence Suppliers Forum (DSF)[5] and through a number of technical MOD/Industry sub-groups set up to look at specific aspects of the reform, such as confidentiality. Industry was able to provide its views to the MOD through the regular meetings of these various formal groups and this engagement resulted in changes as the Bill developed (such as the creation of a criminal offence for unauthorised disclosure of information). In addition, the MOD worked closely with the defence industry trade body ADS[6] which has co-ordinated the views of the defence industry.

8.3 With regard to the development of the regulations, the MOD has issued six iterations of the draft regulations and has received detailed written comments on each from industry (again, co-ordinated by ADS). In addition, a series of MOD-Industry workshops were held (7-8 Jan, 22-23 Jan, 1 Apr, 7-8 May, 30 Jun, 1-2 Jul, and 7 Jul) to explain MOD thinking and to discuss industry's concerns. MOD officials also met with many of the leading defence companies affected on a one-to-one basis to discuss the proposed reforms. This process has resulted in a large number of amendments (mainly of a technical nature) being made to the regulations before the version which has been laid in draft before Parliament.

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[4] Available on https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/35913/review_single_source_pricing_regs.pdf and https://www.gov.uk/government/consultations/consultation-on-the-independent-review-of-single-source-pricing-regulations-responses.

[5] The DSF is the senior level forum established to discuss strategic engagement between Government (MOD/BIS) and the defence industry (represented by CEOs from the 13 largest UK defence suppliers and representatives of SMEs). It is chaired by the Secretary of State for Defence.

[6] ADS is the main trade organisation representing the UK's Aerospace, Defence, Security & Space Industries.

9. Guidance

9.1 A detailed framework document[7] has been produced and is in its third iteration to reflect amendments that were made to the Bill during its passage through both Houses of Parliament and the maturing regulations, and a shorter Precis document was produced in June. These documents are available on-line. Other high-level MOD guidance documents are in preparation, namely one for non-practitioners and one for contractors new to the framework. The Department is also developing extensive training material which will become available as the new approach comes into effect. MOD is also working closely with the 'early adopter' projects (i.e. the contracts likely to be signed first after the new framework comes into effect) to provide detailed briefing and guidance.

10. Impact

10.1 The impact on business is highly focussed on a relatively small number of contractors to the MOD and defence sub-contractors. The pricing and transparency provisions will require some changes to their processes and some limited additional work (e.g. to prepare the reports). The information which the regulations require, however, is information that a well-run business should already be generating to support their internal management. If this is not the case and contractors have to create new data, they will be able to pass on the costs of this to the MOD through indirect costs on contracts subject to the framework (provided the additional costs are appropriate and reasonable). In addition, industry will share half of the costs of the SSRO but, again, it is expected that this will be a small proportion of the price. The impact on charities and voluntary bodies is nil.

10.2 The impact on the public sector is that considerably more information on single source contracts will become available. This information must be used for the potential benefits of the new framework to be realised. As unauthorised release of this information can be a criminal offence, there will also be specific training and handling instructions.

10.3 An Impact Assessment in relation to these regulations has been prepared and is attached to this memorandum as well as being published on the legislation.gov.uk website. Copies have been placed in the Library of each House of Parliament.

11. Regulating small business

11.1 The legislation has no exemption for small business but only catches single source contracts placed with the MOD with a value greater than £5m or sub-contracts with a value of greater than £25m. We expect that relatively few such contracts or sub-contracts will be placed with small or medium-sized businesses, and even fewer with firms employing up to 20 people. To the extent that such firms will be impacted by the regulations, the qualifying defence contract would account for a large part of their business, so it would not be unreasonable to expect them to comply with specific transparency and pricing regulations. Furthermore, the costs of this compliance can be passed back to the MOD, provided they are appropriate and reasonable.

12. Monitoring & review

[7] The MOD Single Source Procurement Framework (3rd edition, May 2014).

12.1 The SSRO will monitor compliance with the new framework, and will produce an annual compliance report that will be publically available. The SSRO has a legal duty to keep the new framework under review and an obligation to report annually to Parliament on how it is operating. The SSRO is able to recommend to the Secretary of State for Defence any changes to the framework that it considers appropriate. In addition, within three years of the new regulations coming into force, the Secretary of State must carry out a review of these regulations (and then every five years from that point onwards) taking into account any recommendations made by the SSRO.

13. Contact

13.1 Mr Neil Hamilton at the Ministry of Defence Tel: 0207 8070482 or email: DECS-Comms@mod.uk can answer any queries regarding the instrument.