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

Government consultation response – 17 January 2024

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Introduction

1. The Ministry of Defence (MOD) published for consultation[1] its detailed proposed approach to delivering the key reforms to the Single Source Contract Regulations 2014 (SSCRs) as set out in the Command Paper published on 4 April 2022[2]. These reforms are designed to support delivery of the Defence and Security Industrial Strategy (DSIS) through: (i) improving choice and flexibility in the contracting approach by ensuring the SSCRs 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 SSCRs to ensure they support innovation and exploitation of technology.

2. The key reforms set out in this consultation process focussed on four areas: (i) alternative pricing mechanisms including associated reporting requirements; (ii) componentisation of contracts including associated reporting requirements; (iii) the definition of a Qualifying Defence Contract (QDC); and (iv) the Profit on Contracts Once (POCO) adjustment.

3. The consultation was open from 1 November to 1 December 2023. Ten responses to the consultation were received: one from the Single Source Regulations Office (SSRO), two from industry bodies and seven directly from supplier companies.

CONSULTATION APPROACH

4. In advance of the formal consultation period MOD conducted a detailed stakeholder engagement exercise with key stakeholders. This built on the statutory review process that concluded with the April 2022 Command Paper.

5. A bespoke programme of workshops was held with the Defence Single Source Advisory Group (DSAG) and techUK respectively. Papers setting out the detailed policy positions and implementation approaches on each of the reforms covered by this consultation were shared with both bodies at several stages of development between July 2022 and finalisation of the consultation document in October 2023. In addition to this bespoke programme of workshops, MOD also liaised with key stakeholders through the Defence Suppliers Forum (DSF) structure. The DSF includes all the main defence contractors as well as representatives from the Small and Medium-sized Enterprise (SME) community.

6. MOD was grateful for the formal papers submitted by DSAG throughout this stakeholder liaison process. Each of these were considered through the programme of workshops. The MOD was also grateful for the discussions with, and written input received from, techUK. These contributions from both groups formed a key part of the considerations that fed into the consultation document.

[1] https://assets.publishing.service.gov.uk/media/654265e0d36c910012935bbd/Reforms_to_the_Single_Source_Contract_Regulations.pdf

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

7. Many of these reforms will implement recommendations submitted to the Secretary of State by the SSRO as part of the last statutory review. The MOD is grateful to the SSRO for its input to the development of the proposals in the consultation paper. Discussions with the SSRO will continue through the formal legislative process to ensure that their statutory guidance will support the full implementation of these reforms.

RESPONSE APPROACH

8. This document is presented thematically by outlining stakeholder input and Government response under each of the subject areas. This mirrors the approach taken in the consultation document and should be read in conjunction with the proposals as set out there.

NEXT STEPS

9. 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 SSCRs. 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.

10. The first tranche of key reforms, which were the subject of this consultation, will be delivered through secondary legislation amending the SSCRs. The MOD plans to introduce these Amendment Regulations to Parliament in January with a view to them coming into effect on 1 April 2024. The Amendment Regulations must follow an affirmative approach so final timing will be determined by the availability of Parliamentary time to debate and pass the Amendment Regulations. In parallel to this process the SSRO will be consulting on the necessary changes to its Statutory Guidance.

11. A second tranche of secondary legislation will deliver the reporting and more technical changes proposed in the Command Paper. The MOD will follow a similar stakeholder engagement and consultation approach to these reforms prior to finalising further amendment regulations. Current plans are aimed at completing this process in time for these reforms to come into effect in October 2024.

Alternative pricing mechanisms

Commercially priced items

QUESTION 1: Does the [proposal as set out in the consultation document] adequately describe the circumstances when commercially priced items can reasonably be used as an alternative pricing mechanism?

QUESTION 2: Do the changes to reporting [as set out in the consultation document] strike the right balance between reporting effort and assurance and transparency?

Stakeholder responses

12. Stakeholders generally supported the principle of being able to use commercially priced items as an alternative to the default pricing formula but raised several concerns in their detailed responses.

13. Stakeholders' principal concern was over the proposal that either party could make a referral to the SSRO on whether a contract met the criteria to be a commercially priced item post-contract award. They were particularly concerned that a negative determination would require them to continue to deliver outputs as originally contracted but at a price constructed in a fundamentally different way. This would carry a prohibitively high level of commercial risk. Stakeholders also called for greater clarity on some of the descriptions of circumstances when commercial pricing might apply, for example in practice what is meant by "substantially the same specifications" and what would serve as justifiable evidence of a commercial price.

Government response

14. The Government continues to believe that post-contract award referrals that can alter contract prices are necessary to ensure that neither side can use urgency as commercial leverage. However, the Government does accept that a change to price caused by substituting a commercial price for one using the default pricing formula might be so great as to make suppliers unwilling to use this pricing method. The regulations will therefore still allow either party to make a referral to the SSRO for a determination on whether the use of a commercial price was appropriate, but a negative conclusion will not require re-pricing using the default pricing formula. Either party will still be able to refer to the SSRO for a determination on whether an item using this method was priced in accordance with the SSCRs that apply to commercially priced items and to make legally binding changes to that price if necessary.

15. The Government recognises the points stakeholders make about the need for clarity in the way commercial pricing will be applied and reported on. While some of this is dealt with in the Amendment Regulations, in most cases it is more appropriate to provide this clarity in Statutory Guidance. The SSRO will be consulting on its Statutory Guidance early in 2024 with a view to having it in place for April. It is likely that the Statutory Guidance will develop further as experience with using commercial pricing is gained.

Prices regulated by other regimes

QUESTION 3: Does the [proposal as set out in the consultation document] 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?

QUESTION 4: Do the changes to reporting [as set out in the consultation document] strike the right balance between reporting effort and assurance and transparency?

Stakeholder responses

16. Stakeholders supported the principle of using prices regulated by other laws where necessary. Some concerns were expressed around clarity of intent on reporting requirements. There was also a suggestion that this approach should extend to using other countries' single source pricing regimes even where these do not constrain prices charged to other customers.

Government response

17. The regulations will contain provisions that set out the reporting requirements for contracts priced using this method. Additional clarity will be provided in the SSRO's statutory guidance. The intent of this change is to ensure that suppliers can take on contracts for the UK MOD without risking contravening laws in other jurisdictions. Regulations that other countries use to ensure that they pay fair prices for single source work will only be relevant where they constrain what suppliers can charge to third parties.

Converted contracts (committed price[3])

QUESTION 5: Does the [proposal as set out in the consultation document] 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?

QUESTION 6: Do the changes to reporting [as set out in the consultation document] strike the right balance between reporting effort and assurance and transparency?

Stakeholder responses

18. Stakeholders were supportive of the proposed approach.

Government response

19. The Government will implement this approach as proposed with any necessary additional clarity on its practical application being provided through Statutory Guidance.

[3] Previously referred to as "sunk costs".

Novated contracts

QUESTION 7: Does the [proposal as set out in the consultation document] 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?

Stakeholder responses

20. Stakeholders fully supported the approach to pricing of a novated contract that is already under the regime. Responses relating to the application of a zero profit rate where the new owner is the Government highlighted potential legal complexities and suggested they be specifically restricted to Government-owned entities to avoid capturing other non-for-profit organisations.

Government response

21. The Government will implement this approach as proposed with any necessary additional clarity on its practical application being provided through Statutory Guidance. The Government does not believe that it is necessary to create specific provisions for Government owned entities because the desired effect can be achieved by amending the contract at the time of novation.

Competed rates applied to non-competed volumes

QUESTION 9: Does the [proposal as set out in the consultation document] 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?

QUESTION 10: Do the changes to reporting [as set out in the consultation document] strike the right balance between reporting effort and assurance and transparency?

Stakeholder responses

22. Stakeholders supported this alternative pricing method in principle, indicating a general understanding of its purpose. There were some calls for greater clarity on the definitions provided in the consultation document and the way reporting would work in practice.

Government response

23. The Government will implement this approach as proposed with any necessary additional clarity on its practical application being provided through Statutory Guidance.

Agreed changes to the contract profit rate

QUESTION 11: Does the [proposal as set out in the consultation document] comprehensively describe the circumstances when agreed changes to the contract profit rate are used as an alternative pricing mechanism?

QUESTION 12: Do the changes to reporting [as set out in the consultation document] strike the right balance between reporting effort and assurance and transparency?

Stakeholder responses

24. Stakeholders expressed concerns that this proposal was too ambiguous, particularly around what specifically would constitute an error in the profit calculation. There was also uncertainty about why this was being treated as an alternative pricing method.

Government response

25. The regulations will set out clearly that this pricing method will only be used to:
    a. correct errors that would mean a contract was not compliant with the SSCRs, such as using the wrong baseline profit rate; or
    b. agree or modify an addition to profit to incentivise performance made under Step 3 of the profit setting process.

26. The regulations will not allow this power to be used to retrospectively adjust the profit rate for other reasons.

Componentisation

Proposed regulatory approach

QUESTION 13: Does the [proposal as set out in the consultation document] adequately describe the definition of a component?

QUESTION 14: Does the [proposal as set out in the consultation document] 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?

QUESTION 15: Does the [proposed approach as set out in the consultation document] to reporting strike the right balance between effort and assurance and transparency?

QUESTION 16: Does the [proposal as set out in the consultation document] 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?

Stakeholder responses

27. Stakeholders raised a series of concerns relating to componentisation focussed on the definition of a component, when componentisation could or would be applied to a Qualifying Defence Contract and, subject to clarity on those concerns, whether the proposal delivered on the overall intent of the legislation to provide prices that are fair. Several industry responses also raised concerns about the reporting requirements for componentised contracts arguing that they appeared very complex, burdensome and both costly and hard to discharge.

28. Stakeholders agreed that the overall contract price should govern reporting requirements for each component.

Government response

29. The regulations will clearly state that a component will be any part of a contract that uses either a different pricing type or a different profit rate from another part of the same contract. The parties will not need to agree to either of these conditions, except where a contract is amended in a year when a different baseline profit rate is in force. Under these circumstances, multiple amendments may be aggregated into a single component, providing they use the same pricing types and apply the same adjustments under Steps 2,3 and 4 of the profit setting process. The parties may also agree to treat parts of a contract that use the same pricing type and profit rates as separate components to parts of a contract. They might wish to do this either for transparency reasons, such as to allow costs and profit to be identified for different sites, or to allow different final price adjustments or target cost

calculations to be made for different parts of a contract.

30. The Government maintains that this change is necessary to provide fair prices. Without this change, a contract would need to apply the same risk adjustment to profit to a part of the contract that was cost plus, and hence transferred minimal risk to the supplier, as it would to firm price parts that carry significant risk. It is also necessary to ensure that the mechanisms that are designed to mitigate the risk of excessive profit or loss or to allow for 'gain/ pain share' arrangements can be calculated at interim points rather than only at the contract end. This is particularly important on some of the support, training and service provision contracts that can endure for 20 to 30 years.

31. There is already an obligation to report the facts, assumptions and calculations used in determining a contract price. Where amendments have been agreed, this includes reporting the relevant cost and profit information at the next reporting point. Where the contract included different pricing types from the outset, information on the costs and profit for each element would be an important of the Contract Pricing Statement. Moreover, records would need to be kept of the actual costs incurred and estimates to contract completion for each element to allow the price to be calculated. This change will therefore not require a significant increase in reporting requirements. The regulations will, however, provide greater clarity on what needs to be reported when at component level, and give sufficient flexibility to allow the parties to agree pragmatic solutions.

32. In implementing componentisation, the MOD is keen to work closely with the SSRO and industry to ensure that reporting requirements are proportionate. This will include allowing multiple work packages and amendments to be treated as a single component provided they use the same profit rate. MOD will also issue commercial guidance to delivery teams to underline that components should only be used where they add demonstrable value.

Definition of a Qualifying Defence Contract

New vs. amended Qualifying Defence Contract

QUESTION 18: Does the [proposal as set out in the consultation document] comprehensively describe the circumstances when an amended contract should be treated as a new contract for the purposes of the Regulations?

Stakeholder responses

33. Stakeholders sought further clarity on this proposal, including asking whether values could be assigned to definitions such as "substantially" and "extensively", but no fundamental objections were raised.

Government response

34. This proposal is intended to provide legal clarity to an existing practice removing the scope for disagreement over when an amended contract should be treated as a new Qualifying Defence Contract. The amended Regulations will be clearer than the status quo on this question and further clarity will be provided as necessary in the SSRO's statutory guidance.

Substantially for Defence purposes

QUESTION 19: Does the [proposal as set out in the consultation document] 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?

Stakeholder responses

35. Several stakeholders raised concerns about the circumstances when a contract should be treated as substantially for defence purposes and therefore meet the definition to be a Qualifying Defence Contract and fall under the SSCRs. Proposed alternative approaches included a requirement for the contracting authority to be the Secretary of State for Defence. Stakeholders also argued that the proposed thresholds were not appropriate and several suggested they should be set at the Defence element being greater than 50% of the contract price and be over £25m. There was a concern that setting the threshold at 30% of the contract price could trigger a separate process for contract reporting in addition to that required by the SSCRs.

36. Concerns were also raised about how this provision should apply to Qualifying Sub-Contracts with stakeholders arguing that sub-contracts to Qualifying Defence Contracts that are defined as substantially for defence purposes should not be brought under the regime.

Government response

37. The Government does not agree that for a contract to qualify as substantially for defence purposes, the contracting authority has to be the Secretary of State for Defence. The general principle of the regime is that whether a single source contract is a Qualifying Defence Contract depends on the purpose of that contract, not who the contracting authority is. Requiring all Qualifying Defence Contracts to be signed by the Secretary of State for Defence regardless of the defence content would create a perverse incentive to use other parts of Government to avoid compliance with the SSCRs.

38. Given the way that the threshold will operate, the Government sees no reason not to apply these regulations to QSCs.

39. The Government has seen no evidence to suggest that the proposed thresholds of the defence element being £5m and 30% of the contract value or more than £25m are inappropriate. There is also no evidence to support the proposition that the trigger for a separate reporting process should be 50% of the contract price. However, the Government will keep this provision under review. If it transpires that too many contracts are being caught, we will re-visit the thresholds in the next statutory review of the regime. The threshold will also be re-considered as a possible consequential amendment arising from the commitment to review the SSCR thresholds in general in tranche 2 (see para 45).

Profit On Cost Once (POCO)

QUESTION 21: Does the [proposal as set out in the consultation document] 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?

Stakeholder responses

40. There was general support for the approach of moving POCO out of the profit calculation and to apply it as an allowable cost adjustment. There were considerable concerns were raised about the definition of a group sub-contract. There were also concerns raised on how the cost risk and incentive adjustments would be applied in a way that ensured a fair price.

Government response

41. The regulations will ensure that the cost risk adjustment and incentive adjustments on group sub-contracts will be applied in a fair way.

42. The Government does recognise the concerns that stakeholders have raised on thresholds and whether beneficial ownership is the best way to describe the relationship between connected persons. The tranche 1 amendment regulations will therefore implement the proposal to reduce the number of steps in the profit rate calculation with the other elements of the proposal being considered further in tranche 2. This will allow further time to work with stakeholders to develop a robust approach that will support the overall regime objectives of delivering value for money while ensuring a fair price for industry.

Other responses

43. Stakeholders also raised several points that were not directly related to the questions in the consultation document.

Qualifying Defence Contract Threshold

44. One industry body reiterated previous arguments that thresholds of £5m for a Qualifying Defence Contract and £25m for a Qualifying Sub-Contract should be reconsidered as they had been in place since the SSCRs were first implemented in 2014. They proposed a new Qualifying Defence Contract threshold of £20m and a Qualifying Sub-Contract threshold of £30m.

45. The Government has considered these arguments and agrees that there is a case for reviewing the thresholds. This review will be taken forward as part of the detailed consultation process to support development of the tranche 2 amendment regulations. The MOD will discuss this issue with stakeholders prior to consulting on a proposed position as part of the wider consultation process for the tranche 2 amendment regulations.

Removing an activity from the scope of the SSCRs

46. One stakeholder suggested that a particular activity should be taken out of the scope of the regime, particularly when delivered through framework routes which can demonstrate a competitive procurement process at the point of framework award.

47. In response the Government points to the general principle of the regime which is that whether a single source contract is a Qualifying Defence Contract depends on the purpose of that contract. This avoids complex definitional arguments over what a contract is primarily for. Removing a particular sector from the scope of the SSCRs would undermine that principle. The MOD will contact the respondent who raised this point to discuss in detail, but there is no proposal to make this change.

Delaying implementation of the tranche 1 reforms

48. Several stakeholders argued that the scope of the reforms being delivered through the tranche 1 regulations was sufficiently complex to justify delaying implementation from the proposed coming into effect date of 1 April 2024 until a later date (several suggesting October 2024 as more appropriate).

49. The Government does not believe such a delay is necessary. April 2024 is the proposed implementation date of reforms that have been public since the 2022 Command Paper. The detailed implementation approach has been clearly signalled throughout the intervening period. The key defence suppliers have been party to a series of detailed papers and workshops since 2022 setting out the Government's approach so it is disappointing that they have not prepared more to move ahead to the agreed timetable.

50. In addition, the reforms being implemented by the tranche 1 amendment regulations are fundamentally about allowing greater flexibility in the application of the SSCRs. The Government is keen to use these flexibilities as soon as possible, but it does not mandate them. If suppliers therefore feel they are not ready to take advantage of the flexibilities offered by for example use of alternative pricing types, or splitting a contract into components, they do not have to agree to do so.

51. As set out above many of the reforms are addressing issues that are preventing the letting of contracts that both MOD and industry have indicated they feel would be useful. The MOD is keen to have these options in place for several large contracts that are likely to be signed before October 2024 and Delivery Teams have already been talking to suppliers about this in anticipation of the amendment Regulations being passed.

Conclusion

52. The Government was grateful to stakeholders for taking the time and trouble to respond to this consultation document. The support for most of the proposals was welcome and reflects the amount of consultation with key stakeholders as they have been developed since publication of the April 2022 Command Paper. The Government acknowledges those concerns and questions that were raised and will continue working closely with stakeholders and the SSRO as the guidance is developed to ensure that both MOD and industry will benefit from the new flexibilities that these reforms will allow.