EXPLANATORY MEMORANDUM TO

THE SINGLE SOURCE CONTRACT (AMENDMENT) REGULATIONS 2024

2024 No. [XXXX]

1. Introduction

1.1 This explanatory memorandum has been prepared by the Ministry of Defence ("MOD") and is laid before Parliament by Command of His Majesty.

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

2. Purpose of the instrument

2.1 These Regulations make changes to the Single Source Contract Regulations 2014 (the 2014 Regulations). The 2014 Regulations are made under Part 2 of the Defence Reform Act 2014 (the Act). The DRA and the 2014 Regulations make provision for pricing of single source contracts which are defence contracts entered into without competition.

2.2 In addition to this explanatory memorandum the policy intent behind these Regulations can be appreciated by reading the Consultation Document published on 1 Nov 2023, as well as previously published papers. In April 2022 the Secretary of State for Defence completed a review of Part 2 of the Act and the 2014 Regulations (the review). The review, published as a Command Paper on 4 April 2022, supported the delivery of the Defence and Security Industrial Strategy (DSIS) (published in March 2021) and proposed changes to both the Act and the 2014 Regulations. It followed extensive consultation with Government and Industry stakeholders and had regard for recommendations made to the Secretary of State by the Single Source Regulations Office ("SSRO").

2.3 Implementation of the proposals contained in the Command Paper, as well as further minor technical improvements that have been identified since, required amendments to the Act, and to the 2014 Regulations.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 During the process of drafting the Regulations several errors were identified in the 2014 Regulations. These included use of the symbol "%" instead of "percentage points" in regulation 17 (corrected by regulation 21 of the Regulations) and incorrect references to sub-paragraphs instead of paragraphs in regulation 65 (corrected by regulation 42(e) to (i) of the Regulations), omission of "pricing" in what was intended to be the term "pricing amendment" throughout the Schedule and an erroneous reference to "contract profit rate for an amendment" (both corrected by regulation 43 of the Regulations). The latter two points were identified by the Committee in its forty-sixth report of 2017-19. As a result of having to make the corrections and having consulted with the Statutory Instrument Registrar in accordance with paragraph 4.7.6 of the Statutory Instrument Practice, the Department will apply the free issue procedure.

4. Extent and Territorial Application

4.1 The territorial extent of this instruction is throughout the United Kingdom.

4.2 The territorial application of this instrument is to England, Wales, Scotland, and Northern Ireland.

5. European Convention on Human Rights

5.1 James Cartlidge MP, Minister for Defence Procurement, has made the following statement regarding Human Rights:

"In my view, the provisions of the Single Source Contract (Amendment) Regulations 2024 are compatible with the Convention Rights."

6. Legislative Context

6.1 MOD policy is to procure contracts via an open competitive process wherever possible but there are circumstances where only one contractor is able, or willing, to meet the MOD's requirements or where MOD decides to award a contract without competition for reasons of national security.

6.2 Part 2 of the Act creates a regulatory framework for "single source contracts" with the detail being set out in the Single Source Contract Regulations, currently the 2014 Regulations. The Act does not specify whether a contract should be competed. Before the Act came into force, there was no legal framework regulating single source defence 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"). This voluntary framework was superseded by the legislation when the regulations came into effect on 18th December 2014. Substantial parts of the new regulatory framework were set out in the 2014 Regulations rather than in the Act.

6.3 The framework is engaged when a defence contract is awarded with a value above a threshold specified in the 2014 Regulations (currently £5 million) without any competition, unless one or more of the specific exclusions set out in the 2014 Regulations apply. These contracts are known as qualifying defence contracts (QDCs), with non-competitive sub-contracts made in connection with them and above a specified value threshold known as qualifying sub-contracts (QSCs). Where the framework is engaged it makes provision for the pricing of QDCs and QSCs. It also makes provision for transparency, reporting and record-keeping requirements, from the beginning of a qualifying contract to its completion.

6.4 The Act also created an executive Non-Departmental Public Body, known as the Single Source Regulations Office (SSRO), to support the oversight of the new regulatory framework. The Act sets out the SSRO's functions, 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.

6.5 Since the 2014 Regulations came into force, they have been amended by three Statutory Instruments (SI). The first (the Single Source Contracts (Amendment) Regulations 2018), which came into force on 1st August 2018, clarified which contracts cannot be subject to the legislation (exclusions) and corrected drafting defects identified by Joint Committee on Statutory Instruments. The second (the

Single Source Contracts (Amendment) (No. 2) Regulations 2018 (the second 2018 Regulations), which came into force on 1st April 2019 changed both the provisions for repricing contracts that fall under the regime when they are amended and the time limits for referrals to the SSRO. The third (the Single Source Contracts (Amendment) Regulations 2019), which came into force on 1st September 2019, implemented some of the conclusions of a review made by the SSRO in June 2017. They also made further minor technical improvements and addressed some deficiencies identified by the Joint Committee on Statutory Instruments ("JCSI") in relation to the second 2018 Regulations.

7. Policy background

What is being done and why?

7.1 The 2014 Regulations address long standing issues with the MODs expenditure on non-competitive defence procurement. They ensure that the MOD obtains value for money in public expenditure while ensuring a fair price is paid to industry (as is normally achieved by competitive procurement).

7.2 Under Section 39 of Act, the SSRO has a duty to keep under review the provision made by Part 2 and the single source contract regulations which are in force and the Secretary of State has a duty to carry out a review within 3 years of the first SSCRs coming into force and every 5 years thereafter. In carrying out this review the Secretary of State must have regard to any recommendations made by the SSRO.

7.3 The legislation was reviewed in December 2017. The review concluded that, the legislation was functioning as intended and was effective. However, changes were made as described in paragraph 6.5 above.

7.4 In the time since the SSCRs have been in place, it has become apparent that the approach set out by the regime does not always properly address the range of price determination that is sometimes needed in practice. While the second statutory review of the legislation was not required to be completed until December 2022, review and extensive consultation with stakeholders took place between 2019 and 2022, with a Command Paper published as described in paragraph 2.2 above. The review concluded that changes were needed both to the Act and to the 2014 Regulations. Changes to the Act were made by Schedule 10 of the Procurement Act 2023. These Regulations make some of the amendments that the review identified as necessary to the 2014 Regulations. It is expected that the remaining amendments identified as necessary will be made in the near future.

Meaning of "defence purposes" and "substantially for defence purposes"

7.5 The review found there was some uncertainty around the meaning of a contract being "for defence purposes". This had led to a few situations where contracts which had not really been intended to come under the Regulations had been included, and other situations were contracts should ideally have been in scope but were not. To bring more certainty to this area of the Regulations, Regulation 4 substitutes regulation 3 of the 2014 Regulations (meaning of "defence purposes" and "substantially for defence purposes"). Section 14(2)(a) of the Act has been amended so that a contract which is "substantially for defence purposes" can be a qualifying defence contract. "Substantially for defence purposes" is to be defined in single source contract regulations (section 14(2)(c) of the Act). The new regulation 3 specifies that a contract is substantially for defence purposes if the contract fulfils a requirement for

goods, works of services for defence purposes and either that (1) the value for defence purpose is greater than £5m and at least 30% of the total value of the contract; or (2) the value for defence purpose is greater than £25m.

Components

7.6 One of the conclusions of the review was that it should be possible for QDCs to be split into components. The concept of a QDC having distinct "components" already exists in Regulation 10(3) of the 2014 Regulations, but only where a QDC is amended. Broadening the use of the concept will allow a more flexible approach to pricing, for example, allowing different contract profit rates to be applied to different components where this is appropriate. Several amendments have been made to the 2014 regulations to allow contracts to be split into components, the main ones are as follows.

7.7 Regulation 11 inserts a new Regulation 9A into the 2014 Regulations (Components of Qualifying Defence Contracts). Regulation 9A describes the meaning of a component in a QDC. Generally, a part of the contract must be a separate component if it has a different pricing method or a different contract profit rate from other parts of the contract, if it is priced or re-priced using a previously agreed price or re-priced using commercial pricing. The parties to a QDC may also agree to split the contract into components (section 15(7)(b) of the Act), but not if the purpose of doing so is to affect the final price adjustment under regulations 17 and 18 (regulation 9A(2)).

7.8 Regulation 6 inserts new Regulation 4A into the 2014 Regulations (Meaning of Contract Price). Regulation 4A defines the meaning of 'contract price' in circumstances both where no components have been created and where they have been.

7.9 Once prices have been agreed for different components of a contract, the total price for the contract will be determined by aggregating the components of the contract. There will be circumstances where this will not be straightforward, for example where the parties agree to make a 'contract level' cost risk adjustment or an adjustment to incentivise the performance of provisions of the contract (see paragraph 7.37 below).

7.10 Should the contracting parties fail to agree on the appropriateness or otherwise of splitting a contract into components, paragraph 11 of Schedule 10 of the Procurement Act 2023 amends the Act to confer a power on the SSRO to take a referral on whether the componentisation criteria in the Regulations are being met.

Meaning of a "new contract"

7.11 An issue which has practical significance to the operation of Part 2 of the Act is whether entering into an agreement to provide new goods, works or services constitutes a new contract or an amendment to an existing contract for the purposes of the Act. Under the Act, where an amendment to an existing contract which is not already a QDC is agreed, the new work will not come within the regulatory framework unless there is an agreement between the Secretary of State and the contractor to convert the whole of the existing contract to be a QDC – see sections 14(4)(d) and (5)(d) of the Act. If the new work that is being contracted for is a new contract, and meets the criteria required by the legislation, such consent is not required. Whether or not an agreement for additional goods, works or services is to be regarded as an amendment to an existing contract or a new contract can be a matter of some uncertainty. The practical effect is that it is not possible to know if a purported

amendment to an existing contract will be a QDC. Section 14(5A) of the Act now gives the Secretary of state power to make regulations to specify in single source contract regulations the circumstances in which an agreement to enter into new work is or is not to be treated as a new contract for the purposes of the framework.

7.12 Regulation 8 inserts a new Regulation 7A into the 2014 Regulations. Regulation 7A specifies that an agreement to supply additional goods, works and services through an existing contract will be treated as a new contract, where: 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; procuring the additional goods, works or services under a separate contract would not give rise to unavoidable and material commercial risk or duplication of costs and resource; and the provision of the additional goods, works or services is not subject to an existing price restriction (a pre-existing pricing mechanism for additional goods, works or services which is binding on the parties and contrary to the pricing requirements of the regulatory framework).

Pricing of QDCs

7.13 Part 3 of the 2014 Regulations deals with pricing of QDCs. The 2014 Regulations provided for a single method to be used when pricing a QDC or QSC. The existing approach, dictated by Section 15(2) and (4) of the Act, requires that the price be determined in accordance with the following price formula: (Contract Profit Rate x Allowable Costs) + Allowable Costs = Contract Price. This "price formula" has proved in some circumstances to be insufficiently flexible, for example where despite the procurement being single source, the price being offered (in whole or part) is a "commercial price". In these circumstances, where a supplier may be justifiably unwilling to contract under the Regulations, and the market provides a price which is demonstrably fair, the MOD has often needed to use powers available within the legislation to exempt the contract from the Regulations. Exemptions may only be granted with the direct approval of the Secretary of State and are time-consuming for all parties. There are other circumstances which have also required the Secretary of State to exempt contracts, for example where another Government's laws prevent a foreign-based supplier from complying with the price formula.

7.14 To address these matters, paragraph 3(3) of Schedule 10 of the Procurement Act 2023 amends the Act to include new sections 15(2)(a) and 15(2)(b), which provide for Regulations to describe when the pricing formula can be set aside, and alternative methods used to price a qualifying contract. This will have the effect of enabling fairer and more appropriate pricing, so bringing more single source contracts under the protection of the Regulations and minimising the number of exemptions that need to be granted by the Secretary of State. Paragraphs 7.16 – 7.29 describe the expanded range of permitted pricing methods, including changes to the profit rate process within the existing price formula approach.

7.15 Regulation 12 of this SI inserts Regulation 9B and Regulation 9C into the 2014 Regulations. Regulation 9B requires that a contract pricing method be used when pricing a QDC or QSC, but now allows that it may either be a "default pricing method" (i.e. using the extant 'price formula' approach) or an 'alternative pricing method'. Regulation 9C describes that the Schedule to the 2014 Regulations make provision for the re-determination of the contract price or the component price of such a contract, when that contract or component is amended. Regulations 13 – 23 of this

SI describe amendments to the 2014 Regulations that apply when undertaking the 'default pricing of contracts' and Regulation 24 describes the different types of 'alternative pricing methods' that may now be used. These Regulations 13-24 are now further described.

7.16 Regulation 13 of this SI amends Regulation 10 of the 2014 Regulations to 'Default Pricing of Contracts'. It makes additions to Regulation 10 to allow that the default pricing method may also be used to price a component of a contract, as well as a whole contract. It makes changes to two of the existing default pricing methods, known as the Estimate-Based Fee method (EBF) and the Target Pricing method (commonly known in MOD as the Target Cost Incentive Fee method, or TCIF). The changes are to allow that when estimating the costs to agree an EBF contract price, it will in future be permissible to agree that the estimated costs at the time of agreement may be adjusted in accordance with changes in specified indices or rates, as between the time of agreement and a future specified date.

7.17 Permitting the use of price indexation in EBF contracts reflects a change in MOD commercial policy actioned in 2022, which recognised that in times of high inflation it will often make commercial sense for the MOD and a contractor to share inflation risk. For the MOD to try and get a single source contractor to take all the inflation risk in times of high inflation is likely to delay or prevent contracts being placed, as well as making them unaffordable, because contractors will cover the cost risk by making the worst-case inflation assumptions. Regulation 13 of this SI permits the same price-indexation considerations when using the TCIF pricing method and adapts TCIF to allow the incorporation of the Volume-Driven pricing method.

7.18 Regulation 14 of this SI amends Regulation 11 of the 2014 Regulations (Steps in Determining the Contract Profit Rate) by making changes to the methodology for determining the Contract Profit Rate (CPR), which is used in the default pricing methods (noting that elements of the price formula, including the setting of a CPR, may also be used to different extents in some of the alternative pricing methods, a point that will be further explained when those methods are described below). The current CPR methodology is a "six step" process, and the amendments to the Regulations will amend this to a "four step" process. The two steps to be omitted are the current 'step 3' 'Profit on Costs Once' (POCO) adjustment (see paragraphs 7.19 – 7.22) and the current 'step 4' 'SSRO Funding Adjustment'. The latter is a small downward adjustment to profit designed to reclaim some of the funding for the SSRO from suppliers but, given the purposes for which profit is paid, the review concluded it was not appropriate to retain. Supplier contributions could instead be sought by direct payments, but the MOD considers these would then be legitimate costs to the overheads recoverable through single source contracts. The SSRO funding contribution from suppliers has therefore been abolished; the SSRO will continue to be funded through Grant-in-Aid, solely funded by the MOD. The renumbered 'four step' process in the amended Regulation 11 are Step 1- Baseline Profit Rate; Step 2 – Cost Risk Adjustment; Step 3 – Incentive Adjustment; and Step 4 – Capital Servicing Adjustment.

7.19 Regulation 15 of this SI omits Regulation 12 (Calculation of the POCO adjustment) from the 2014 Regulations. The current POCO adjustment has been necessary because suppliers sometimes sub-contract on a single source basis to companies within their own group of companies, which means that they can earn profit on the group costs they incur at multiple levels. POCO is intended to ensure that the agreed regulated

profit is only recovered once on the single source costs of a contract incurred within a group.

7.20 Following the review of the Regulations the MOD concluded that it would be simpler and more transparent if the objective of the POCO adjustment were addressed as an adjustment to the prime contractor's allowable costs, rather than as an adjustment to the profit rate. The existing Regulations do already allow for the POCO adjustment to be made in the allowable costs, in which case the 'step 3' POCO adjustment is zero. The SI removes the option of making the POCO adjustment as part of profit rate calculation and requires it to be made (when necessary) as an adjustment to the allowable costs of the prime contract.

7.21 Regulation 17 of this SI inserts a new Regulation 13A into the 2014 Regulations (Costs Associated with Group Profits) which states that the costs of a prime contract will not meet the requirements of Section 20(2)(a) to (c) of the Act (for the allowable costs of a contract to be "appropriate, attributable and reasonable"), if the prime contractor enters a group subcontract and a deduction from the allowable costs has not been made in accordance with the remaining provisions of Regulation 13A. They define what is meant by a 'group subcontract' (and 'further group sub-contract', because there can be multiple group contracts forming a supply chain beneath the prime contract) and set a minimum threshold value of £0.25m for a group subcontract to be within scope of the Regulation. They also establish that subcontracts with group companies placed under a *competitive process* are not in scope of the POCO adjustment.

7.22 Regulation 13A requires that the 'attributable profit' of any group subcontract be removed from the Prime contractor's allowable costs. The adjustment does not affect the price (including profit) paid by the prime to the group subcontractor but does mean is that if profit has been paid to a group subcontractor, the MOD does not pay a second layer of profit on those costs when they flow-up into the prime contract. The subcontract 'attributable profit' to be removed from the Prime's allowable costs does not include any 'risk premium' profit paid to the subcontractor which is *over and above* any risk premium paid by MOD to the prime contractor. If performing the contract for the MOD includes specific cost risk that the subcontractor is taking and not the prime, then it is appropriate for MOD to pay for that within the prime contract price.

7.23 Regulation 16 of this SI amends Regulation 13 of the 2014 Regulations (Rates Agreed on a Group Basis) and deals with two matters in setting the contract profit rate. The first concerns 'step 2' which is currently an adjustment to reflect the cost risk to the contractor in taking the contract (or in this case where the profit rate is to be agreed on a group basis, more than one contract). At present the 'cost risk' is narrowly defined as being the risk that the actual costs to perform the contract(s) will be different from the estimated costs used to price the contract(s). Following close engagement with industry about the cost risk adjustment over an extended period, the amendment will widen the definition of cost risk by referring instead to the "financial risks" of entering the contract(s) and allow for the risk adjustment to consider the types of activity carried out by the primary contractor. This change will allow a wider assessment of the risk a contractor is taking in accepting a contract, and hence the setting of fairer contract profit rates. The second amendment concerns the alignment of Regulation 13 with the changes to the POCO adjustment made by new Regulation 13A, as described above.

7.24 Regulations 18-21 and 23 of the SI amend Regulations 14-17 and 19 respectively, to align those Regulations with the introduction of "contract components" (see paragraphs 7.6 – 7.10 above). Regulation 17 is significant in that it permits the existing Final Price Adjustment (FPA) provisions of the Act and Regulations to be applied at a component level, where the parties to the contract agree to do that, rather than at a whole contract level. The FPA is a mechanism whereby on contracts or components using particular default pricing methods, where the outturn costs of the contractor are significantly at variance from the estimated cost used to agree the price (i.e the costs underrun or overrun significantly), the parties are required to apply the FPA mechanism to determine whether a FPA payment should be paid by one party to the other (i.e. in the case of a supplier cost underrun, whether some of the agreed contract price should be refunded to the MOD; and in the case of a cost overrun causing the contractor a loss, whether further payments should be made by the MOD). The ability to apply the FPA at the component level is a sensible step given the long duration of many defence contracts.

7.25 Regulation 22 of this SI amends Regulation 18 of the 2014 Regulations (Determination of Contract Profit Rate Adjustments). The amended Regulation 18 permits the SSRO, on application by either the Secretary of State or an authorised person, to reach a determination in relation to any of the contract profit steps set out in Regulation 11 (as amended, see para 7.18 above). Previously the SSRO could not take referrals on 'step 1', the Baseline Profit Rate (BPR) – this was originally considered unnecessary because the BPR is published annually following recommendations by the SSRO, and is not of itself the subject of any negotiation between the contracting parties. However, whilst the BPR changes annually (being fixed on the 1st April each year), in practice disputes can arise as to which year's BPR should be applied, particularly in relation to contract amendments. The review of the Regulations concluded the SSRO should be able to decide on this matter when the parties cannot agree. The review also concluded that the 'step 3' Incentive Adjustment, which may be made at the MOD's discretion, should also be referrable to the SSRO, in the event of a dispute.

Alternative pricing methods

7.26 Regulation 20 of the Regulations makes provision for seven new alternative pricing methods. These are regulation 19A to 19G of the 2014 Regulations.

Commercial pricing

7.27 Regulation 19A makes provision for the commercial pricing method, which may be used if the contractor has supplied the same or substantially same goods, works or services to: the Secretary of State under a competitive process; another party under a competitive process; any other person in an open market where such goods, works or services are on sale; or where the Secretary of State is satisfied that a supplier (who may be the prime contractor) has supplied the same or substantially same goods, works or services to other parties in a competitive environment.

7.28 This method may be used when the Secretary of State is satisfied that the price has been tested in market conditions. It may not be used if the Secretary of State has made a direct payment for the development of the goods works or services to be supplied. Regulation 19A makes provision for determining the price to be paid, making necessary adjustments for such factors as volume, a change in economic conditions and change in terms and conditions of supply. The contractor has a duty to

supply the Secretary of State with all information in its possession to ensure that the goods, works and services have in fact been supplied commercially and to ensure that the price is accurately adjusted.

Prices determined in accordance with law

7.29 Regulation 19B makes provision for circumstances where the price which is payable for the goods, works and services provided under the contract is subject to another law (the relevant law) and the pricing requirements of the relevant law are inconsistent with the Act and 2014 Regulations being applied in full. Examples might include utilities in the UK or berthing charges in some overseas ports. Only laws that regulate the price payable by the Secretary of State would be a relevant law. Foreign laws that regulate the prices paid by other Governments would not be relevant laws, unless those laws effectively constrain the price paid by the Secretary of State.

7.30 In these circumstances, the disapplication of the framework in the Act and 2014 Regulations 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 relevant law might control the whole price paid, in which case the framework would be disapplied altogether. In other cases, the relevant law might specify how elements used in pricing are calculated. For example, there might be a requirement in the relevant law to apply a minimum profit to an element of allowable costs. This might require an adjustment to the way that the Regulations are applied but would still allow their application to all other aspects of the price unaffected by the relevant law.

Previously agreed price

7.31 Regulation 19C makes provision for circumstances where a price has previously been agreed between the parties, either prior to the contract being converted to become a QDC or before the relevant scope of work was transferred from one QDC to another.

7.32 Section 14(4) and (5) of the Act allows an existing contract to be converted to fall within the framework in the Act and 2014 Regulations by agreement between the contracting parties. It is usually not practicable to apply the framework where goods, works and services have already been priced, particularly where the work may have been completed sometime prior to conversion. Where a contract is converted in this way to become a QDC, this alternative pricing method addresses the prices which had been agreed between the parties prior to conversion of the contract. In respect of goods, works or services provided under the contract prior to the date of conversion, the price for those goods, works or services is as the parties had agreed *prior* to conversion. In respect of goods, works or services provided under the contract prior to the date of conversion, the price is as previously agreed, after the date of conversion, but for which the parties had agreed a price before conversion, the parties have two options: (i) to keep the price as previously agreed; or (ii) re-price those goods, works or services in accordance with another contract pricing method at the date of conversion.

7.33 Where the price for goods, works or services is agreed under one QDC and then the contractual obligation to provide and pay for those goods, works or services is transferred to another QDC (the transfer of scope), Regulation 19C provides that the price payable for those goods, works or services shall be as agreed between the parties prior to the transfer of scope.

Novated contract

7.34 Regulation 19D makes provision for circumstances where a QDC has been novated. In such circumstances, the only change is to the identity of the supplier(s) to the contract. Since there is no change being made to the goods, works and services being provided, or to the terms on which they are provided, there is also no change to the price which had been agreed for those goods, works or services prior to novation.

Competed rates applied to uncompeted volumes

7.35 Regulation 19E makes provision for competed rates applied to uncompeted volumes. This alternative pricing method will apply 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. In these circumstances, it is unnecessary to apply to the *competed unit prices* the rules that state that costs must be shown to be appropriate, attributable to the contract and reasonable, or apply the default pricing method profit rate. However, there will be an obligation on both the contractor and the Secretary of State to be satisfied that the *estimated volumes* which are applied to the competed unit prices to calculate a price for the relevant goods, works or services are appropriate, attributable to the contract and reasonable in the circumstances.

Agreed changes to the contract profit rate

7.36 Regulation 19F makes provision for agreed changes to the contract profit rate. It has not previously been possible to amend a previously agreed profit rate, even if there had been an error in setting it, without re-pricing the contract. Regulation 19F will allow the parties to: correct an error in the profit calculation; or change by agreement step 3 (Incentive Adjustment) of the profit calculation without having to make any other adjustments to the contract price previously agreed.

Aggregation of components

7.37 Regulation 19G makes provision for aggregation of components where the contract contains more than one component. Where Regulation 19G does not apply, the price of a contract that has two or more components will be determined by adding together the price of those separate components. Regulation 19G makes provision for circumstances where the parties have agreed that there should be an adjustment made *at the contract-level* to either step 2 of the contract profit rate calculation (the cost risk adjustment) and/or step 3 (the incentive adjustment).

7.38 Where the contract requires the primary contractor to integrate outputs from different components of the contract, the parties may consider that the cost risk adjustments made in respect of the components of the contract are insufficient to reflect the financial risks to the primary contractor of entering the contract, taking account of the requirement to integrate outputs from different components of the contract. In those circumstances, Regulation 19G provides that the parties can make a 'contract-level' cost risk adjustment to address that insufficiency. That contract level cost risk adjustment is subject to a limit set out in Regulation 19G.

7.39 Regulation 19G also enables the parties to agree an incentive adjustment which is additional to any incentive adjustments agreed in respect of each component of the contract. The maximum limit for total incentive payments under the Regulations is not changed by this SI and remains at 2% of the total allowable costs of the contract.

Pricing Amendments

7.40 The Schedule to the 2014 Regulations makes provision for re-pricing of QDCs. Regulation 43 amendments the Schedule to provide for redetermining the price on amendment of either a contract, or a component of a contract and to provide for the re-pricing of a contract or component which has been priced using one of the new alternative pricing methods.

Reporting

7.41 The Act and Part 5 of the 2014 Regulations make extensive provision for the contractor under a QDC and a sub-contractor under a QSC to provide reports to the Secretary of State to ensure transparency from before a contract is entered into until after it is concluded. The Regulations amend Part 5 (reports on qualifying defence contracts). The amendments are generally necessary to make provision for: contracts being split into components under the amended Regulations; and new alternative pricing methods which do not have a requirement to separately identify the cost and profit elements of a price (e.g. when using the new 'commercial pricing' method). This accordingly changes some of the existing 'general reporting requirements' in relation to costs.

7.42 Part 6 of the 2014 Regulations makes provision for reports by a contractor on overheads and forward planning. Regulation 31 of the 2014 Regulations provides that a supplier with an ongoing qualifying contract or contracts totalling £50m or more is required to submit the supplier reports detailed in Part 6 (supplier reports are primarily related to a supplier's overhead costs, in contrast to individual contract reports provided under Part 5). This provision has been amended by regulation 36 of the Regulations. The amendment disapplies certain contracts priced under alternative pricing methods from the assessment of the £50m value threshold.

Powers of the SSRO

7.43 Part 9 of the 2014 Regulations makes provision for opinions and determinations made by the SSRO. Regulation 39 of the regulations amends Regulation 51 of the 2014 Regulations (Matters on which the SSRO must give an opinion). These amendments are necessary to reflect amendments to the contract profit rate steps, the introduction of alternative pricing methods, the potential for componentisation of contracts, and the redetermination of contract prices using the amended Schedule.

7.44 Regulation 40 of the Regulations amends Regulation 52 of the 2014 Regulations (Matters on which the SSRO must make a determination) to reflect the potential for componentisation of contracts.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 There are no plans to consolidate the legislation.

10. Consultation outcome

10.1 The Act requires the Secretary of State to carry out a review of the legislation within three years of the first single source contract regulations coming into force, and

thereafter every five years. Also, the Act requires the SSRO to keep the legislation under review and where it considers appropriate to make recommendations to the Secretary of State on any proposed changes.

10.2 The Act requires that the Secretary of State must have regard to any recommendations made by the SSRO, stemming from any review under the Act, and, or as part of their statutory function.

10.3 The main stakeholders affected by the Regulations are suppliers in the defence industry. The Secretary of State has been engaging with these suppliers (and through the defence industry trade bodies, Defence Single Source Advisory Group, the Association of Defence Suppliers, and TechUK, which have been acting to co-ordinate the views of the defence sector) through a detailed series of workshops starting in 2019 and which have continued through to the end of 2023.

10.4 This bespoke programme of meetings has supplemented the regular liaison that occurs through the Defence Suppliers Forum (DSF) which includes all main defence contractors as well as those representing SME's and the MOD.

10.5 Industry has been supportive of many of the proposed changes but has raised several concerns about others, in the meetings referenced above and in response to the public consultation on the proposals (November 2023). The Government is providing a separate, formal response to these concerns.

11. Guidance

11.1 Guidance on all aspects of the of the 2014 Regulations, included all implemented changes to date, can be found on the MOD Commercial Toolkit (which is also accessible, on request, by defence suppliers). The Toolkit will be updated to reflect the amendments made by this SI.

11.2 The MOD is the SSRO's sponsoring Department. The MOD will work with the SSRO to provide stakeholders with guidance on how the regulatory amendments contained in this SI will operate. This guidance will be available to the public on the SSRO website.

12. Impact

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

12.2 There is no, or no significant, impact on the public sector as the amendment(s) to Regulations.

12.3 An Impact Assessment has been prepared for this instrument.

12.4 As suppliers will be subjected to a simplified process of setting profit rates, more efficient framework processes, and a decrease in aspects of the current reporting requirements, it is assessed that additional costs to industry arising from these amendments will be marginal and any costs of compliance can be reclaimed from MOD as allowable costs of under the Act and 2014 Regulations, providing suppliers can demonstrate that these costs are appropriate, attributable, and reasonable (see s.20(2) of the Act).

13. Regulating small business

13.1 The legislation applies to activities that are undertaken by small businesses but, as it only applies for QDCs with an individual value greater than £5M and QSCs with an

individual value greater than £25M, the impact on small businesses from the current legislation is small. It is assessed that the additional impact on small businesses arising from the amendments will therefore be negligible.

14. Monitoring & review

14.1 Under Section 39 of Act, the SSRO has a duty to keep under review the provision made by Part 2 and the single source contract regulations which are in force and the Secretary of State has a duty to carry out a review within 3 years of the first SSCRs coming into force and every 5 years thereafter. In carrying out this review the Secretary of State must have regard to any recommendations made by the SSRO.

14.2 While the next statutory review of the legislation was not required to be completed until December 2022, review and extensive consultation with stakeholders took place between 2019 and 2022, with a Command Paper published in April 2022. The review concluded that changes were needed both to the Act and to the 2014 Regulations. Changes to the Act were made by Schedule 10 of the Procurement Act 2023 and these Regulations make some of the amendments that the review identified as necessary to the 2014 Regulations. It is anticipated that the remaining amendments identified as necessary will be made in the near future.

14.3 The changes to the Regulations delivered by this SI are the most significant to date. They ensure that the Regulations can be applied to a wider range of contracts by providing greater choice in the pricing methods available, to agree a fair price for goods, works, or services. They allow the componentisation of contracts which allows for more useful contract reports and enhance the potential for good contract management. The changes ensure that the reporting requirements on suppliers are less burdensome and that the process for dispute resolution is simplified.

15. Contact

15.1 Steve Davies at the Ministry of Defence Telephone: 07881 101232 or email: steve.davies262@mod.gov.uk can be contacted with any queries regarding the instrument.

15.2 Charly Wason, Deputy Director for Single Source Contract Regulations Review Team, at the Ministry of Defence can confirm that this Explanatory Memorandum meets the required standard.

15.3 James Cartlidge MP at the Ministry of Defence can confirm that this Explanatory Memorandum meets the required standard.