EXPLANATORY MEMORANDUM TO

THE SINGLE SOURCE CONTRACT (AMENDMENT) REGULATIONS 2018

2018 No. [XXXX]

1. Introduction

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

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

2. Purpose of the instrument

2.1 These regulations make changes to the Single Source Contract Regulations 2014 ("the SSCRs") and refer to Part 2 of the Defence Reform Act 2014 ("the Act"). They are not affected by EU Exit legislation.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 The amendments to regulation 5 (calculating the value of a contract) and regulation 13 (rates agreed on a group basis) are made in response to comments made in November 2014 by the JCSI in their report on the SSCRs.[1] Replying to the JCSI Report, Mr Philip Dunne, the then Parliamentary Under-Secretary of State for Defence, made a commitment on behalf of the government on 10 December 2014 to the Seventh Delegated Legislation Committee to make suitable amendments to the regulations in both cases as soon as a convenient opportunity arose.

3.2 The purpose of this instrument is to implement the most pressing of a number of changes identified in a review of the legislation. The defects in drafting which were remedied by regulations 3 and 5 were identified by the JCSI in 2014, and Ministers undertook to remedy them when the opportunity arose, and so that is being done in this instrument. However, the overriding purpose of this instrument is to give effect to the policy on exclusions, not to remedy the deficiencies, which were not identified in the consultation as matters which cause concern or confusion to users, and would not in themselves have warranted a separate instrument. Therefore it has been decided not to make the instrument free of charge to known recipients of the SSCRs.

Other matters of interest to the House of Commons

3.3 The territorial application of this instrument includes Scotland and Northern Ireland and it is not a financial instrument which relates exclusively to England, Wales, and Northern Ireland.

3.4 This instrument is subject to affirmative procedure.

[1] 15th Report of Session 2014-2015 (published 8th December 2014); paragraph 2.2 and 2.3 discuss regulation 5, and paragraphs 2.11 and 2.12 discuss regulation 13.

4. Legislative Context

4.1 The Defence Reform Act 2014 is intended to improve the procurement and support of defence equipment by the MOD and to strengthen the reserve forces. The Act contains four Parts and seven schedules.

4.2 Part 2 of the Act creates a regulatory framework for "single source contracts" (that is, contracts which are not competed) in the defence area. This framework applies both to primary contracts (those to which the Secretary of State is party) and to non-competed sub-contracts resulting from those primary contracts. EU law requires most government contracts to be procured via an open process that involves publicly advertising the fact that the contract is available for tender, and then a competitive process to select the successful contractor. However, there are circumstances where only one contractor is able, or willing, to meet the MOD's requirements. There are also circumstances where MOD may decide to award a contractor without competition for reasons of national security, which can be done in accordance with Article 346 of the Treaty of the Functioning of the EU. Before the Act coming into force, there was no legal framework regulating defence single source contracts but there were voluntary arrangements in place contained in a document called the Government Profit Formula and its Associated Arrangements (usually referred to as the "Yellow Book"). The new regulatory framework came into force on 18 December 2014.

4.3 Part 2 of the Act also created a new executive Non-Departmental Public Body (NDPB) known as the Single Source Regulations Office (SSRO) to support the oversight of the new regulatory framework. The SSRO replaced an existing (non-statutory) NDPB, the Review Board for Government Contracts, which was set up to monitor the Yellow Book arrangements. Part 2 of the Act sets out the functions that the SSRO must perform to support the new regulatory framework, which include advising the Secretary of State on setting key rates used in the regulatory framework (including the baseline profit rate), monitoring the operation of the framework, undertaking analysis, and keeping the regulatory framework under review. The SSRO may make recommendations to the Secretary of State for changes to the regulatory framework.

4.4 Part 2 contains a civil compliance regime to ensure compliance with key aspects of the regulatory framework, and the SSRO has an important role in supporting this. The SSRO has the power to adjudicate in disputes referred to it by either a contractor(s) or the MOD relating to the application of specified aspects of the regulatory framework. Part 2 also created a new criminal offence relating to unauthorised disclosure of information, to deal with the possibility of any person releasing commercially sensitive information obtained under this Part without proper authorisation. Part 2 enables standardised costs reports which help MOD identify where prices may be at odds with historic information from comparable projects. It also contains pricing and transparency provisions for qualifying defence contracts and qualifying sub-contracts.

4.5 Substantial parts of the new regulatory framework were set out in the regulations known as the SSCRs rather than the Act. The SSCRs came into force on 18 December 2014.

5. Extent and Territorial Application

5.1 The territorial application of this instrument extends throughout the United Kingdom

5.2 This applies to England, Wales, Scotland, and Northern Ireland.

6. European Convention on Human Rights

6.1 Guto Bebb, Minister for Defence Procurement, has made the following statement regarding Human Rights:

"In my view the provisions of the Single Source Contract (Amendment) Regulations 2018 are compatible with the European Convention on Human Rights."

7. Policy Background

What is being done and Why?

7.1 Apart from the amendments which are made because of undertakings given to the JCSI (see para 3.1 above), the purpose of the proposed changes is to clarify which contracts cannot be subject to the legislation (exclusions).

7.2 The SSCRs currently specify five categories of contract that cannot be qualifying defence contracts, which are commonly referred to as 'exclusions'. Experience to date has indicated three of these are working well. There are, however, two that have caused issues, and one additional exclusion that is desirable.

International cooperative programmes (regulation 7(b))

7.3 The Department is keen to ensure that all appropriate single source contract spend is made subject to the legislation. We currently hold some large single source contracts which include a comparatively small component that delivers requirements developed in cooperation with our allies. This means that the whole contract, including the UK-specific parts that would otherwise be subject to the legislation, may not be subject to the legislation.

Current Arrangements

7.4 Regulation 7(b) says that contracts made within the framework of an international cooperative defence programme may not be qualifying defence contracts. This means that large multi- and bi-lateral defence programmes such as the A400M transport aircraft or Typhoon jet are excluded. It would not be practicable to gain agreement from all international parties to apply the UK legislation to such contracts, and there is no desire to remove this exclusion all together. There are, however, cases where a contract placed by the MOD to deliver UK requirements is also used to deliver capability requirements developed with one or more of our allies. These contracts are currently entirely excluded from the legislation.

Detail of Proposed Changes

7.5 The proposed change is that contracts made within an international defence framework will be subject to the legislation if the MOD and the supplier agree. Contracts where there is no agreement that application of the legislation would be practical will still be excluded, while allowing the reach of the regime to be significantly extended. The need for agreement from both parties may limit increased take-up to an extent. But such agreement has been reached on several large contracts that are already in existence.

Intelligence Activities (regulation 7(c)(iii)

7.6 To retain flexibility in interpretation, the term 'intelligence activities' is not defined in the Act. It has been interpreted in different ways for different contracts, and both suppliers and MOD staff are currently unclear about how this regulation should be applied.

Current Arrangements

7.7 Regulation 7(c)(iii) says that contracts made wholly for intelligence activities may not be qualifying defence contracts. The Department spends significant sums of money on systems, such as satellites, surveillance aircraft or sensors on ships, whose purpose is to gather intelligence. While the exact capabilities of these systems may be highly classified, the fact of their existence and costs are widely known and so these contracts are being needlessly excluded from the framework. Conversely, there are some contracts where inappropriate disclosure of information such as the nature, timing or location of the goods or service being procured might compromise national security. This might include contracts for equipment or services that provide capabilities which we would not want our enemies to know we possessed. At the moment, it can reasonably be argued that both categories would be caught by the 'intelligence activities' exclusion.

Detail of Proposed Changes

7.8 The proposed change will mean that the exclusion will cover potential risk to national security rather than intelligence activities as such. Contracts for capabilities such as satellites or reconnaissance drones, whose existence is widely known or where there is no risk to national security, will not be excluded. Other contracts, such as for the provision of port services in a particular location, will be excluded if compliance with the reporting requirements in the legislation would require disclosure of information which the Secretary of State considers would create a risk to national security, even if the contracts are not related to intelligence activities.

7.9 Complying with the reporting requirements in the legislation requires information to be disclosed to the SSRO and various teams within the MOD, all of whom are cleared to see classified information to a certain level. The proposed exclusion will only apply where the information contained in the statutory reports or the other disclosure requirements is above that level. In practice, existing security classifications will generally be used, which will avoid ambiguity.

New contracts which replace an existing contract (new regulation 7(e))

7.10 Defence contracts are sometimes transferred from one legal entity to another. This is usually due to re-structuring in the defence industry. It can also occur when the MOD wishes to transfer a contract which it has let. An example of this would be where the MOD has let a contract for a weapon system for an armoured vehicle, but now wants to transfer the contract to the prime contractor for the whole vehicle, who is better placed to manage the risk of integration. If the terms of these contracts do not change, and where they were originally won through competition, there will be little value in making them subject to the legislation because competitive pressure will have ensured value for money. It may well be in the interests of all the parties to allow the contract to be transferred, but if the contract is not already subject to the framework, it would have to be re-negotiated if the transfer did cause it to come under the framework, and that may well deter the transfer. Commonly, such a transfer is done by way of

novation, which is a common law term meaning an arrangement whereby, with the consent of all parties, one of the parties to a contract is replaced, with the effect that a new contract is substituted for an existing contract and the latter discharged. However, there may also be cases where not all parties consent; an example will be where the contractor has ceased to exist (because it is a company which has been wound up) before the MOD becomes aware of the situation and it is therefore not possible to obtain its agreement to the new contract.

Current Arrangements

7.11 Currently, a new contract which replaces an existing contract, if it has not been placed through a competitive process, and if it meets the other criteria set out in the legislation, will be subject to the legislation. This applies even if the original contract was placed competitively.

Details of Proposed Change

7.12 The proposed change will introduce a new exclusion for new contracts which replace existing contracts. To avoid potential abuse, it will apply only if the new contract is in all material respects the same (save for the identity of the parties) as the one which it replaces. Subsequent changes will be subject to the same tests applied on amendment to contracts let before the SSCRs came into force or originally won through competition.

Requirements for qualifying sub-contracts

7.13 We are also proposing changes to Regulation 58 (requirements for qualifying sub-contracts) which have equivalent effect for qualifying sub-contracts as the changes described above do for qualifying defence contracts.

Consolidation

7.14 There are no plans to consolidate the legislation.

8. Consultation outcome

8.1 The Act requires the SSRO to keep the legislation under review and it may make recommendations to the Secretary of State on any proposed changes which it considers appropriate. In addition, the Act requires the Secretary of State to carry out a review of the legislation within three years of the SSCRs coming into force. As part of this, the Secretary of State must have regard to any recommendations made by the SSRO.

8.2 The SSRO undertook the following public consultation process on its review of the framework:

1st Call-for-input	May 2016 to July 2016.
2nd Call-for-input	Sept 2016 to Nov 2016.
Public consultation	Jan 2017 to Mar 2017.
SSRO Publishes recommendations	28 Jan 2018.

8.3 Several interested stakeholders from the defence industry and the MOD, as well as several NGOs, responded to the SSRO consultation with written inputs. In addition, the SSRO carried out an extensive series of engagements with the MOD and industry on specific aspects of the review beginning in mid-2016 and running to March 2017. In June 2017, the SSRO submitted its recommendations on proposed changes to the legislation to the Secretary of State. This was followed by a series of further engagements between the MOD, industry, and the SSRO to explore these recommendations and other proposals made by either MOD or industry.

8.4 The Secretary of State, having had regard to the SSRO's recommendations, completed his review of the legislation in December 2017 but he requested further work by the MOD into how the proposed changes might be implemented. A Command Paper will be published setting out the Government's position on the review. This identifies 24 proposed changes which the MOD will seek to implement when Parliamentary time permits. These regulations implement the most pressing of these proposed changes. Further changes will be considered by MOD in the autumn.

9. Guidance

9.1 As the SSRO's sponsoring Department, the MOD will work with the SSRO to provide general guidance on exclusions.

10. Impact

10.1 There is no impact on business, charities or voluntary bodies.

10.2 There will be an impact on the public sector resulting from these changes but this will be focused on a relatively small number of single source defence contractors to the MOD and the related sub-contractors. However, it is assessed that the *additional* impact from making these changes to the regulations will be limited.

10.3 An Impact Assessment will be provided as soon as it is available and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The legislation does apply to activities that undertaken by small businesses but only single source contracts with a value of greater than £5m and related single source sub-contracts with a value greater than £25m are caught. We assess that there will be limited *additional* impact on small businesses arising from the amendments. Furthermore, the costs of any compliance on the part of contractors can be passed back to the MOD, providing they can be demonstrated as being appropriate and reasonable.

12. Monitoring & review

12.1 The Act requires the Secretary of State to undertake a review of single source legislation within three years of the legislation coming into force and thereafter every five years. The Secretary of State, however, has decided that, given the complexity of the framework and the need to keep it as current as possible, the next review should be completed within three years (i.e. by December 2020). The SSRO has been invited to support this review.

12.2 The Act requires the SSRO to keep the legislation under review, and it may make recommendation to the Secretary of State on any changes which it considers appropriate.

13. Contact

13.1 Neil Hamilton at the Ministry of Defence (telephone: 0207 2188255 or email: neil.hamilton747@mod.gov.uk) can respond to any queries regarding the instrument or this Explanatory Memorandum.