Defence and Security Industrial Strategy: Consultation on amendments to the Single Source Contract Regulations.

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Any enquiries regarding this publication should be sent to us at steve.davies262@mod.gov.uk

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Executive Summary

1. The Ministry of Defence (MOD) introduced the Single Source Contract Regulations in December 2014 to address long-standing issues with the £9bn per year that the MOD spends on non-competitive defence procurement. The Regulations are expressly designed to provide value for money in public expenditure while ensuring fair prices are paid to industry. As of April 2023, 459 Qualifying Defence Contracts (QDCs) and 76 Qualifying Subcontracts (QSCs) with a total value of £83.6bn have been brought under the regime.

2. Part 2 of the Defence Reform Act 2014 requires the Secretary of State for Defence to review the legislation underpinning this framework on a regular basis. The most recent review concluded with the publication of a Command Paper on 4 April 2022[1]. This review was timed to ensure that the Regulations would support the delivery of the Defence and Security Industrial Strategy (DSIS) which was published in March 2021.

3. The Command Paper included 30 proposals for reforming the single source procurement regime. The reforms support the delivery of the Defence and Security Industrial Strategy through: (i) improving choice and flexibility in the contracting approach by ensuring the Regulations can be used in a wider range of sectors and contract types; (ii) allowing the regime to be used to speed up and simplify the acquisition process; and (iii) adapting the regulations to ensure they support innovation and exploitation of technology. All the proposed changes were discussed extensively with key stakeholders over the period of the review and responses to the Command Paper were taken into account in developing the implementation of the proposals.

4. Implementation of these proposals will require a combination of primary and secondary legislation as well as changes to the statutory guidance published by the Single Source Regulations Office and internal MOD commercial guidance and practice.

5. The necessary primary legislation has been enacted through Schedule 10 of the Procurement Act 2023, which amends the Defence Reform Act 2014. The MOD proposes two tranches of secondary legislation that will make amendments to the Regulations. Some of these changes will use the new powers taken in Schedule 10 while others can be made using existing powers in the Defence Reform Act 2014.

6. The first tranche of secondary legislation will deliver the most urgent reforms required to support the delivery of the Defence and Security Industrial Strategy, including providing more flexibility in the ways contracts can be priced. We are planning to pass these changes through the Parliamentary process in time for them to come into force in April 2024. A second tranche of secondary legislation will deliver the reporting and more technical changes proposed in the Command Paper.

7. This consultation document seeks views on the changes being made in tranche one. Each section of the consultation document is in two parts. The first explains what the

[1] www.gov.uk/government/publications/defence-and-security-industrial-strategy-reform-of-the-single-source-contract-regulations

changes are intended to deliver, building on the proposals in the Command Paper. The second sets out the detailed changes that the amended Regulations will need to include to deliver those policy intentions. In some instances, the MOD is seeking stakeholders' agreement on whether the detailed changes deliver the broad intent set out in the Command Paper. In others there are more open questions. The second section is not intended to be a substitute for the actual drafting of the Regulations. This will be done in the light of the responses to this consultation and scrutiny will be through the usual Parliamentary process.

8. A second consultation exercise will be held to ensure stakeholders have a formal opportunity to response to the proposed tranche two changes. The on-going engagement on these changes will continue in the meantime.

9. While all the proposed changes have been discussed extensively with key stakeholders, the Secretary of State will consider any additional views from stakeholders submitted in response to this consultation by noon on 1 December 2023 to steve.davies262@mod.gov.uk.

Alternative pricing mechanisms

Introduction

10. Proposal 1 of the Command Paper says the MOD "will change the primary legislation to allow the Regulations to specify circumstances under which a fair price for the supplier and value for money in public expenditure for all or part of the contract may be demonstrated without using the pricing formula set out in section 15(4) of the Act." The formula in Section 15(4) of the Defence Reform Act 2014 says that the price must be the allowable costs of the contract plus a profit calculated in the way prescribed in Section 17 and 18. The relevant amendment to the Defence Reform Act 2014 is being made through paragraph 3 of Schedule 10 to the Procurement Act 2023.

11. The circumstances where it is proposed that it might be desirable to determine fairness other than by using the pricing formula are where the price:

a. can be determined by reference to market prices ("Commercially Priced Items");
b. is constrained by other regulations or statutes ("Prices Regulated by other Regimes");
c. includes costs and profit that were agreed before a contract became subject to the Regulations ("Committed Price");
d. is the same as the price determined for a contract for the same scope of work, but the identity of one or both of the parties to that contract has changed ("Novated Contracts");
e. is calculated by multiplying the price of inputs that have been competed by an estimated volume; and
f. is calculated by using previously agreed estimated costs but a revised rate has been used to calculate the profit.

12. The Regulations will also be amended to ensure reporting on contracts priced using one of the alternative means continues to meet the requirements and objectives of the regime.

13. Disputes may arise between the MOD and a supplier about whether or not an alternative pricing mechanism should be used in place of the pricing formula in Section 15(4) of the Defence Reform Act 2014. Paragraph (5)(3) of Schedule 10 of the Procurement Act 2023 will therefore amend the Defence Reform Act 2014 to confer a power on the Single Source Regulations Office to take referrals from either party for an *opinion* on whether a proposed Qualifying Defence Contract, or a proposed component of a Qualifying Defence Contract, meets the criteria set out in the Regulations. It is not proposed to give the Single Source Regulations Office the power to make a *determination* that it was inappropriate to use an alternative pricing method for a contract that has already been agreed and that the pricing formula must therefore be applied retrospectively. The MOD believes that exposing suppliers to the risk that an agreement to use an alternative pricing method could be subsequently overturned on referral would be a significant deterrent to contracting on this basis.

14. Parties to a contract that do not use the pricing formula may still disagree about whether the price arrived at through an alternative mechanism is fair to the supplier and

value for money to the public. The Regulations will therefore be amended to allow either party to make a referral to the Single Source Regulations Office to make a determination on what the price should be for a contract (or component of a contract) priced using an alternative pricing mechanism. This amendment of the Regulations is enabled by paragraph 4(3) of Schedule 10.

15. Wider context can be found in the Command Paper.

Proposed regulatory approach

16. To implement the changes set out above the MOD proposes making the Regulations as set out below.

"Commercially Priced Items"

17. Paragraph 3(3) of Schedule 10 of the Procurement Act amends section 2 of the Defence Reform Act 2014 to include new sections 15(2)(a) and 15(2)(b) which provide for Regulations to set out the circumstances when the pricing formula can be disapplied. For commercially priced items these circumstances are where:

a. the primary contractor has supplied goods, works or services to the same, or substantially the same specifications:
    i. to the Secretary of State under a contract placed by following a competitive process;
    ii. to another party under a contract placed following a process that would satisfy the requirements of Regulation 59 had the party purchasing the goods, works or services been a contracting authority; or
    iii. to other parties in an open market where such goods, works or services are offered for sale.

    or

b. another supplier has supplied goods, works or services to the same, or substantially the same specifications under the circumstances set out above. and

c. the primary contractor demonstrates that the price payable by the Secretary of State for the goods, works or services is:
    i. the same as was payable in (a) and/or (b) above;
    or
    ii. where there is a difference in the price payable, that difference is attributable to a justifiable adjustment based on changes in volume, specification, terms of supply, changed economic conditions or technical or performance advances.

d. this Regulation does not apply to goods, works or services where the Secretary of State has made a direct payment for the development of those specified goods, works or services.

QUESTION 1: Does the above adequately describe the circumstances when commercially priced items can reasonably be used as an alternative pricing mechanism?

18. It would clearly be impractical to apply many of the reporting requirements set out in the Regulations to prices that are not calculated by adding profit to allowable costs. The

MOD therefore proposes that the Regulations specify the following for reporting on contracts, or components of contracts, that are commercially priced items:

a. The **Contract Pricing Statement** will set out:
    i. How the contract meets the criteria contained in the relevant part of the Regulations.
    ii. The facts, assumptions and calculations used to assess the price agreed, including an explanation of any adjustments made to the market price.
    iii. The details of any mechanisms contained in the contract that could cause a variation of price, and the estimated impact on price payable, including:
        (a) Variations of price according to specified indices or rates.
        (b) Variations caused by changes in volume.
        (c) Any incentive fee applied to that contract.
        (d) The effect of currency fluctuations.
b. All requirements in the Regulations relating to **Interim Contract Reports** are disapplied except:
    i. The current estimate of the total price to be paid; and
    ii. An explanation and calculation on any variation in price from that previously reported.
c. The **Contract Reporting Plan** will specify:
    i. That the periodic dates on which the submission of Interim Contract Reports are required will be specified by the contracting authority. The requirement to provide a Quarterly Contract Report shall exclude the market-priced items component from the reporting requirement threshold.
d. The **Contract Notification Report** will:
    i. Disapply all information about costs, profit and sub-contractors from the interim reports and contract completion reports.
    ii. Require a description of milestones and deliverables.
    iii. Require reporting on progress against milestones and any agreed changes to deliverables.

QUESTION 2: Do the above changes to reporting strike the right balance between reporting effort and assurance and transparency?

Prices regulated by other regimes

19. The circumstances specified for the purposes of new section 15(2)(A) and 15(2)(B) in the Defence Reform Act 2014 will be where the price for the required goods, works or services or any component of them is regulated by another law in a way that is inconsistent with the Defence Reform Act 2014 or Single Source Contract Regulations being applied in full. Examples might include utilities in the UK or berthing charges in some overseas ports. This would only include other laws that regulate the price payable by the UK Government. It would therefore not apply to foreign laws that regulate the prices that their own Government pays, unless these effectively constrain the price paid by the MOD.

20. In these circumstances, the disapplication of the pricing formula will be to the minimum extent necessary to comply with the other relevant law. In many cases, such as the provision of waste-water services in the UK, the other law might control the whole price

paid, in which case the pricing formula would be disapplied altogether. In other cases, the other law might specify how elements used in pricing are calculated. For example, there might be a requirement in the other law to apply a minimum profit to an element of allowable costs. This would require an adjustment to the way that the Single Source Contract Regulations are applied but would still allow application of the Single Source Contract Regulations to all other aspects of the price unaffected by the other law.

QUESTION 3: Does the above adequately describe the circumstances when prices regulated by other regimes can be used to adapt the price payable under the Single Source Contract Regulations, and what price would be payable under these circumstances?

21. In addition to the existing reporting requirements the supplier will need to explain why the contract in question meets the criteria set out above. In cases where the whole price is regulated by another law and the pricing formula is inapplicable, the reporting regime will be very similar to that proposed for commercially priced items. Where the pricing formula is still applied to some or all of the price, the relevant report will need to set out:

a. an explanation of why the other law requires an adjustment to the price that would otherwise be payable under the Single Source Contract Regulations;
b. those elements of cost, profit or price that are affected by other law; and,
c. the facts, assumptions and calculations used in determining the adjustment.

QUESTION 4: Do the above changes to reporting strike the right balance between reporting effort and assurance and transparency?

Converted contracts (committed price[2])

22. Section 14(4) and (5) of the Defence Reform Act 2014 allows an existing contract to be converted to fall under the Single Source Contract Regulations by agreement between the contracting parties. It is usually not practicable to apply the Single Source Contract Regulations to work that has already been priced outside them, particularly where the work may have been competed some time prior to conversion. The MOD therefore proposes splitting the contract into two types of component: those where both the price and scope of work were agreed before conversion, and those agreed after. The circumstances specified for the purposes of new section 15(2)(A) and 15(2)(B) of the Defence Reform Act 2014 is therefore where, the scope and price of part of a contract was agreed prior to it becoming a Qualifying Defence Contract.

23. In these cases, where the *scope and price* of the work had been agreed prior to conversion using the firm, fixed or volume-driven pricing methods, the component price will be the price previously agreed. Following conversion, any subsequent amendments to the prices previously agreed for such components will require pricing under the Schedule to the Regulations. In the case of work agreed prior to conversion using the cost-plus pricing method, the component price will be the costs incurred up the point of conversion plus an addition for profit at the previously agreed rate. Costs incurred after the point of conversion on a cost-plus contract will require pricing in accordance with the pricing formula at Section 15(4) Defence Reform Act 2014. In the case of work agreed prior to conversion using either

[2] Previously referred to as “sunk costs”.

the estimate-based fee or target-cost pricing methods, the estimate-based fee or target-fee will remain unchanged from that previously agreed, where the scope of work is unchanged. Following conversion, any subsequent amendments to the prices previously agreed for such estimate-based fee or target-cost components will require pricing under the Schedule to the Regulations.

QUESTION 5: Does the above adequately describe the circumstances when prices for a contract that is converted to be a Qualifying Defence Contract would not be calculated using the pricing formula and how that price would be calculated?

24. Where the scope and price of a component has been agreed prior to conversion to be a Qualifying Defence Contract the supplier will need to report:

a. The price of the components to which this alternative pricing method applies.
b. In future reports, any changes to that price through the application of an existing contractual mechanism that does not require further agreement between the parties.
c. An explanation of why the relevant component(s) of the contract meet the criteria for this alternative pricing method.

QUESTION 6: Do the above changes to reporting strike the right balance between reporting effort and assurance and transparency?

Novated contracts

25. The circumstances specified for the purposes of new section 15(2)(A) and 15(2)(B) of the Defence Reform Act 2014 apply to any new Qualifying Defence Contract which is created through the novation of an existing Qualifying Defence Contract. In such circumstances, the only change is to the identity of the supplier(s) to the contract. Therefore, as there is no change being made to the work being carried out or the price being paid for the work, MOD considers that it would not be appropriate to require any change to the previously agreed price.

26. There are no changes to reporting requirements resulting from this alternative pricing method.

QUESTION 7: Does the above adequately describe the circumstances when prices for a novated contract can be used as an alternative pricing mechanism?

QUESTION 8: Does a specific regulation need to be made to take account of circumstances where the new owner is the Government and a zero profit rate may need to be applied?

Competed rates applied to non-competed volumes

27. The circumstances specified for the purposes of new section 15(2)(A) and 15(2)(B) of the Defence Reform Act 2014 apply to those elements of a contract price where a unit price of an input required to perform a contract has been set by a competitive process, but the estimated volume required to meet the contractual requirements has not.

28. In these circumstances, it would not be necessary to apply rules that state that costs must be appropriate, attributable to the contract and reasonable or the profit rate to the *price* of the competed inputs. There would remain an obligation on both the contractor and

the Secretary of State to satisfy themselves that the estimated volumes used to deliver the outputs were reasonable. The price for the component or contract using this approach would be calculated by multiplying those volumes by the competed rates.

QUESTION 9: Does the above adequately describe the circumstances when prices for a competed rate are applied to a non-competed volume as an alternative pricing mechanism and how the price would be calculated?

29. Where prices for a competed rate are applied to a non-competed volume as an alternative pricing mechanism the supplier will need to report:

a. On the competed prices following the same requirements as for commercially priced items.
b. On the non-competed volumes following the same requirements as a Qualifying Defence Contract not using an alternative pricing mechanism.
c. An explanation of why the circumstances for the contract in question meets the criteria for this alternative pricing mechanism.

QUESTION 10: Do the above changes to reporting strike the right balance between reporting effort and assurance and transparency?

Agreed changes to the contract profit rate

30. The circumstances specified for the purposes of new section 15(2)(A) and 15(2)(B) of the Defence Reform Act 2014 apply so as to allow the costs as at the last point of agreement to remain unchanged (i.e. without need to be re-estimated), in order to:

a. Correct an error in step 1 and/or step 2 of the profit calculation; or
b. Change step 3 and/or step 4 by agreement.

QUESTION 11: Does the above comprehensively describe the circumstances when agreed changes to the contract profit rate are used as an alternative pricing mechanism?

31. In addition to the existing reporting requirements a supplier using this alternative pricing mechanism will need to explain in the next appropriate pricing report, the reason for the change and what profit rate has been agreed.

QUESTION 12: Do the above changes to reporting strike the right balance between reporting effort and assurance and transparency?

Pricing: other matters

32. For contracts using the target pricing method, Regulation 10 of the Single Source Contract Regulations specifies that the allowable costs are as estimated at the time of agreement (i.e. determined in the same way as for the 'Firm' pricing type). The MOD has found that in practice it is sometimes desirable to adjust the estimated costs according to changes in specified indices or rates, or changes in volume, as permitted in the 'Fixed' or 'Volume Driven' pricing types specified in Regulation 10. The MOD therefore proposes amending the wording for the 'target price' type in Regulation 10 to allow estimated costs to be adjusted in this way.

33. Where contracts are segmented into different components (see following chapter), paragraph 5 of Schedule 10 of the Procurement Act 2023 provides for regulations to govern how those different components should be aggregated. Where anything other than a

straight-forward addition is required this will be dealt with by use of an alternative pricing method.

COMPONENTISATIONON

Introduction

34. Section 15 of the Defence Reform Act 2014 has the effect that, at the point of contract award, a single profit rate needs to be applied to the whole of a Qualifying Defence Contract. This is true even where a contract is comprised of elements that use different pricing methods or have different risk profiles. This means that that the profit might be too high on some elements and too low on others. It also means that if the balance between the elements changes over time, the profit rate on the whole contract might not be fair.

35. The concept of a Qualifying Defence Contract having distinct "components" already exists in Regulation 10 (3) of the Single Source Contract Regulations, which explicitly allows different pricing methods to be applied to different parts of a contract. Moreover, the Schedule to the Single Source Contract Regulations sets out circumstances where, when a contract is amended, a different profit rate will be applied to part of the contract. However, the Act does not currently permit the parties to agree at contract award that the contract will split into two or more components which use a different profit rate.

36. In the Command Paper, MOD's Proposal 6 says "we will change the legislation to allow for a contract to be split into different segments, each of which can have its own approach to pricing, profit rate and calculation of final price. We will also define how the various segments must be aggregated. We will include safeguards to ensure that this can be done in a proportionate and pragmatic way".

37. Paragraph 3(8) of Schedule 10 of the Procurement Act 2023 amends the Defence Reform Act 2014 to allow the parties to agree to treat different components of a contract distinctly from other parts in determining the price payable under the contract. It also provides for the Single Source Contract Regulations to specify circumstances in which certain parts of a Qualifying Defence Contract may or may not be treated distinctly from other parts of the same contract.

38. Once a price has been achieved for different elements of the contract, the total price for the contract will be determined by aggregating the components of the contract. There will be circumstances where this aggregation will not be straightforward, for example where there is an agreed contract level risk adjustment or incentivisation.

39. Where disputes between the MOD and suppliers arise relating to the application of segmentation to a Qualifying Defence Contract, paragraph 11 of Schedule 10 of the Procurement Act 2023 amends the Defence Reform Act 2014 to confer a power on the Single Source Regulations Office to take a referral on whether the criteria in the Single Source Contract Regulations are being met.

40. Wider context can be found in the Command Paper.

Proposed regulatory approach

41. The Regulations will specify that a component will be a part of the contractual

requirement that is priced separately from one or more other parts.

QUESTION 13: Does the above adequately describe the definition of a component?

42. The Regulations will also specify that:

a. A part of a contract **must** be treated as separate component at contract award (and/or later if the contract is amended) where the parties agree to use:
    i. a different pricing method as defined in Regulation 10;
    ii. a different amount for one or more of the steps used to calculate the contract profit rate; or
    iii. a different pricing type, as set out in previous chapter.
b. The parties **may not** agree to split a contract into components where the purpose of doing so is to change the way that other parts of the Defence Reform Act 2014 operate, such as to avoid thresholds set elsewhere in the regime or to affect the application of the final price adjustment.
c. Subject to 41.b above, the parties **may** agree to opt to split a contract into components in circumstances where they are not compelled to, for example where part of a contract uses the same pricing type and profit, but it may be useful for contract management purposes to report its costs and profits separately.

QUESTION 14: Does the above adequately describe the circumstances where a part of a contract may or may not be treated as a separate component? Should there be minimum thresholds for the size of a component?

43. To maintain transparency in the way that contract prices are calculated, and to allow effective analysis of the data on single-source contracts, suppliers will be required to include data on each component in their statutory reports. This will broadly mirror the data that would be required had the component been let as a separate contract, although things such as data on the supplier level will pull-through from the overall contract. The Authority may decide that detailed reports on a particular component are required less frequently than for the overall contract. This will be set out in the Contract Reporting Plan. There will also be a requirement for the contract level report to set out how the overall contract price has been calculated.

QUESTION 15: Does the above approach to reporting strike the right balance between effort and assurance and transparency?

44. The Regulations will also set out how the price of the overall contract will be calculated from the price of each component. Where each component has been priced according to the pricing formula and the total contract price is to be the sum of each component price, the pricing formula will apply. Where the total contract price is to be calculated in a different way, for instance because the parties agree:

a. to an incentive fee payable on the overall contract or to make an adjustment to reflect risk held at a contract level, there will be a category of alternative pricing method created to govern this;
b. that alternative pricing method will ensure that the overall scale of each

adjustment is within the bounds set for each adjustment at contract level. For those components that use a pricing type that does not require costs to be separately identified, these will be calculated by reference to price rather than costs.

QUESTION 16: Does the above deliver the intent set out in the Command Paper, and the overall intent of the legislation to provide prices that are fair?

QUESTION 17: Should the overall contract price govern the reporting requirements for each component?

DEFINITION OF A QUALIFYING DEFENCE CONTRACT

New vs. amended Qualifying Defence Contract

Introduction

45. Under the Defence Reform Act 2104, there is an important distinction between the creation of a new contract, which will automatically fall under the Single Source Contract Regulations if the relevant criteria apply, and the amendment of an existing contract. In the latter case, the contract will only fall under the Regulations if both parties agree. Whether the parties' agreement amounts to an amendment of an existing contract or the creation of a new contract can be a matter of some uncertainty. Further context can be found in the Command Paper.

46. To address this paragraph 2(3) of Schedule 10 of the Procurement Act 2023 provides for the Regulations to specify the circumstances in which a contract is or is not to be treated as amending an existing contract.

Proposed regulatory approach

47. For the purposes of the Defence Reform Act 2014 and the Single Source Contract Regulations, an agreement to supply additional goods, works and services through an existing contract would be considered a new contract, rather than an amendment to that contract where:

a. substantially the same commercial outcome could be achieved either by amending the existing contract or by procuring the additional goods, works or services under a separate contract without making extensive amendments to the existing contract;
b. procuring the additional goods works or services under a separate contract would not give rise to unavoidable additional risk or material and unavoidable duplication of costs and resource; and
c. the provision of the additional goods, works or services are not subject to an existing price restriction as set out at paragraph 48 below.

48. A relevant pricing restriction would exist where the award of the existing contract was:

a. the result of a competitive process and the provision of additional goods, works or services are subject to a binding pricing agreement, resulting from a competitive process, which is incompatible with the pricing requirements of either the Act or these regulations; or
b. not the result of a competitive process and the provision of additional goods, works or services are subject to an agreement made between the parties in the existing contract and prior to the relevant date with is incompatible with the pricing requirements or the Act or these regulations.

QUESTION 18: Does the above comprehensively describe the circumstances when an amended contract should be treated as a new contract for the purposes of the Regulations?

Substantially for Defence purposes

Introduction

49. Section 14(2)(a) of the Defence Reform Act 2014 defines a Qualifying Defence Contract as being a contract for goods, works or services for defence purposes. Regulation 3 of the Single Source Contract Regulations goes on to define defence purposes as "the purposes of defence (whether or not of the United Kingdom) or related purposes". In effect this means that if any part of a contract is not for defence purposes, it cannot be a Qualifying Defence Contract.

50. There are some cross-Government single source contracts that are used by both MOD and other Government Departments. To ensure such contracts could be brought under the single source procurement regime where appropriate, proposal 25 of the Command Paper said "we will change the legislation to enable the Regulations to set out the conditions under which a cross-Government contract that is partially for defence purposes could become a Qualifying Defence Contract". Paragraph 2(4) of Schedule 10 of the Procurement Act 2023 amends the Defence Reform Act 2014 to enable Regulations to specify when a contract is to be treated as substantially for defence purposes.

Proposed regulatory approach

51. A contract will be substantially for defence purposes where there is a portion that is for defence purposes, and the value of that portion is:

a. More than 30% of the total expected value of the contract and more than £5m; or
b. More than £25m, irrespective of the total contract value.

QUESTION 19: Does the above adequately describe the circumstances when a contract should be treated as substantially for defence purposes?

QUESTION 20: Do the proposed thresholds meet the policy intent?

PROFIT ON COST ONCE (POCO)

Introduction

52. The current six-step contract profit rate calculation under the Single Source Contract Regulations includes a "profits on cost once" (POCO) adjustment. This adjustment was necessary because suppliers sometimes sub-contract to companies within their own group of companies which means that they can earn profit on the costs they incur at multiple levels. POCO is intended to ensure that the agreed regulated profit is only recovered once on the costs of a contract incurred within a group. While this provision captures profits within a group as defined by the Regulations, it may not deal with cases where two or more contractors set up a joint venture or special purpose vehicle to deliver a contract and then sub-contracts elements to the owners of that enterprise.

53. Moreover, following the recent review of the Regulations MOD concluded that it would be simpler and more transparent if the objective of the POCO adjustment were addressed as an appropriate adjustment under allowable costs, rather than as an adjustment within the profit rate calculation. This approach was put forward as Proposal 9 in the Command Paper.

54. Paragraph 8 of Schedule 10 of the Procurement Act 2023 removes POCO as an adjustment in the profit calculation in the Defence Reform Act 2014. Paragraph 11(3) of Schedule 10 will also amend the Defence Reform Act 2014 to allow Regulations to define the relevant connection between a primary contractor and a sub-contractor for the purposes of the POCO adjustment and what adjustments should be made to allowable costs.

Proposed regulatory approach

55. The POCO allowable costs adjustment applies to a Qualifying Defence Contract or Qualifying Subcontract if, at the time of agreement, the primary contractor is party to, or proposes to enter into, a sub-contract to a party which is connected to the primary contractor as defined in paragraph 61 below.

56. Where this is the case:

a. the allowable costs of that Qualifying Defence Contract that relate to the price payable under any sub-contract must be decreased by an amount equal to the attributable profit on that sub-contract; and
b. the allowable costs of that Qualifying Defence Contract that relate to the price payable under any further group sub-contract which relates to the group sub-contract described in (a) above must be decreased by an amount equal to the attributable profit on that further group sub-contract.

57. This will apply to a contracts:

a. under which the price payable includes an amount of profit;
b. which is made between the primary contractor and any person connected with the primary contractor;
c. the value of which is no less than £1 million;

d. the award of which was not the result of a competitive process as defined in Regulation 59 or 60 of the Single Source Contract Regulations;
e. the price of which would not satisfy the criteria for the commercially priced item alternative pricing mechanism; and
f. where the goods, works or services to be provided under the contract are necessary to enable the performance of a Qualifying Defence Contract.

58. The same criteria apply to a "further sub-contract" with the exception of (b) where the contract would be made between two or more persons each of which is connected with the primary contractor.

59. The attributable profit is:

a. Where all of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the Qualifying Defence Contract, all the profit element in the price payable under that group sub-contract or further group sub-contract; or
b. Where only part of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the Qualifying Defence Contract, that part of the profit element in the price payable under that group sub-contract or further group sub-contract which relates to the output necessary for that performance.

60. Attributable profit does not include:

a. Any capital servicing adjustment made under Regulation 11; or
b. Any profit which is received by a person which is not connected with the primary contractor.
c. Any profit which is received by a person connected with the primary contractor but which is not received through a group sub-contract as defined at paragraph 57 above.

61. In this Regulation one person is "connected" with another if:

a. They are group undertakings in relation to each other; or
b. One has at least a 20% beneficial ownership of the other.

QUESTION 21: Does the above adequately described the circumstances when an allowable cost adjustment should be applied?

QUESTION 22: Are the thresholds proposed appropriate?

QUESTION 23: Is beneficial ownership the best way to describe the relationship between connected persons?

Implementation

Approach

62. This consultation process addresses the first tranche of changes to the Single Source Contract Regulations required to implement the proposals in the Command Paper. The MOD will consider carefully any views expressed in response to this consultation at the final regulations to be introduced to Parliament are developed. In parallel the MOD will work with the Single Source Regulations Office to ensure that its process to implement related changes to statutory guidance are developed in parallel.

63. The MOD will also continue to work with industry stakeholders over this period.

Timescales

64. The MOD currently plans to introduce the first tranche of regulations to Parliament around January 2024 with a view to them coming into effect for 1 April 2024. These changes will need to follow an affirmative process and therefore timings will be subject to the availability of Parliamentary time. The second tranche of regulations delivering the rest of the reforms set out in the Command Paper will follow.

Consultation approach

65. MOD has been liaising with industry about this review of the Single Source Contract Regulations since late 2019 when an initial call for comments was made.

66. A detailed programme of workshops with key industry representatives were held during 2021/22 and this programme of industry liaison is continuing as these proposals are developed into draft legislation and, with the Single Source Regulations Office, statutory guidance.

67. In addition to this bespoke programme of meetings, the MOD has liaised with industry through the Defence Suppliers Forum structure. This Forum includes all the main defence contractors as well as representatives from the SME community. The MOD was grateful for the papers submitted by the Defence Single Source Advisory Group and techUK as this consultation was developed.

68. The MOD will consider any representations submitted in response to this consultation by noon on 1 December 2023 to steve.davies262@mod.gov.uk.

ANNEX A – BACKGROUND AND HISTORY OF THE SINGLE SOURCE PROCUREMENT REGULATIONS

1. The MOD's preferred approach to procurement has been through open competition through the domestic and global market. By its nature, however, defence equipment often requires advanced and specialist technology and we are often limited to a single supplier to provide the capabilities our Armed Forces require. We may also need to preserve key industrial and technological capabilities within the UK for strategic reasons. In either case, we may be reliant on single source suppliers. Around 50% of the MOD's annual spend on equipment and services is on non-competitive procurement with this proportion likely to increase with the implementation of the Defence and Security Industrial Strategy.

2. In a commercial marketplace, the MOD can rely on competitive forces to ensure that prices paid provide value for money to the taxpayer and a fair return for industry. The legislation covering single source procurement aims to secure a similar balance on non-competed contracts. In these circumstances, the MOD may enjoy considerable influence as the main or sole purchaser in the UK market, but our ability to exert strong commercial leverage is constrained by the imperative to ensure that the UK Armed Forces are provided with the equipment that they need, when they need it.

3. Between 1968 and 2014, the MOD and industry employed a single-source pricing framework known as the 'Yellow Book', overseen by a non-Departmental Public Body called the Review Board for Government Contracts. The Yellow Book was not based in statute, and changes could only be achieved through consensus between the MOD and industry. Consequently, the Yellow Book framework failed to respond adequately to far-reaching changes to the structure and practices of the global defence industry which have occurred over the last 50 years and was largely unable to resolve disputes which arose between the MOD and its single source suppliers.

4. Concerns in 2010 about the MOD's inability to achieve value-for-money in single source procurement in the absence of market pressures led to the appointment of Lord Currie of Marylebone to carry out an independent study into this issue. In his report, *Review of Single Source Pricing Regulations* published in October 2011, Lord Currie recommended a fundamental reform to the MOD's approach to single source procurement. This helped shape Part 2 of the Defence Reform Act 2014 by which the MOD introduced new, statutory controls on single source contracts. The new regime has three key features:

a. Clear rules on how qualifying single source defence contracts can be priced;

b. Greater transparency, including a suite of mandatory reports, and an obligation placed on suppliers to demonstrate that single source costs to the MOD are 'appropriate, attributable to the contract, and reasonable'; and

c. The creation of a new arms-length body, the Single Source Regulations Office, to issue guidance on application of the regulations and arbitrate between the MOD and suppliers. If a dispute is referred by either party, the Single Source Regulations Office can make legally-binding decisions on contract price.

5. Section 39 of the Defence Reform Act 2014 sets out the process for reviewing single

source legislation as follows:

a. The Single Source Regulations Office must keep the framework under review and may make recommendations to the Defence Secretary “as it considers appropriate” and “at least six months before the end of the review period”.
a. The Defence Secretary must “have regard to any recommendations” made by the Single Source Regulations Office and must complete his review of the legislation within three years of the framework coming into force, i.e. by December 2017, and thereafter each subsequent five-year period.