

## DEFENCE REFORM ACT 2014

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### EXPLANATORY NOTES

#### COMMENTARY ON SECTIONS

#### Part 2: Single Source Contracts

#### *Sections 17 and 18: Contract profit rate*

62. The SSCRs must make provision for determining the CPR for each QDC, and that determination must be taken by following the six steps that are set out in *subsection (2)* of section 17. The SSRO may issue guidance as to any of the steps (section 18(1)). Some of these steps themselves have further provision in other sections. The steps are:
- a) *Step 1* - the “baseline profit rate” (BPR) is the starting profit rate for all QDCs before other adjustments are applied at steps 2 to 6. The BPR will be determined annually, as provided for in section 19.
  - b) *Step 2 - (cost risk adjustment)* – an adjustment to reflect the residual cost risk retained by the contractor under the QDC, within a range to be specified in the SSCRs. The contractor and the Secretary of State will each be able to refer this adjustment to the SSRO for an opinion, as this will be a matter to be specified under section 35(1)(a). This adjustment **may increase or decrease** the CPR.
  - c) *Step 3 - (profit on cost once)* – QDCs often have complex commercial supply chains involving sub-contracts that may themselves also have further sub-contracts etc. This adjustment is to ensure that where a QDC has single source sub-contracts, profit is only charged once upon allowable costs. The contractor and the Secretary of State will each be able to refer this adjustment to the SSRO for an opinion, as this will be a matter to be specified under section 35(1)(a). This adjustment **may decrease** the CPR.
  - d) *Step 4 - (SSRO funding adjustment)* - the SSRO will be funded equally by industry and the Secretary of State. This step provides for an adjustment to the CPR to fund the SSRO, and is the means whereby industry funding is intended to be equitably shared across contractors based upon the value of their QDCs. The SSRO funding adjustment will be determined annually, as provided for in section 19. This adjustment **will decrease** the CPR.
  - e) *Step 5 - (incentive payment)* – there are circumstances in which it is appropriate to provide additional financial incentives to a contractor under a QDC, where such incentives are related to the performance of specific provisions (to be specified by the Secretary of State). This adjustment allows for an incentive element in the CPR, subject to a maximum amount to be specified in the SSCRs. This adjustment **may increase** the CPR.
  - f) *Step 6 (capital servicing allowance (CSA))* – in performing a QDC a contractor may make use of both fixed capital (buildings, plant and equipment etc) and working capital. This adjustment allows for the contractor to receive an appropriate and reasonable return on this capital employed in performing the

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contract. The contractor and the Secretary of State will each be able to refer this adjustment to the SSRO for an opinion, which will be provided for under section 35(1)(a). This adjustment **may increase or (exceptionally) decrease** the CPR.

63. Steps 2, 3 and 6 provide for amounts to be agreed, and section 17(4)(a) provides that “agreed” means agreed by the Secretary of State (or an authorised person) and the contractor. The reference to an “authorised person” is to allow for the fact that a contractor or the employee of a contractor under arrangements mentioned in section 1 of this Act may be authorised by the Secretary of State to exercise this function.
64. In some cases the Secretary of State will have many similar QDCs with one contractor (for example when let under a framework agreement). In these cases it may be more efficient to determine one CPR to be used for a group of contracts, rather than make an individual assessment for each QDC. This is provided for by section 18(2)(c).
65. Either party may ask the SSRO for a determination if they consider that an adjustment under step 2, 3 or 6 was not appropriately determined in accordance with this section, based upon information available to either party at the time the QDC was entered into (section 18(3)(a)). Where the SSRO determines that a different adjustment under step 2, 3 or 6 should have been made, it may further determine a price adjustment to the extent that that adjustment varies from the one made at the time the contract was entered into (section 18(3)(b)). Enforcement of this price adjustment is provided for by section 22.
66. The SSCRs may allow for some of the six steps to be disapplied for lower value QDCs (section 18(2)(a)) or for those steps to be applied in a modified way (section 18(2)(b)). This means that, for low value QDCs, the SSCRs will be able to make provision for a simplified process of determining the CPR.