EXPLANATORY MEMORANDUM TO

THE SINGLE SOURCE CONTRACT (AMENDMENT) REGULATIONS 2019

2019 No. 1106

1. Introduction

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

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

2. Purpose of the instrument

2.1 The regulations make changes to the Single Source Contract Regulations 2014 ("the 2014 Regulations"), the Single Source Contract (Amendment) (No. 2) Regulations 2018 ("the 2018 Regulations") and refer to Part 2 of the Defence Reform Act 2014 ("the Act"). They are not affected by EU Exit legislation.

2.2 In December 2017 the Secretary of State for Defence completed a review of Part 2 of the Act and the 2014 Regulations. This review followed extensive consultation with stakeholders and had regard to the 14 recommendations made to the Secretary of State by the Single Source Regulations Office ("SSRO") in June 2017. These changes to the 2014 Regulations implement some of the conclusions of that review, as well as further minor technical improvements that have been identified since. The regulations also address some deficiencies identified by the Joint Committee on Statutory Instruments ("JCSI") in relation to the Part 2 2018 Regulations.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 Regulations 23 and 24 address points raised by the JCSI in its report of 30 January 2019 in relation to the 2018 Regulations.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 As the instrument is subject to negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument 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 As the instrument is subject to negative resolution procedure and does not amend primary legislation no statement is required.

6. Legislative Context

6.1 The Act 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. Part 2 creates a regulatory framework for "single source contracts" (that is, defence contracts which are not competed). 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. This can be done in accordance with Article 346 of the Treaty of the Functioning of the EU. Substantial parts of the new regulatory framework were set out in the 2014 Regulations rather than in the Act.

6.2 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.

6.3 The Act also created an executive Non-Departmental Public Body, known as the 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.

6.4 Since the 2014 Regulations came into force, Parliament has passed two Statutory Instruments (SI) that have amended them. The first, 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, 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.

7. Policy background

What is being done and why?

7.1 The Secretary of State is required by the Act to review single source legislation within three years of the legislation coming into force and must consider the recommendations made by the SSRO for changes. This review is to ensure that the legislation is operating as intended and to allow stakeholders to provide feedback. This review was completed in December 2017. It concluded that the legislation was functioning as intended and was effective, but it also identified several changes where improvements could be made.

7.2 The first amendments to the 2014 Regulations were made by statutory instrument which came into force on 1st August 2018. These covered changes which were required to be made as soon as possible and which were relatively straight-forward. Further changes came into force on 31 January and 1 April 2019.

7.3 The second amendments to the 2014 Regulations were made by statutory instrument which came into force on 17th December 2018. These covered clarification on how amendments are priced and changed some of the time limits for referral to the SSRO.

7.4 The changes in this SI are intended to clarify the regulations, correct some minor errors and ensure that the right balance is struck between the administrative burden placed on suppliers and the need to ensure that adequate measures are in place to prevent either party from avoiding the requirements of the legislation. In detail they are:

7.5 **Regulation 3**: The intent of the legislation is that documents that contractors are required to supply under the regime should be subject to the reporting requirements set out in Part 5 of the regulations, which refers to such documents as 'reports'. Regulation 2(2) of the 2014 Regulations lists documents that should be treated as reports but are called 'statements' or 'plans' but does not include the estimated rates agreement pricing statement. The change corrects this.

7.6 **Regulation 4**:

a) The change to Regulation 5(4)(b) ensures that where the Secretary of State is not the contracting authority (such as when the contract is between a prime contractor and a sub-contractor) the value of resources provided by the contracting authority is not included in calculation of the contract value. This ensures that the value of contracts is calculated in a consistent way;

b) Regulation 5(4)(c) currently says that the value of contracts priced in foreign currencies should be converted to sterling using an exchange rate calculated in accordance with the contracting authority's accounting policies. Treatment of exchange rates is not necessarily an 'accounting policy' and there may be circumstances where no policy is in place. The change caters for a wider range of practices, while maintaining a requirement that the rate used must be reasonable;

c) Regulations 5(5) to 5(12) are intended to prevent contracts over the £5M threshold being split into several smaller contracts to avoid the regulations by requiring the value of contracts let to the same supplier for the same requirement to be aggregated. The proposed changes:

i) Provide a single way of doing this, rather than the two alternative methods allowed under the current regulations, by deleting Regulations 5(9) to 5(12). This will simplify the regulations without diluting the anti-avoidance effect;

ii) Exclude competitively let contracts from the aggregation exercise. It is unlikely that either the MOD or the supplier would seek to compete a contract to avoid the regulations. Moreover, the competitive process provides assurance that value for money is achieved, and so application of the regulations would not yield any benefit;

iii) Change the method of aggregation to ensure a disproportionate burden is not placed on suppliers by bringing a large number of low value contracts under the regime. This is done by disregarding contracts under £250,000 altogether, and by requiring contracts between £250,000 and £1M to be included in the aggregation calculation, but not requiring them to become Qualifying Defence Contracts (QDC) themselves. These changes only apply if the contracting authority is satisfied that the contracts have not been deliberately split up to avoid the legislation.

7.7 **Regulations 5 and 18**: The current regulation 9 may allow some confusion over what is meant by the term 'framework contractor'. The changes provide greater clarity on who is being referred to in each part of the regulation.

7.8 **Regulations 6 and 7**: The 2014 Regulations permit a Final Price Adjustment (FPA) designed to reduce the profit paid to suppliers where actual costs are significantly lower than those estimated when the contract was let, and, conversely, provide some relief to suppliers where actual costs are higher than estimates. The risk of excessive profit or loss only arises on contracts using the fixed, firm or volume driven pricing methods, and so the regulations only apply to these contracts that use these pricing methods.

7.9 A problem arises where a contract has some elements priced using the fixed, firm or volume driven methods, but other elements use one of the other prescribed methods. Under the current regulation, this would require an FPA to be applied to the whole contract, including the elements priced under the cost-plus, estimate based fee or target cost methods. The changes made by these regulations to Regulations 16 and 17 of the 2014 Regulations correct this by ensuring that the FPA is only applied to the components of the contract that use the prescribed pricing methods.

7.10 **Regulations 8 – 12, 17 and 21**: The current regulations use the term 'contract value' to refer to both the total spend that the contracting authority expects to flow through the contract (which is used to determine whether the contract should become a QDC and which reporting requirements it should be subject to), and the figure that should be submitted in the mandatory reports. This presents practical problems for suppliers filling in the reports, who may not be aware of the authority's spend estimates and be required to provide a cost breakdown for work that has yet to be fully specified. The change makes a clear distinction between 'contract value', which is the estimated figure used for threshold purposes, and 'contract price', which is the figure that the authority is committed to pay for the contract. On cost-plus or framework contracts these figures can vary significantly: many framework contracts are let at a very low value, which builds up over time as tasks are placed.

7.11 **Regulations 9, 10 and 19**: The current set of mandatory reports do not allow an assessment to be made of how contracting authorities are fulfilling their obligation to assess whether sub-contracts should become Qualifying Sub-Contracts (QSCs) and hence fall under the regulations. The change rectifies this by ensuring that the relevant reports identify all contracts valued at over £15M and, where an assessment has been made not to make such contracts a QSC, an explanation is provided.

7.12 **Regulation 13 and 15**: Regulations 35(8)(b) and 37(8)(a) of the 2014 Regulations require an explanation of any variation between actual and estimated cost contained in the Qualifying Business Unit (QBU) reports. Estimates nearly always vary from actuals by at least a small amount and explaining every minor change may put a disproportionate burden on suppliers. This change ensures that explanations are only required for material variances.

7.13 **Regulation 14**: Regulation 36(3)(d) of the 2014 Regulations requires suppliers to submit 'the budget for the QBU'. Suppliers have pointed out that budgets are not necessarily allocated on QBU basis, and that there may not be a budget for the QBU as such. The change deals with this by requiring the budget data related to the unit, rather than the budget itself.

7.14 **Regulation 16**: Suppliers have pointed out that the requirement to provide a description in the Strategic Industrial Capacity Report of any site to which more than £1M of costs have been allocated may introduce a disproportionate reporting burden. This change raises the threshold to £10M.

7.15 **Regulation 20 and 22**: This adds a new provision that any amounts payable as a result of an FPA on a QSC are dealt with directly between the Secretary of State and the sub-contractor rather than going through the prime contractor. This is simpler and avoids the prime contractor having to recover amounts from the sub-contractor that it did not determine.

7.16 **Regulation 21**: There are circumstances under which a sub-contract can cease to be a QSC, such as when the QDC under which the QSC was awarded is complete, but the prime contractor continues to use the sub-contract for other purposes. This change ensures that records only need to be kept for two years after the date a contract ceases to be a QSC rather than the contract completion date.

7.17 **Regulation 23 & 24**: The Joint Committee on Statutory Instruments reported the MOD for 2 instances of defective drafting in their Forty-sixth Report of Session 2017–19 on the second SI laid in December 2018. The MOD undertook to correct these as soon as possible. This change does this.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not relate to withdrawal from the European Union or 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 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, and thereafter every five years. As part of this review, the Secretary of State must have regard to any recommendations made by the SSRO.

10.2 The SSRO undertook the following public consultation as part of the review:

- 1st Call-for-Input May 2016 – July 2016
- 2nd Call-for-Input September 2016 – November 2016
- Public Consultation January 2017 – to March 2017.

10.3 Details of this consultation and inputs from stakeholders can be found on the SSRO website along with its published recommendations to MOD.

10.4 In June 2017, the SSRO submitted its recommendations to the Secretary of State. This was followed by a series of further engagements by MOD with industry and the SSRO lasting from December 2017 to July 2018. The first SI, which came into force on 1st August 2018, and the second SI which came fully into force on the 1st April 2019 was made as a result of this review.

10.5 The main stakeholders affected by the amendments to these regulations are suppliers in the defence industry. The MOD has been engaging with these suppliers (and through the defence industry trade body, ADS, which has been acting to co-ordinate the views of the defence sector) through a series of workshops during 2018 and 2019.

Industry have been supportive of the proposed changes which will clarify how this operates within the legislation.

11. Guidance

11.1 Guidance on all aspects of the of the 2014 Regulations, included all implemented changes, can be found on the MOD Commercial Toolkit (which is accessible, on request, by defence suppliers).

11.2 As the SSRO's sponsoring Department, the MOD will work with the SSRO to provide stakeholders with guidance on how the amendments contained in this instrument will operate. This guidance is 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 to regulations is expected to provide clarification previously identified in the 2017 review and reduce the administrative burden on suppliers.

12.3 An Impact Assessment has not been prepared for this instrument for the following reasons. The Better Regulations Executive (BRE) at the then Department for Business, Innovation, and Skills was consulted in 2013-2014 concerning the new legislation. It advised MOD that as suppliers would be reimbursed for costs incurred in complying with the new requirements, and as all single source procurement was "an explicit rejection of the market", the new framework would not be regarded as "regulations" from the point of view of the Regulatory Policy Committee.

12.4 As suppliers will be subject to the same reporting burden as at present, we assess that the 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 a QDC or QSC, providing suppliers can demonstrate that these costs are appropriate, attributable, and reasonable (see s. 20(2)).

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. We assess that the additional impact on small businesses arising from the amendments will therefore be negligible.

14. Monitoring & review

14.1 The Act requires Secretary of State to undertake a review of the legislation within three years of it 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 current, the next review should be completed within three years (i.e. by December 2020). This review will include significant engagement with the SSRO and the defence industry as it develops. The Act also requires the SSRO to keep the legislation under review and it may make recommendations to the Secretary of State on any changes which it considers appropriate.

15. Contact

15.1 Mary Gee at the Ministry of Defence Telephone: 0207 218 0861 or email: mary.gee103@mod.gov.uk can be contacted with any queries regarding the instrument.

15.2 Charly Wason SCS1, at the Ministry of Defence can confirm that this Explanatory Memorandum meets the required standard.

15.3 Stuart Andrews at the Ministry of Defence can confirm that this Explanatory Memorandum meets the required standard.