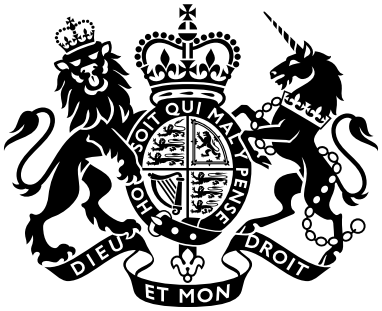
Ministry
of Defence

Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations

April 2022

CP 647



Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations

Presented to Parliament
by the Secretary of State for Defence
by Command of Her Majesty

April 2022

CP 647

This publication is available at www.gov.uk/official-documents.

Any enquiries regarding this publication should be sent to us at steve.davies262@mod.gov.uk

ISBN 978-1-5286-3283-6

E02736607 04/22

Printed on paper containing 40% recycled fibre content minimum

Printed in the UK by HH Associates Ltd. on behalf of the Controller of Her Majesty's Stationery Office

Contents

1. Executive summary

1. The Defence and Security Industrial Strategy (DSIS) establishes a more strategic relationship between Government and the defence and security industries. Through DSIS we have replaced the policy of competition by default with a more flexible and nuanced approach, where on a case-by-case basis we will consciously assess the best approach to through life acquisition. This still allows us to use competition where appropriate but also means we may opt in certain circumstances for long-term strategic partnerships. Where we do procure in the absence of competition, it remains vital that we pay fair prices for the goods and services we buy, to provide value for money for the taxpayer while ensuring the UK defence sector remains an attractive place to invest.

2. The single source procurement regime plays a key role in striking this balance. As of December 2021, it covered 365 contracts with a combined value of £62.1bn. But for us to deliver DSIS, we will need to reform the Single Source Contract Regulations 2014 (SSCRs) to ensure they deliver fair prices across the full breadth of single source work. We also want to speed up the acquisition process by cutting the time and cost to MOD and industry of applying the SSCRs.

3. This Command Paper sets out a significant reform agenda, focused on three main themes.

Choice and Flexibility

4. Providing more choice and flexibility will ensure that the regulations can be applied to a wider range of contracts, including by introducing new ways of determining a fair price for goods or services. Chief amongst these will be allowing prices to be set by reference to market prices, rather than always having to use the bottom-up pricing formula set out in the Act. We will specify in regulations exactly when prices can be set in this way, with the overall aim to ensure that the SSCRs can be used to assure value for money in areas such as off-the-shelf software or engineering commodities.

5. It will also be vital that we can pay a fair profit rate for all the different sectors where we single-source. We are keen to ensure that where possible the profit rate available to suppliers accurately reflects the full range of financial risks that they take on when

they enter into a single source contract. It is the Government's view that these risks vary significantly from sector to sector, and that it is therefore appropriate to take sectoral variations into account when calculating that adjustment made for risks. We therefore propose to change the wording of the step that adjusts the profit payable on a contract to take account of risks.

Speed and Simplicity

6. We will draw on experience gained since the legislation was introduced in 2014 to speed up and simplify how the framework is used. To ensure transparency and provide assurance on value for money, the regulations include a range of reporting requirements on suppliers. We will make these requirements simpler and more efficient by ensuring that suppliers are only required to produce the information the MOD needs, and we will be clear about what that information will be used for.

7. We will ensure that the statutory dispute resolution mechanisms built-in to the regime can be used more frequently to speed-up contract negotiations. This includes widening the range of subjects that can be referred to the Single Source Regulations Office (SSRO) and making changes to the nature of those referrals.

8. We will simplify the profit setting process by reducing the current six steps to four. We will also enact a raft of technical changes to clarify and simplify the regime.

Stimulating innovation and exploiting technology

9. We will adapt the SSCRs if necessary to cater for new contracting approaches, stimulating innovation through allowing co-funding of research into cutting-edge technologies and supporting the exploitation of that new technology. We will also ensure that appropriate research and development costs can be practically recovered through overheads.

Conclusions

10. Alongside the current reform of the Public Contract Regulations (PCRs), these changes will be key to ensuring that we can deliver the policy outcomes set out in the Defence and Security Industrial Strategy. They also reflect the need to the continuously

improve the SSCRs to ensure that they support the long-term sustainability of the UK defence sector by providing a fair price for industry while delivering value for money for the UK taxpayer.

2. Introduction

11. The Ministry of Defence (MOD) introduced the Single Source Contract Regulations (SSCRs) in December 2014 to address long-standing issues with the £9bn per year that the MOD spends on non-competitive defence procurement. The regulations are expressly designed to provide value for money in public expenditure while ensuring fair prices are paid to industry. As of December 2021, 365 Qualifying Defence Contracts (QDCs) and 60 Qualifying Subcontracts (QSCs) with a total value of £62.1bn have been brought under the regime.

12. Part 2 of the Defence Reform Act 2014 requires the Secretary of State for Defence to review the legislation underpinning this framework on a regular basis. While the next statutory review of the legislation is not required to be completed until December 2022, this review has been timed to ensure that the regulations help deliver the DSIS White Paper published in March 2021. While all the proposed changes have been discussed extensively with key stakeholders over the period of the review, the Secretary of State will consider any additional views from stakeholders submitted in response to this Command Paper by noon on 3 May 2022 to steve.davies262@mod.gov.uk.

13. Implementation of these proposals will require a combination of primary and secondary legislation as well as changes to the statutory guidance published by the SSRO and internal MOD commercial guidance and practice. We will be working with the SSRO to develop an implementation plan.

14. This Command Paper sets out the Secretary of State's policy proposals for the SSCRs in this context. It responds to the recommendations put forward by the SSRO which were made in the light of input from external stakeholders, particularly our suppliers, and those from acquisition practitioners in the MOD. It also gives an indication of how the Government plans to implement these changes through a combination of legislation and working with the SSRO on statutory guidance, or changes to MOD contracting policy or processes. The necessary changes to primary legislation will be brought forward when parliamentary time allows.

15. The formal review of the legislation began in mid-2019 and the main phases are set out in Table 1. This involved both an extensive public consultation underpinning the SSRO's recommendations as well as a comprehensive series of workshops between the MOD, the SSRO, and industry. MOD is grateful for the significant role played by the SSRO in contributing to this review, particularly the recommendations submitted in June 2021. We also appreciate the contribution made by individual suppliers as well as by the relevant trade associations, including ADS and TechUK.

Table 1: Main Phases for the Review

Review of the Single Source Contract regime – Main Phases
MOD liaison with industry including call for initial policy proposals – November 2019
Public Consultation initiated by SSRO – 20th December 2019 to 28th February 2020
SSRO submits its initial recommendations to Secretary of State – 17th Jun 2020
On-going industry liaison – January to December 2020
Issue-specific stakeholder workshops (MOD, SSRO, industry) – December 2020 to June 2021
SSRO submits its final recommendations to the Secretary of State – 14th June 2021
Secretary of State completed review and publishes Command Paper – 4th April 2022
Deadline for responses on changes to primary legislation – noon 3 May 2022

16. The next review will be due five years after the completion of this one. In the meantime, MOD and the SSRO will keep the SSCRs under review to ensure they continue to deliver against their objectives.

3. Choice and flexibility

Introduction

17. DSIS will significantly increase the breadth and diversity of sectors and contract types that MOD will need to use to deliver the capability we require. DSIS addresses this by providing more choice and flexibility in how we procure and support capabilities in response to the needs of each capability segment and the status of the market that these segments need to access. We will adapt the single source contracting regime to align it with this DSIS objective to:

a. Make available alternative pricing methods, such as by reference to market prices;
b. Update the definition of risk in the profit-setting process to ensure it reflects the full range of risks and activity types across all sectors and contract types;
c. Update the legislation to provide a better definition of the element of profit related to incentivisation and provide clarity on how and when incentives should be used; and
d. Enhance the agility of the SSCRs to ensure they can be applied in all circumstances where they will add benefit in a post-DSIS world.

Alternative ways of establishing a fair price for some or all of a contract.

18. For bespoke contracts in competitive markets, suppliers will often set prices by calculating the costs that they expect to incur and adding on profit. Competitive pressure will ensure that costs are tautly estimated and that profit is set at the minimum level needed for the long-term viability of the supplier. The SSCRs emulate this approach by specifying that the price for a single source contract should be set by calculating the estimated or actual costs attributable to the contract and adding on a profit calculated using a prescribed process.

19. This mechanism works well for many ‘traditional’ single source contracts for the acquisition or support of military equipment, especially where the Government is the main customer. However, there are an increasing number of contracts, such as those for software licences, where the cost of production may be relatively low, but the supplier needs to recoup significant initial and ongoing development costs through the unit price.

In other cases, such as support for some aircraft engines, the UK MOD requirement may be a small part of the supplier's business, and the supplier may have a set of tariffs which it uses for both their commercial and defence business. In both cases, it is often difficult to accurately apportion costs to the MOD part of a wider cost pool. Moreover, it is possible to get adequate assurance on value for money because both profit and costs are determined by market forces. We therefore believe that, with suitable safeguards, it would be desirable to change the legislation to allow assurance on fairness and value for money to be provided by reference to market prices rather than application of the pricing formula. This especially applies where part of the contract might be for commercially available items, such as software licences, and part for the integration of those items. Under the current legislation, the entirety of such a contract might have to be exempted from the legislation.

20. There are also other cases where it would be useful to be able to disapply the pricing formula to part of the contract. One of these is where single source contracts have been amended to come under the SSCRs, but there have been substantial costs committed and payments made prior to the conversion. In these examples the legislation currently states that the whole contract must be re-priced. In many cases, it may be impracticable to carry out such re-pricing because of the duration of the contract, or there may be little value in re-opening parts of the contract where the work has already been done and the agreed price paid. This issue can be a significant barrier to converting contracts, and hence reduce the take-up of the regime. In these circumstances, we therefore believe it would be desirable to change the legislation to allow the pricing formula to be applied only to new elements of the contract.

PROPOSAL 1: We will change the primary legislation to allow the regulations to specify circumstances under which a fair price for the supplier and value for money in public expenditure for all or part of the contract may be demonstrated without using the pricing formula set out in Section 15(4) of the Act.

PROPOSAL 2: We will introduce a new regulation that specifies that where it can be demonstrated that a product or service has been sold in open markets and in comparable circumstances (volume, specification etc), value for money may be demonstrated by reference to this price.

PROPOSAL 3: We will introduce a new regulation that says that where a contract is converted to come under the regulations by amendment, the pricing formula need not be applied to work where the scope and price were agreed prior to conversion. We will also consider whether there is merit in specifying other cases where the pricing formula need not be used, such as when prices are already regulated.

Fair profit rates for all contract types

21. As part of this review, we conducted a series of workshops and one-to-one conversations with a range of stakeholders on what factors are relevant to determining a 'fair' profit rate for a single-source contract. We concluded that profit is paid to:

a. ensure that UK defence work is sufficiently attractive compared to other opportunities where suppliers are faced with either/or decisions;
b. provide shareholders with adequate returns on the funds they invest;
c. support the long-term resilience of the UK defence industry;
d. incentivise suppliers to commit to maintaining the long-term capability to deliver complex single source contracts;
e. allow the appropriate allocation of risk and reward; and
f. incentivise performance.

The current 'six step' contract profit-setting arrangements

22. The current arrangements broadly reflect these factors. Profit rates for individual contracts are calculated using the following six steps:

- Step 1 – Baseline Profit Rate (BPR). The BPR is announced by the Secretary of State each year, after considering recommendations from the SSRO. The SSRO calculate the BPR based on the average mark-up on costs of a basket of companies that perform work that is broadly comparable to most single source defence work. The 2021-22 BPR is 8.31%.
- Step 2 – Cost Risk Adjustment (CRA). An adjustment of +/-25% of the BPR can be made to reflect the risk that the actual costs incurred under a contract might vary from the estimated costs, and thus increase or reduce the profit the supplier makes. At the current BPR of 8.31% the range available after the CRA adjustment is between 6.2% and 10.4%.

- Step 3 – Profit on Cost Once (POCO). The POCO adjustment ensures that, where a prime contractor places a sub-contract with a member of the same group, profit is only taken once.
- Step 4 – SSRO Funding Adjustment – This is a small adjustment designed to reclaim some of the funding for the SSRO from suppliers.
- Step 5 – Incentive Adjustment. This step currently enables up to an additional 2 percentage points of profit to be paid for improved performance.
- Step 6 – Capital Servicing Allowance (CSA). This adjustment adds an amount to profit based on the amount of fixed and working capital that is employed on the contract. The SSRO recommends rates to the Secretary of State each year based on short and long-term borrowing rates.

Changing the definition of financial risk used in calculating contract profits rates

23. The legislation currently stipulates that the BPR should be adjusted at step 2 to 'reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs'. We believe that this definition is too narrow because it excludes financial risks that are not directly related to costs, such as provision of warranties or reputational risks, and for which the contractor's shareholders could legitimately expect to be compensated. It also does not specify that the adjustment should be made for risks borne by the contractor. While we believe that it is reasonable to infer that this is the case, we will take this opportunity to make this explicit.

24. The SSRO calculate the BPR from an average of profit earned by companies undertaking similar activities, which they define as 'design and make' or 'provide and maintain'. These profit rates include a reward for the risk taken by these companies, and hence we believe that the BPR provides a reasonable proxy for a fair rate for a typical of contract for undertaking those kinds of activities. The purpose of step 2 is to allow an adjustment to be made to this rate where it can be shown that the risks involved are significantly higher or lower than those faced in a 'typical' contract placed by a firm in the comparator group. There are many reasons for risks in a particular contract being different from those in a typical contract, but a common one is because the contract is for a type of activity – such as construction or IT services – that falls outside the ones used in the comparator group. We believe that this is sufficiently important that there is

merit in explicitly allowing activity type to be taken into account when determining the risk adjustment. Exactly how this should be done will be refined in the relevant regulations and guidance as necessary.

Incentive adjustment

25. The incentive adjustment enables an additional two percentage points of profit to be paid in return for improved performance. To ensure that these two percentage points can deliver maximum benefit to both MOD and its suppliers under all circumstances, we believe that the wording of step 5 should be changed to permit the regulations to set out in more detail when the incentive fee can be used. We also believe that step 5 should be brought into line with other elements of the profit rate calculation by giving the SSRO the power to issue statutory guidance and take referrals on matters relating to the incentive adjustment.

Capital Servicing Allowances (CSA).

26. The CSA is an allowance towards the costs that our single source suppliers incur to finance their fixed and working capital requirements. We did consider whether, like the adjustment for inter-group profits (see paras 35-36), taking the CSA out of the profit-setting process and instead including capital financing charges as part of the allowable cost consideration would simplify the process. We have not currently found a way of achieving this objective, but it remains an option which we will keep under review. For now, we propose no change to the current arrangements.

PROPOSAL 4: we will amend the wording of step 2 to ensure that the adjustment reflects all the financial risks taken on by a contractor and to explicitly state that activity type can be taken into account when calculating this step.

PROPOSAL 5: We will amend the wording of step 5 to allow regulations to set out how and when the incentive fee can be used and to give the SSRO the power to issue statutory guidance and take referrals where necessary.

Segmentation

27. The current legislation states that a single profit rate needs to be applied to the entirety of each contract that falls under the regulations. For some of the larger single-source contracts, it makes commercial sense to use different pricing types for different

elements of the contract. This is expressly permitted by the current legislation, but the application of a single profit rate across the various elements means that the profit might be too high on some elements and too low on others. This problem is particularly acute where part of the contract is priced using cost-plus contracts, where any increase in those costs will attract a higher profit rate than it would do if it were contracted for separately. We will change the legislation to explicitly allow contracts to be split into different segments where they use a different pricing method, such as by reference to market prices (see above), have different profit rates or where it makes sense to calculate the final price differently for different sectors. We will also specify how the various segments must be aggregated to arrive at an overall contract price. We will ensure that the approach is proportionate and does not lead to different approaches being used for small cost pools. It is important to stress that this change will not mandate the use of segmentation: it will simply allow segmentation of contracts to be done sensibly where it is commercially desirable. This will allow the flexibility to use the most appropriate commercial construct for each of our contracts.

28. Segmentation also feeds into the reporting requirements under the SSCRs. The main changes to reporting requirements are covered under the Speed and Simplicity chapter. However, this change will also allow clearer reporting of variances against cost and profit for each element.

PROPOSAL 6: We will change the legislation to allow for a contract to be split into different segments, each of which can have its own approach to pricing, profit rate and calculation of final price. We will also define how the various segments must be aggregated. We will include safeguards to ensure that this can be done in a proportionate and pragmatic way.

Contracts where a rate has been competed, but a volume has not

29. In some circumstances, we will let a contract using unit prices that have been competed prior to being placed on a MOD or cross-Government framework. The resulting price will often be the unit price multiplied by the estimated number of units needed to produce the output specified in the contract. For example, the MOD might place a single-source contract for developing a bespoke piece of software. The supplier then produces a firm price calculated by multiplying the competed daily rate for software developers by the estimated number of days required to write the software. In this case, the current legislation

stipulates that both the daily rate and number of days must be checked against the criteria set out in Act, even though the rate had been competed. We believe it would be better to rely on the competitive process to provide assurance on the unit price but allow the normal processes to be used to check the volume was reasonable.

PROPOSAL 7: We will change the legislation to ensure that for contracts where a rate has been competed but a volume has not, the reasonableness test required by the legislation need only be applied to the volume.

Joint Ventures

30. The SSCRs currently prevent profit being charged on sub-contracts that prime contractors place with companies in the same group, through the 'Profit on Cost Once' (POCO) provisions. This is to prevent profit being charged at multiple levels for a single piece of work. The restriction only applies to 'associated persons' as defined by the Companies Act, which usually means that the prime needs to have at least a 50% stake in the sub-contractor or vice versa.

31. To meet some of the MOD's more complex requirements, contractors with different specialisms sometimes form joint ventures or special purpose vehicles. The joint venture then holds the prime contract, and often sub-contracts relevant components of the work to the owner of the joint venture best able to carry it out. While this can be a highly effective way of ensuring that the various parties work together to deliver the outcome required by the MOD, under the current legislation the owners of the joint venture can draw profit on the sub-contracts that they take-on, and again through their share of the profit payable to the prime. This is because the POCO arrangements do not apply, because none of the joint venture owners have a controlling stake.

32. We believe that this is an anomaly, which constrains the way we can contract for some of these requirements. We will therefore amend the POCO rules to ensure that they prevent profit being drawn by the shareholders multiple times for the same piece of work, even if the 'associated person' test does not apply. We will ensure that the approach is proportionate, and only captures those cases where cross-ownership is significant.

PROPOSAL 8: We will change the legislation to ensure that profit is not paid on costs more than once where the prime contractor has a significant interest in the sub-contractor, or vice-versa.

4. Speed and simplicity

Introduction

33. A key objective of DSIS is to improve the speed and simplicity of the systems that MOD uses to acquire, support and upgrade military capability. These need to be underpinned by processes to reduce timescales for placing contracts, including where let on a single-source basis. We will use the SSCRs to speed-up the contracting process by:

a. Introducing a simpler way of determining appropriate contract profit rates by reducing the number of steps in the profit calculation;
b. Simplifying reporting requirements and making better use of the reports we do mandate;
c. Making better use of the referrals process to resolve protracted arguments before contracts are signed and expanding the issues on which the SSRO can be asked to make a determination; and
d. Clarifying and generally tidying up the SSCRs based on the experience of those who use them to remove ambiguities and make them easier to apply.

Reducing the "six step" contract profit setting process

34. At para 22 we explained that there is currently a six-step process to set the profit rate on a single source contract. We will simplify the profit setting process by reducing this to four steps.

Removal of the POCO adjustment

35. We set out the purpose of the POCO adjustment in paras 30-32 above. The SSCRs currently give a supplier two choices on how the impact of inter-group profits should be eliminated:

a. demonstrate to the MOD that the relevant subcontract costs are only costs, and do not include any profit; or, if they do include profit, that an equivalent cost adjustment has been made to effectively eliminate the profit element. If they do this, there is no need to make the 'step 3' POCO adjustment; or

b. to leave any profit element as part of the subcontract costs (in effect, leave it as a subcontract price, including profit), without any cost adjustment, and then make the compensating POCO adjustment via 'step 3' of the prime contract profit rate calculation.

36. In line with the intent of the SSRO recommendations (see Annex B) we will remove this second option, which is complex and increases the time it takes to agree profit rates. Instead, we will require suppliers to make an appropriate adjustment to their proposed costs. The adjustment will remain a technical one, but we agree with the SSRO that dealing with it through scrutiny and assurance of allowable costs is a simpler and more transparent approach. This new, single permitted approach will simplify the SSCRs and speed up the agreement of contract prices.

PROPOSAL 9: We will abolish the current step 3 of the contract profit rate. We will continue to apply the principles of POCO through allowable costs to ensure we do not pay too much profit on contracts under the SSCRs. We will simplify the mechanism, addressing inter-group profits where they arise in costs, rather than making compensating adjustments to the contract profit rate. This will require some change to the costs section of primary legislation.

Removing the SSRO Funding Adjustment

37. The SSRO was established under the legislation to perform a variety of roles. Many of these, especially recommending the level of the BPR, making impartial determinations on contract prices and producing statutory guidance on allowable costs, require the SSRO to be at arms-length from the MOD. When the SSCRs were introduced, it was therefore considered appropriate that industry should contribute to the running of the SSRO. The SSRO is funded by Grant-in-Aid and the industry contribution is collected by a small downward adjustment to the profit rate of any SSCR contract. During this review, we have considered the purposes for which profit is paid and concluded it is not appropriate to retain this reduction of profit.

38. If industry contributions were to continue to be required, they could be sought via direct payments from suppliers, not a reduction in profit. However, if our suppliers were to incur this cost because they had contracts subject to the SSCRs, then we believe that

those costs would be legitimate costs of those contracts, and hence chargeable back to the MOD. We will therefore amend the SSCRs to remove the SSRO Funding Adjustment. The SSRO will continue to be funded through Grant-in-Aid, solely funded by the MOD.

PROPOSAL 10: We will abolish the step 4 of the contract profit rate, the SSRO Funding Adjustment.

Reporting requirements

39. The legislation mandates a series of contract and supplier reports. These reports increase transparency, aid contract management and supply chain awareness, and provide MOD and the SSRO with a consistent data set for analysis. In the longer term, the data is intended to enable the development of more accurate 'should cost' models to inform future decision-making, budgeting and pricing. These benefits need to be carefully balanced against the effort required to complete the reports. We also need to ensure that we have the processes and structures in place to properly exploit the information gathered.

40. Mandatory reporting requirements are kept under constant review to ensure suppliers are clear on what they need to provide, that we only collect the information we use, and the utility of the reports is maximised. In addition to changing the legislation, over the next few years we will look more closely at the connections between the SSRO's DefCARS online reporting system and MOD systems to increase the integrity of the data and avoid duplication and inefficiency. In this section we set out our main legislative change proposals in relation to Contract and Supplier Reports. There are also some more important technical changes to reporting requirements described in Annex D.

Contract Reporting – the Defined Pricing Structure (DPS)

41. The current legislation requires suppliers to identify the costs in a contract in two different ways:

a. first according to their own accounting systems, which will generally be the basis on which the price was constructed; and
b. second under a set of headings defined by the SSRO through statutory guidance, known as the Defined Pricing Structure (DPS).

There are sixteen DPS's for various types of equipment (Submarines, Missile Systems, Fixed Wing Aircraft etc.) defined by the SSRO, each of which splits the costs into major systems (wings, engines, avionics etc.) and other costs drivers such as training or safety assurance. The purpose of requiring suppliers to submit this information is to establish a centrally available, comprehensive data set to determine relationships between costs and outputs and compare the estimated and outturn costs. The SSCRs also set a requirement to include a list of output metrics that will be used to describe deliverables (e.g. speed, weigh, size), for each of the DPS templates. In the longer-term the intention is that this data will be used for modelling the 'should costs' of acquiring and supporting military capabilities; for comparison between contracts; to identify cost drivers; and to inform long-term budgeting by MOD centre.

42. Under the current SSCRs the parties to a contract must agree what DPS will be used, prior to the first set of mandatory reports being submitted. Suppliers must use the agreed DPS in the Contract Notification Report (submitted at the start of the contract); Interim Contract Reports (submitted at agreed intervals specified by MOD, over the life of the contract); and the Contract Completion Report (submitted at the end of the contract).

43. In reviewing the legislation, we found that mapping the costs of a contract to the categories set out in the DPS can take significant effort from suppliers. We also found that splitting the costs in this way on the Interim Contract Reports, rather than by using the contractors' own Work Breakdown Structure, prevents these reports being used to compare ongoing costs against the estimates used to construct the price at the start of the contract. This severely limits the value of the mandatory reporting for contracts under £50M. This does not apply to contracts over £50M, which are required to produce Quarterly Contract Reports split by the Work Breakdown Structure.

44. This is borne out by the findings of the SSRO. They concluded that there was limited evidence of the current DPS dataset being used by the MOD, although they also said that may be linked to its relative immaturity at this time, and that usage may be expected to increase as the database grows. They also cautioned against relaxing this requirement at this stage because of the potential long-term value of this data.

45. We agree that the data provided by the DPS might have long-term value for pricing large platforms, particularly where technology is primarily driven by military requirements. But there are many other types of procurement, ranging from facilities management to communications satellites, where past costs charged to the MOD provide limited insights for future prices. We therefore believe that the use of the DPS should be confined to those equipment types where it can add value and should be done at an appropriate frequency. Given the lifecycle of these equipment types can be several decades, an updated DPS is unlikely to be required more than every three years.

46. We also found that there is significant uncertainty about what output metrics should be reported. This is compounded by the fact that some of the performance metrics of military equipment are highly classified and estimating them at contract outset is difficult. While this data can often be highly valuable for cost-estimation, we therefore do not support the SSRO's view that it should be captured by the statutory reporting or held on DefCARS.

PROPOSAL 11: We will change the regime to make sure that the DPS is only used for those contracts where the data collected is likely to be useful for long-term 'should-cost' calculations. This will be done primarily through changes to statutory guidance.

PROPOSAL 12: Where reporting by DPS is valuable, this will be done at the outset of the contract through the Contract Notification Report, the end of the contract through the Contract Completion Report, and at a frequency of no more than once every three years in between, as required by the MOD.

PROPOSAL 13: The Interim Contract Report will be split by the data categories used in the Contract Pricing Statement, which will generally follow the contractor's work breakdown structure.

PROPOSAL 14: The requirement to include output metrics as part of the DPS reporting will be removed. Requirements to report against milestones and key indicators for performance of the contract (as opposed to the equipment) will remain, but as part of the standard reporting by Work Breakdown Structure.

Supplier Reporting

47. Part 6 of the SSCRs sets out the criteria under which suppliers are required to submit reports for any part of their business defined by the SSCRs as a Qualifying Business Unit (QBU). In broad terms supplier reports are required from any QBU that has a QDC(s) of £50m or more.

48. Many of the supplier reports are required to support the agreement between MOD and a particular contractor of overhead recovery rates, which are used for pricing single source contracts. Other reports set out the contractor's long- term strategic direction and are required to help the MOD develop an evidence-base for understanding its supply chain, address any misperceptions and give early sight of how their cost bases might develop. The eight supplier reports described in the SSCRs are the:

- Estimated Rates Claim Report (ERCR) – sets out the basis for the overhead rates that will be included in relevant single-source contracts;
- QBU Estimated Cost Analysis Report (QBUECAR) – provides analysis for those rates;
- Estimated Rates Agreement Pricing Statement (ERAPS) – agreed pricing statement for estimated rates;
- Actual Rates Claim Report (ARCR) – details actual costs incurred by the QBU;
- QBU Actual Cost Analysis Report (QBUACAR) – provides a standard format of costs, to allow comparisons to be made over time and between business units;
- Rates Comparison Report (RCR) – compares actual rates to estimated rates in detail;
- Strategic Industry Capacity Report (SICR) – sets out the overall strategic direction for largest single-source contractors; and
- Small and Medium-sized Enterprises (SME) Report – contains details of how the large contractors support SMEs.

49. We have discussed in detail with our MOD teams, industry and the SSRO, the value of each of these reports. We have confirmed that most of the information contained is necessary to ensure that overhead charges are appropriate, attributable and reasonable, that sound judgements can be made on efficiency opportunities and to give the MOD visibility of changes in suppliers' costs that will feed into contract prices. However, we found that the criteria used to determine whether a supplier has one or more QBUs can be

technically complex and give rise to uncertainty about whether a supplier unit is a QBU or not. We also concluded that while the collection of the data in a single Rates Comparison Report may have some use, it could be collected on a more bespoke, 'as needed' basis. This will save suppliers having to produce a report that may not be used and is not necessary to ensure that the overhead rates are appropriate, attributable and reasonable.

50. We also considered removing the requirement for the report on Small and Medium-sized Enterprises (SME) report, since MOD also collects SME data through other means, including contract conditions. We have concluded that for now the requirement for the regulatory SME Report should be maintained but kept under review.

PROPOSAL 15: We will simplify the definition in the legislation of a Qualifying Business Unit (QBU).

PROPOSAL 16: We will remove the requirement to complete the Rates Comparison Report.

Changes requiring resubmission of some supplier 'rates reports'

51. As listed at para 48 above, there is a requirement for each QBU to submit 'rates claim' reports, in relation to both Estimated and Actual Overheads. These claimed rates are investigated by the MOD and very often changes are agreed between the parties to arrive at 'agreed rates'. It is these agreed rates that are used to price individual contracts.

52. However, the SSCRs do not currently require the supplier to record on DefCARS the rates that were actually agreed or the basis for that agreement. This means that it is not possible to identify in DefCARS a clear link between the rates included in supplier reports and those used in calculating costs for individual contracts. It also makes it more difficult to use the data for benchmarking overheads, supplier-to-supplier comparisons, monitoring cost efficiency, trend analysis, should-cost modelling, budgeting and so on.

PROPOSAL 17: We will introduce a new requirement that Estimated and Actual Rates Claims Reports (ERCR and ARCR), and the Estimated Rates Agreement Pricing Statement (ERAPS), must be resubmitted to reflect the rates that the MOD and the contractor have agreed will be used in the pricing of contracts.

Changes to the Strategic Industry Capacity Report (SICR) requirement

53. The purpose of the SICR is to provide a long-term view of key suppliers' capacity, and overheads relevant to the MOD's current and future single source requirements. The SICR is split into four individual reports:

- Corporate structure;
- Activities, people and infrastructure;
- Forecast costs of maintaining industrial capacity; and
- Capacity and supply chain.

54. Under the SSCRs the SICR is compiled and reported at the level of the Ultimate Parent Undertaking of the QBU which the MOD may be contracting with. We have found that for some suppliers, particularly those owned overseas, much of the work undertaken by the ultimate parent will have little relevance to the pricing or performance of UK single-source contracts. Moreover, the future direction of some of our overseas contractors is likely to be mainly determined by their assumptions about future requirements from their own governments, which they may not be able to share with the UK. At the same time having the detail required in the SICR for UK based subsidiaries, along with the information contained in the other supplier reports, would be valuable. We will therefore amend the legislation to allow for the submission, at MOD's discretion, of SICRs at a level below that of the Ultimate Parent Undertaking.

55. At present, under the SSCRs, if a supplier meets the criteria which invokes the supplier reporting requirement, then all supplier reports must be provided, including the SICR. If, for the reasons set out above, it is not practical or valuable for a supplier to complete the SICR, the only option available is to effectively exempt a supplier from providing any of the supplier reports, using the power in Section 25(8) of the Act. This means that in these circumstances none of the mandatory reports used to calculate overheads for a business unit are required.

PROPOSAL 18: We will amend the legislation to allow the Secretary of State to agree that the SICR can be produced at a level below ultimate parent undertaking.

PROPOSAL 19: We will amend the legislation to allow the Secretary of State to exempt a supplier from the requirement to provide a Strategic Industry Capacity Report (SICR), but not the other supplier level reports.

Referrals: better use of the SSRO

56. The legislation specifies a number of matters that can be referred to the SSRO for a determination that is legally binding on the parties and can result in changes to the contract price. These powers were introduced because pricing disputes sometimes dragged on for many years, largely because it would always be in one party's financial interests to delay resolution. Moreover, one or other party may use the prospect of delay to contract signature as a lever to secure unfairly high or low prices. In some of these cases, contracts have been signed without a definitive price being agreed, which leads to disputes later on.

57. The SSCRs specify those matters that can be referred to the SSRO for an expert opinion which is non-binding on the parties. In both instances the SSCRs set out who may make the referral – the MOD, the contractor or both. Outside these specified matters, the SSRO may also give an opinion on any matter relating to a QDC or proposed QDC if both the MOD and the primary contractor (or other party to a proposed contract) agree to make the referral jointly.

58. To date, this process has been used rarely, and in its recommendations, the SSRO sets out some of the reasons for this. Both MOD and the SSRO believe that better use of the referrals process could play a key role in speeding up the acquisitions process. Both increasing the number of referrals and widening the breadth of issues that can be referred, particularly for determination, would enhance the speed and simplicity of the procurement process by providing several significant benefits including:

a. Producing definitive opinions on disputed issues prior to contract award when ignoring such opinions will create a high risk of a legally binding change to a contract price post-award;
b. Using the time-bound referrals process to prevent either party from running down the clock to increase leverage during contract negotiations;
c. Increasing the incentive to produce evidence fully and promptly to avoid an unfavourable outcome; and

d. In urgent cases, allowing contracts to be signed before all issues are resolved, with a legally binding determination made by the SSRO at a later date.

59. To support this objective the SSRO made several recommendations for change. These include enabling the SSRO to give opinions upon request about the operation of the regulatory framework without the need for the referral to be made jointly with the other interested party or parties or for the referral to identify a specific contract. They also recommended that the SSRO be able to make a determination in relation to:

a. all of the contract profit steps;
b. whether a contract or proposed contract meets the conditions to be a QDC or QSC; and
c. the agreement of rates that may be used in the pricing of QDCs or QSCs.

60. The MOD supports the SSRO recommendations as sensible and specific solutions to address some of the current limitations in the referrals process. In addition to the changes to step 5 proposed above, there is clear merit in the SSRO being able to give a view on which year's BPR to use at Step 1, particularly when pricing amendments. The current requirement to relate a referral to a specific QDC or QSC is a clear restriction on the effectiveness of seeking a determination on whether a rate used by a supplier across multiple contracts is appropriate, attributable and reasonable. Allowing the referral of the rate itself will speed up the process by which disagreements on a given rate can be settled. We will therefore change Part 9 of the Regulations to take these recommendations forward.

We will change the legislation to allow the SSRO issue guidance on all aspects of the regime and to:

PROPOSAL 20: give opinions upon request about the operation of the regulatory framework without the need for the referral to be made jointly with the other interested party or parties or for the referral to identify a specific contract to take these recommendations forward.

PROPOSAL 21: make a determination in relation to all of the contract profit steps.

PROPOSAL 22: make a determination in relation to whether a contract or proposed contract meets the conditions to be a QDC or QSC.

PROPOSAL 23: make a determination in relation to the agreement of rates that may be used in the pricing of QDCs or QSCs.

61. We have found that the prospect of a referral can often lead to resolution of the immediate contract issue in question without the matter actually being referred. But this often unnecessarily drags out the negotiation process, and, as set out above, shortage of time itself may be used as a negotiating lever. We therefore believe that greater use of the referrals process will not only ensure that our Armed Forces get the equipment they need sooner but will also help ensure prices are fair. Using the referrals process in this way will also enable the SSRO to build and maintain expertise, which in turn will enhance confidence in the process.

62. We will therefore implement changes so that:

a. Any element of contract negotiations where the supplier and the MOD disagree will automatically be referred to the SSRO after two unsuccessful rounds of negotiations, allowing negotiations to proceed on other issues in parallel to the referral. The timescale for two rounds of negotiations will be dependent on the complexity of the contract and issue. To avoid an open-ended process, we would expect to move towards resolution through referral around six months after the issue first being raised;
b. Once the referral process has been initiated, it will be expected to run its course. This will ensure that the referral process cannot be used as leverage during contract negotiations only for parties to settle at the last moment. It will also build up a base of precedents that can be drawn on to speed up future negotiations about similar issues; and
c. Where contracts need to be signed urgently, outstanding matters will be referred to the SSRO for a determination after contract award.

PROPOSAL 24: We will reform MOD policies and procedures to deliver the changes in paras 61-62 above.

63. For these changes to work, it is critical the SSRO has the depth of expertise it needs to arrive at robust, fair judgements on highly technical and complex matters. This applies to the referrals themselves and the Statutory Guidance that effectively sets out the criteria that will be used. In their corporate plan, the SSRO set out a clear intent to be the recognised expert in the regulation of single source procurement. We do not believe any legislative change is required to achieve this, but if in the future it becomes apparent that changes to the legislation would be helpful we will re-visit the possibility.

Miscellaneous measures to clarify and simplify the Regulations

64. The review process, including the SSRO's recommendations and inputs from industry, identified a long list of relatively minor changes which will make the regime easier and quicker to use, through clarifying and simplifying aspects of the regime including the SSCRs and statutory guidance as appropriate.

Contracts partially for Defence purposes

65. The Act currently states that single source contracts under which the Secretary of State procures goods, works or services for defence purposes are covered by the legislation (subject to also meeting other criteria in the Act). There are some cross-Whitehall contracts that are used both by the MOD and other Government Departments (for example secure radios). We will amend the legislation to ensure that when appropriate single source contracts which are partially for defence purposes may also become subject to the legislation.

PROPOSAL 25: We will change the legislation to enable Regulations to set out the conditions under which a cross-Government contract that is partially for defence purposes may become a QDC subject to the legislation.

Treatment of Government credits

66. The UK and other Governments provide credits, often in the form of tax relief, for certain activities. We will provide clarity to the framework on when and how these should be netted off from allowable costs.

PROPOSAL 26: We will clarify where necessary when and how Government credits should be netted off from allowable costs.

Technical changes

67. A wide range of important technical changes to the legislation have been suggested by the SSRO and industry, largely resulting from direct experience in applying the regime in practice. We have also identified some necessary changes through drawing on the experience of MOD delivery teams in using the legislation. This is to be expected in what is essentially a relatively new regime. Addressing these through this review and making any necessary changes to legislation or statutory guidance will reduce the scope for misunderstanding and hence support the objective of speeding up and simplifying the acquisitions process.

68. We do not list all these issues in the body of the Command Paper, but further details can be found in Annexes C and D where we set out how we will respond to each of the suggestions, including where we will make changes.

PROPOSAL 27: We will make all necessary changes to address the technical changes identified in the Annex to this Command Paper.

5. Stimulate innovation and exploit technology

Introduction

69. DSIS aims to stimulate innovation and exploit technology through procurement to unlock value from new suppliers, increase responsiveness to technological change and enable our capabilities to remain current whilst they are in service. We will align the legislation with this DSIS objective by using the regime in new and innovative ways and working with the SSRO to make clarifications in statutory guidance, particularly as it relates to allowable costs. The key changes will be:

a. Ensuring incentive methods drive innovation where appropriate, including rewarding suppliers for innovative ideas;
b. Ensuring the Regulations allow for the proper reward of Research and Development including mechanisms that support shared ownership of any Intellectual Property where appropriate; and
c. A full assessment of what can currently be specified in contracts that will achieve wider Government objectives and ensure where necessary any associated costs are allowable.

Changes to allowable costs

70. Sometimes expenditure by suppliers on initiatives which support wider Government objectives cannot be attributed to an individual contract, and hence they might not be allowable under the Regulations, for example social value. We will work with the SSRO to change the statutory guidance on allowable costs, and change the legislation if necessary, to make sure that appropriate costs can be allowable and that we do not disincentivise contractors from investing their own money in research or prosperity initiatives.

PROPOSAL 28: We will ensure that costs incurred in pursuit of the Government's innovation and technology aims can be allowable in single-source contracts, subject to appropriate safeguards. We currently believe that this is achievable within the current legislation and we will work with the SSRO and our suppliers to update the relevant statutory guidance.

Benefits sharing and research costs

71. We intend to increasingly let contracts for innovation where both the benefits and the costs are shared between the MOD and the supplier. Currently it is not always clear how the attributability and reasonableness tests for costs are applied in these circumstances. We believe that, subject to appropriate safeguards, parties should be able to agree how the funding should be split without using quantified estimates of financial benefits.

PROPOSAL 29: We will make any necessary changes to the legislation and Statutory Guidance to allow the MOD and the contractor to enter into joint funding for innovation without quantifying the financial benefits each party expects to accrue. We currently believe that this is achievable within the current legislation and we will work with the SSRO and our suppliers to update the relevant statutory guidance.

Supporting new ways of funding innovation

72. Under DSIS the MOD will be continually looking at new ways of funding innovation. At this stage it is not possible to predict how each of these approaches will work in practice. We will therefore change the legislation to ensure there is sufficient flexibility to enable these approaches to fit under the single source procurement regime.

PROPOSAL 30: If necessary, we will introduce sufficient flexibility to the legislation to ensure it can take account of new ways of funding innovation.

6. Implementation

Approach

73. The changes proposed in this Command Paper will require amendments to the single source contracting regime. We will work with the SSRO to make these changes through statutory guidance where possible. Guidance will provide the flexibility to make further adjustments as and when changing circumstances demand. However, the more significant changes will require secondary and in limited cases primary legislation.

74. We will continue to work with industry stakeholders over this period to ensure that outside views are taken into account as legislation and guidance is developed.

Timescales

75. We plan to introduce the changes in several stages as appropriate. The limited primary legislation changes will be largely to provide the vires to deliver the detail in secondary legislation or statutory guidance as appropriate. The primary legislation will be delivered when parliamentary time allows.

76. We anticipate that the secondary legislation will be introduced in two tranches. The first will implement key flexibilities such as alternative pricing methods, with the remaining changes being made in a second tranche later.

77. Where possible we will work with the SSRO and internal MOD commercial policy experts to deliver changes to statutory guidance and commercial practice in parallel with changes in legislation.

7. Consultation approach

78. MOD has been liaising with industry about this review of the SSCRs since late 2019 when an initial call for comments was made. The responses received from industry through this process, along with subsequent submissions and discussions can be found at Annexes C and D.

79. A detailed programme of workshops with key industry representatives were held during 2021 and this programme of industry liaison is continuing as these proposals are developed into draft legislation and, with the SSRO, statutory guidance. The programme of main policy development workshops is summarised in the table below:

DATE	ORGANISED WITH	SUBJECT
28/01/2021	ADS	Technical issues
18/02/2021	ADS	Legislation review workshop planning.
11/03/2021	ADS	Reporting
18/03/2021	ADS	Legislation review workshop planning.
23/03/2021	DSF Commercial Working Group	Overview of the review of legislation
25/03/2021	ADS	Scope
31/03/2021	ADS	Technical issues
22/04/2021	ADS	Legislation review workshop planning
29/04/2021	ADS	Allowable costs & contract status
04/05/2021	Rolls Royce, BAE, Babcock & ADS	Profit workshop
05/05/2021	ADS	Reporting requirements
11/05/2021	DSF Commercial Working Group	Overview
12/05/2021	ADS	Reporting requirements
14/05/2021	Tech UK	Overview of review of legislation
03/06/2021	ADS	Reporting requirements
15/06/2021	Leonardo	Profit review
15/06/2021	DSF Commercial Working Group	Overview
16/06/2021	Babcock, BAE, Raytheon, Thales & Leonardo	Profit summit
21/06/2021	ADS	Alternative pricing methods
25/06/2021	Tech UK	Review update

80. In addition to this bespoke programme of meetings, we have liaised with industry through the Defence Suppliers Forum (DSF) structure. The DSF includes all the main defence contractors as well as representatives from the SME community. We were grateful

for the formal papers submitted by the Defence Suppliers Advisory Group (DSAG). We have discussed each of these through the programme of workshops set out above and they form a key part of the considerations that fed into this Command Paper.

81. The key policy areas in this Command Paper were covered as part of the SSRO's process in developing its recommendations to the Secretary of State. A formal consultation published in December 2019 and stakeholders' views were covered in the SSRO's recommendations which were submitted to the Secretary of State and published in June 2020. The SSRO recommendations were subsequently revised and re-submitted in June 2021.

82. We have continued to work with the SSRO throughout the review process and are grateful for their participation at the industry workshops.

83. This Command Paper is the last stage of the formal consultation process outlined above. We will consider any further representations submitted by noon on 3 May 2022 to steve.davies262@mod.gov.uk .

84. MOD and the SSRO as appropriate will continue to work with industry stakeholders to ensure they have opportunities to discuss changes to the legislation and guidance as they are developed.

ANNEX A – BACKGROUND AND HISTORY OF THE SINGLE SOURCE PROCUREMENT REGULATIONS

1. The MOD's preferred approach to procurement has been through open competition through the domestic and global market. By its nature, however, defence equipment often requires advanced and specialist technology and we are often limited to a single supplier to provide the capabilities our Armed Forces require. We may also need to preserve key industrial and technological capabilities within the UK for strategic reasons. In either case, we may be reliant on single source suppliers. Around 50% of the MOD's annual spend on equipment and services is on non-competitive procurement with this proportion likely to increase with the implementation of DSIS.

2. In a commercial marketplace, the MOD can rely on competitive forces to ensure that prices paid provide value for money to the taxpayer and a fair return for industry. The legislation covering single source procurement aims to secure a similar balance on non-competed contracts. In these circumstances, the MOD may enjoy considerable influence as the main or sole purchaser in the UK market, but our ability to exert strong commercial leverage is constrained by the imperative to ensure that the UK Armed Forces are provided with the equipment that they need, when they need it.

3. Between 1968 and 2014, the MOD and industry employed a single-source pricing framework known as the 'Yellow Book', overseen by a non-Departmental Public Body (NDPB) called the Review Board for Government Contracts. The Yellow Book was not based in statute, and changes could only be achieved through consensus between the MOD and industry. Consequently, the Yellow Book framework failed to respond adequately to far-reaching changes to the structure and practices of the global defence industry which have occurred over the last 50 years and was largely unable to resolve disputes which arose between the MOD and its single source suppliers.

4. Concerns in 2010 about the MOD's inability to achieve value-for-money in single source procurement in the absence of market pressures led to the appointment of Lord Currie of Marylebone to carry out an independent study into this issue. In his report, *Review of Single Source Pricing Regulations* published in October 2011, Lord Currie recommended

a fundamental reform to the MOD's approach to single source procurement. This helped shape Part 2 of the Defence Reform Act (DRA) 2014 by which the MOD introduced new, statutory controls on single source contracts. The new regime has three key features:

a. Clear rules on how qualifying single source defence contracts can be priced;
b. Greater transparency, including a suite of mandatory reports, and an obligation placed on suppliers to demonstrate that single source costs to the MOD are 'appropriate, attributable to the contract, and reasonable', or AAR for short; and
c. The creation of a new arms-length body, the Single Source Regulations Office, to issue guidance on application of the regulations and arbitrate between the MOD and suppliers. If a dispute is referred by either party, the SSRO can make legally-binding decisions on contract price.

5. Section 39 of the DRA 2014 sets out the process for reviewing single source legislation as follows:

a. The SSRO must keep the framework under review and may make recommendations to the Defence Secretary "as it considers appropriate" and "at least six months before the end of the review period".
b. The Defence Secretary must "have regard to any recommendations" made by the SSRO and must complete his review of the legislation within three years of the framework coming into force, i.e. by December 2017, and thereafter each subsequent five-year period.

ANNEX B – SSRO RECOMMENDATIONS

The SSRO submitted its review of the legislation recommendations in June 2021. The table below lists each of the SSRO's recommendations and summarises the MOD's response with references to the body of the Command Paper where appropriate.

Aspect of the regime/ recommendation reference no.	**SSRO proposal**	**MOD response (including section of Command Paper)**
R1 Cost Risk Adjustment	Section 17(2) of the Act and regulation 11(3) should be amended to provide that the adjustment to the baseline profit rate at step 2 should reflect the contractor's exposure to cost risk if it materialises, in addition to reflecting the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs.	MOD supports this recommendation. Implementation will form part of the wider changes being made to the Cost Risk Adjustment as part of the Choice and Flexibility chapter, section on profit.
R2 QDCs by amendment: incurred and committed pre-amendment costs	A new section should be inserted in the Act to permit the Regulations to provide that the price formula may be applied to a defined component of a contract. A new regulation should be added to specify that where a contract becomes a QDC by reason of an amendment, the price payable under the amended contract must be determined in accordance with the formula but excluding any incurred or committed price.	MOD agrees with this recommendation and will make the necessary amendments to the regime to deliver the policy intent – see Segmentation section.
R3 Multiple baseline profit rates and segmented contract profit rates	The Act and Regulations should be amended to permit or better support: • a range of baseline profit rates, determined based on the type of acquisition; and • a profit rate for each defined component of a single contract, each determined by the application of a six-step process beginning with the appropriate baseline profit rate.	MOD supports this recommendation and will work with the SSRO to make the necessary changes to the legislation. The second part of R3 will be subject to the proposed changes to the six- step process set out in the Speed and Simplicity chapter.

Aspect of the regime/ recommendation reference no.	SSRO proposal	MOD response (including section of Command Paper)
R4 POCO	The legislation should be amended to: • Replace some specified terms with principles that can be applied to the specific facts and circumstances of a contract, with facility for the SSRO to provide statutory guidance such that the following are achieved: i. POCO applies where the primary contractor has significant influence over the sub-contractor, replacing the existing test of whether a sub-contractor is 'associated', within the meaning of the Companies Act. ii. In addition to excluding sub-contracts that are the result of a competitive process from the scope of POCO, excluding sub-contracts if their price is equivalent to a competitive price. iii. The detail of what constitutes attributable profit is left to statutory guidance, in place of the definition in regulation 12(7) and (8). • Alternatively, aspects of the recommendations above could instead be addressed through additional legislation rather than guidance. SSRO would be pleased to work with the MOD on the detailed legislative changes if that approach is preferred. • Delete the existing option to address POCO through the contract profit rate, thereby requiring any applicable adjustment to be made to allowable costs. • Raise the threshold sub-contract value for a POCO adjustment to £1 million while including provision for the contracting authority to include lower value contracts if the authority considers contracts have been sub-divided to avoid POCO. • Require contractors to report the attributable profit of sub-contracts where a POCO adjustment has been made, supplementing the existing reporting requirements about sub-contracts in a contract notification report, quarterly contract report, interim contract report and contract completion report.	The MOD supports the intent of the SSRO's recommendation but proposes to take a different approach. We will abolish the current step 3 of the contract profit rate. We will continue to apply the principles of the POCO adjustment to ensure we do not pay too much profit on contracts under the Regulations. We will simplify the mechanism, addressing inter-group profits where they arise in costs, rather than making compensating adjustments to the contract profit rate. We will work with the SSRO to ensure changes to Statutory Guidance are consistent with this intent.
R5 Pricing method: target price	Amend regulation 10(11) to additionally specify that the allowable costs estimated at the time of agreement may be adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different allowable costs).	The MOD supports this recommendation and will work with the SSRO to develop the necessary changes to the regulations.
R6 Final price adjustment	Amend regulation 17 as follows: • In paragraph (2), substitute "5% but less than 10%" with "5 percentage points but less than 10 percentage points" • In paragraph (3) substitute "10% but less than 15%" with "10 percentage points but less than 15 percentage points" • In paragraph (4) substitute "15%" with "15 percentage points"	The MOD supports this recommendation and will work with the SSRO to develop the necessary changes to the regulations.

Aspect of the regime/ recommendation reference no.	SSRO proposal	MOD response (including section of Command Paper)
R7 Overheads	Amend Regulation 37(7) to reflect the original intention of these requirements by aligning the QBU estimated cost analysis report (QBUECAR) reporting period with that of the estimated rates claim report (ERCR).	The MOD supports the intent of this recommendation. The overall intent and scope of QBUECAR and ERCR has been agreed and we will work with the SSRO on potential refinements to the wording of the regulations.
R8 Time limits for QSC assessments and notice of positive assessment	Regulation 61 should be amended to add the requirement that a QSC assessment is to be completed, and a positive QSC assessment notified to the Secretary of State and the prospective sub-contractor, before the sub-contract is entered into; and Regulation 62(3) should be deleted so that sub-contractors that receive a positive QSC assessment following entry into the sub-contract may appeal the assessment up to six months following receipt of the notice.	The MOD supports this recommendation and will work with the SSRO to develop the necessary changes to the regulations.
R9 Reporting the outcome of a QSC assessment	The Regulations should be amended so that in addition to reporting the outcome of a negative QSC assessment, a contractor is required to specify the reasons for the negative assessment by reference to which of the conditions under section 28 of the Act and regulation 58 are not satisfied.	The MOD supports this recommendation and will work with the SSRO to develop the necessary changes to the regulations.
R10 Notification of reporting requirements	Regulation 5 should include a requirement that the contracting authority notify the contractor of the reporting requirements arising from the assessed value.	The MOD supports this recommendation and will work with the SSRO to develop the necessary changes to the regulations.
R11 Variances	Regulations 26(6)(f), 27(4)(i) and 28(2)(i) should be amended to include a new materiality provision for reporting variances. Contractors should only be required to explain 90% of variances when the quantum of all variances exceed £100,000 or 1% of the contract price, whichever is the greater.	The MOD supports this recommendation and will work with the SSRO to develop any necessary changes to the Regulations to deliver the policy intent.

Aspect of the regime/ recommendation reference no.	SSRO proposal	MOD response (including section of Command Paper)
R12 Referrals and guidance	The Act and Regulations should be amended to: • Enable the SSRO to: give opinions, upon request, about the operation of the regulatory framework without the need for the referral to be made jointly with the other interested party or parties or for the referral to identify a specific contract; • Make a determination in relation to adjustments under all six of the contract profit rate steps in section 17(2) of the Act; • Make a determination in relation to whether a contract or proposed contract meets the conditions to be a QDC or QSC; and • Make a determination in relation to the agreement of rates that may be used in the pricing of QDCs or QSCs. • Enable the SSRO to issue guidance in respect of any aspect of the regulatory framework and to require contracting parties to have regard to that guidance.	MOD agrees with the SSRO proposals relating to the referrals process under SSRO R12. We will work with the SSRO to make the necessary changes to legislation and guidance to implement these changes.

ANNEX C – INDUSTRY PROPOSALS

Throughout the review process, industry has had the opportunity to make suggestions for changes to the SSCRs that it sees as necessary. These inputs included a wide-ranging series of policy papers which are covered by the main body of the Command Paper. There were also a number of more detailed suggestions which are either summarised in the table below or are in the list of technical changes proposed in Annex D.

REF	Aspect of the regime	Proposal	Raised by	MOD response
1	**Pricing of amendments**	Change the Act so that only amendments to the requirements of the contract are priced in accordance with subsection 15(2), and that the price for deductive work is based on its original pricing.	ADS	Discussed in industry workshop. MOD does not propose to progress at this time.
2	**Definition of QSCs**	Confine QSCs to subcontracts that arise from a QDC and that but for the QDC would not be required. Amend definition of a QSC in DRA subsection 28(3)(a). These amendments would apply in the following subsections: S28(3)(a), 28(4)(a), s29(1)(b), 29(3)(c).	ADS	Discussed in industry workshop. MOD does not propose to progress.
3	**Disapplication under Schedule 5 of the Act for information available to the public**	Avoid a disapplication of paragraph 2(1) of Schedule 5 to certain information merely because a part of the information to which the Schedule applies appears to be in the public domain. In Schedule 5, delete paragraph 4 and renumber subsequent paragraphs.	ADS	Discussed in industry workshop. MOD does not propose to progress.

REF	Aspect of the regime	Proposal	Raised by	MOD response
4	**Permitted disclosures under Schedule 5 of the Act – Freedom of Information**	Schedule 5 should not be disapplied for a request under the Freedom of Information Act. The Act should properly reflect the functioning of the Freedom of Information Act, so that permitted disclosures are only those for which there is a requirement to disclose, notwithstanding available defences. Either • Delete paragraph 5(1)(g); Or • In Schedule 5, subparagraph 5(1)(g), amend to read "under the Freedom of Information Act 2000 unless prohibited by available defences,"	ADS	Discussed in industry workshop. MOD does not propose to progress.
5	**Over-reaching of regulations 56(2)(b) and 56(5)(b) concerning the prejudice to commercial interests**	Remove the additional criterion of having to show that an unauthorised disclosure would be likely to substantially prejudice the commercial interests of any person. This would leave the information specified in regulation 56 as the only criterion to which para 1(1)(c) relates. In regulation 56, delete sub-paragraph 56(2)(b) and sub-paragraph 56(5)(b) and renumber.	ADS	Discussed in industry workshop. MOD does not propose to progress.
6	**Definition of Non-Recurring**	The expression "non-recurring" is not defined within the legislation. **Suggested definition** Non-recurring costs are the reported costs that would not be incurred if a subsequent contract was placed for the same outputs or capability. Examples include, but are not limited to, design engineering, development, system engineering, environmental and performance testing, qualification testing, pre-production models, test samples, special-to-type tooling and test equipment, technical data pack preparation, production planning, spares ranging and scaling, logistic support planning, special storage, transport and handling facilities and some programme management. Recurring costs are therefore the reported costs that would be incurred if a subsequent contract was placed for the same outputs or capability.	ADS	Discussed with in industry workshop. MOD has considered but as this has not been a problem in practice, does not propose to progress.

REF	Aspect of the regime	Proposal	Raised by	MOD response
7	**Alternative ways of demonstrating AAR**	Allow the regulations to specify circumstances where price reasonableness can be demonstrated other than by applying the pricing formula. These changes will need to establish: i. The duty of the supplier to demonstrate that the prices/costs provided comply with the relevant parts of the regulations, if requested; and ii. The duty of the MOD to be satisfied with the assessment made by the supplier in this regard (i.e. that it does comply). This will involve adding to Section 20 to make it consistent for either "costs" or "commercial prices"; The following categories of contracts (or their parts) have been identified for where this proposed change could be applied: a. Contracts or parts of contracts providing for products or services where the supplier can demonstrate a reasonable price for a commercial item or "market price" or "price list", referred to as "commercial prices"; b. For parts of a contract made up of priced work and committed costs ("sunk costs"). This is especially relevant in the context of contracts that are converted to qualifying status upon amendments under Regulation 14; c. For contracts where the profit that a contractor is paid is related to capital employed rather than costs, (notably in a Public Finance Initiative or PFI contract) and; d. For parts of a contract that provide for the recovery of specified costs that are not allowable costs for performance of work, such as redundancy costs or other settlement arrangements.	ADS	Discussed in industry workshop. Will be taken forward. MOD will continue to discuss with industry as changes to legislation are developed and implemented.
8	**Allowable Costs – section 20(2) of DRA**	Amend section 20 of the DRA to read: 20 (2) In determining whether a particular cost is an allowable cost under a qualifying defence contract, the Secretary of State or an authorised person, and the primary contractor, must be satisfied that the cost is— (a) appropriate, (b) attributable to the contract if it — (i) is incurred specifically for or as a consequence of the contract and compliance with requirements or procedures under or by virtue of this Part; (ii) benefits both the contract and other work and can be distributed to them in reasonable proportions; or (iii) is necessary for the overall operation of the business and to maintain the enterprise as a going concern, and (c) reasonable in the circumstances	ADS	Discussed in industry workshop. MOD does not propose to progress.

<table>
<tr><th>REF</th><th>Aspect of the regime</th><th>Proposal</th><th>Raised by</th><th>MOD response</th></tr>
<tr><td>9</td><td>Inflation Adjustment of Thresholds</td><td>A new section should be added to the Defence Reform Act Part 2, to provide for an independent authority to assess and make inflation adjustments to acquisition related thresholds in the legislation at defined intervals by reference to an independent index.</td><td>ADS</td><td>Discussed in industry workshop. MOD does not propose to progress at this time but commits to re-visiting as part of the next statutory review.</td></tr>
<tr><td>10</td><td>Single source subcontracts scenarios and “completion dates”</td><td>The following recommendations have been made regarding single source subcontract types:
<table>
<tr><th></th><th>Description</th><th>Duration</th><th>Completion date [for regulatory purposes]</th><th>Proposed approach</th></tr>
<tr><td>1.</td><td>Third party utility/ local authority/ lessor [usually pre-existing prior to QDC/ QSC award]</td><td>Continuing on X months’ notice</td><td>Undefined</td><td>To be exempted from QSC legislation. Only AAR applies to QDC/ QSC input costs, with MoD having access to charging rates and records. No action needed.</td></tr>
<tr><td>2.</td><td>Inter Group legal entity providing corporate services [usually pre-existing prior to QDC/ QSC award]</td><td>Continuing on Y months’ notice</td><td>Undefined</td><td>To be exempted from QSC legislation. Only AAR applies to QDC/ QSC input costs, with MoD having access to charging rates and records. No action needed.</td></tr>
</table></td><td>ADS</td><td>10 – 1 – progressing through the proposals relating to alternative pricing methods.
10-2 – MOD has considered and does not propose to progress.
10-3 – no action needed.
10-4 – no action needed
10-5 – MOD has considered and does not propose to make any changes.
10- 6 – MOD has considered and does not propose to make any changes.</td></tr>
</table>

<table>
<tr><th>REF</th><th>Aspect of the regime</th><th>Proposal</th><th>Raised by</th><th>MOD response</th></tr>
<tr><td></td><td></td><td>
<table>
<tr><th></th><th>Description</th><th>Duration</th><th>Completion date [for regulatory purposes]</th><th>Proposed approach</th></tr>
<tr><td>3.</td><td>Inter Group legal entity providing contract specific goods or services or both post QDC/QSC award</td><td>Specified for QDC/ QSC</td><td>Defined but likely to be concurrent with parent QDC/QSC performance and warranty period</td><td>No action needed.</td></tr>
<tr><td>4.</td><td>Third party supplier pre-existing prior to QDC/QSC award</td><td colspan="3">Not regulated. Only AAR applies to QDC/QSC input costs. No action needed.</td></tr>
<tr><td>5.</td><td>Third party supplier >50% costs for multiple QDCs/ QSCs, but <50% costs for any one QDC/QSC</td><td>Duration of call-off for specific QDCs can be assessed</td><td>The date that the supply content for all QDCs/QSCs falls below 50%.
Earlier than parent QDC/QSC</td><td>Contracting authority gives notice to the subcontractor of cessation of subcontract as a QSC when <50% threshold met.</td></tr>
<tr><td>6.</td><td>Third party supplier >50% costs for single QDC/QSC</td><td>Duration of call-off for the specific QDC can be assessed</td><td>The date that the supply content for all QDCs/QSCs falls below 50%.
Earlier than parent QDC/QSC</td><td>Contracting authority gives notice to the subcontractor of cessation of subcontract as a QSC when <50% threshold met.</td></tr>
<tr><td>7.</td><td>Third party supplier 100% for single QDC/QSC</td><td>Specified for QDC/ QSC</td><td>Defined but earlier than parent QDC/ QSC</td><td>No action needed.</td></tr>
</table>
</td><td></td><td>10-7 – no action needed</td></tr>
</table>

REF	Aspect of the regime	Proposal	Raised by	MOD response
11	**Risk between contract phases**	Have consideration of different levels of risk within different phases of a single contract which can bear very different risks.	techUK	Discussed in industry workshop. MOD believes this can be dealt with adequately through the existing CRA mechanism.
12	**Ability to vary BPR for future contract years**	Contracts may be multi-year and there is no ability to vary the BPR for future years in the initial pricing exercise even when the rolling three-year average calculation would suggest the BPR will increase.	techUK	Discussed in industry workshop. MOD believes this can already be dealt with by splitting a contract into pricing periods if necessary.
13	**Intellectual Property**	Intellectual Property included in a contract needs to be considered.	techUK	Principle agreed, but MOD does not believe this requires a legislative change.
14	**Innovation**	Careful consideration of stifling innovation should be given.	techUK	Principle agreed. No further action.
15	**TCIF Contracting, CRA & Incentives**	The relationship between TCIF contracting and the CRA & Incentive mechanisms should be reviewed and clarified.	techUK	Principle agreed. Any change will be addressed through guidance.
16	**Risk contingency within cost base**	Review how risk contingency is handled within the cost base of a contract vis-à-vis the allowable cost guidance	techUK	Principle agreed. Any change will be addressed through guidance.

REF	Aspect of the regime	Proposal	Raised by	MOD response
17	**Relationship between Prime and Sub**	Consideration of the relationship between Prime and Sub as two separate commercial entities needs to be taken e.g. open information sharing with a competitor or where other non-SSRO subcontracts are in place.	techUK	Principle agreed. Any change will be addressed through guidance.

ANNEX D – TECHNICAL CHANGES

Addressing these will simplify and clarify the regulations, including rationalisation of areas such as reporting requirements. We have not detailed all these issues in the body of this paper but set out below how we intend to take each of these forward.

UID	Proposal	Raised by	MOD response
1	Section 13(2): add an additional function: "(c) that it acts as an impartial adjudicator on matters referred to it."	ADS	Discussed in industry workshop. MOD does not propose to progress.
2	Section 14(1): add at end "and parts of qualifying defence contracts". Section 14(2)(b) and section 17(2) *Step 2*: after "contract" add "or the relevant part of it".	ADS	Discussed in industry workshop. MOD does not propose to progress.
3	Section 17(2) *Step 6*: Replace "the contract" with "contracts for defence purposes". Para (b) after "allowable costs" insert "charged directly".	ADS	Discussed in industry workshop. MOD does not propose to progress.
4	Section 21(4)(a) after "contracts" add "and elements of them".	ADS	Discussed in industry workshop. MOD does not propose to progress.
5	Section 22(1)(a) add sections 16(2)(b), 23(6) and 35(4) to the list.	ADS	Discussed in industry workshop. MOD does not propose to progress.
6	Section 23(3)(b) insert "material" before "difference" in (ii) and before "matter" in (iii).	ADS	Discussed in industry workshop. Agreed to implement. Considering how to take forward.
7	Section 30(1), exclude section 14 from this provision.	ADS	Discussed in industry workshop. MOD does not propose to progress.
8	Regulation 10, after paragraph (11) insert an italicised title "*Interpretation*".	ADS	Discussed in industry workshop. MOD does not propose to progress.
9	Regulation 11(7), replace "the contract" with "contracts for defence purposes".	ADS	Discussed in industry workshop. MOD does not propose to progress.
10	Regulation 13(4), amend "relate" to read "relates".	ADS	Discussed in industry workshop. MOD does not propose to progress.
11	Regulation 13(5), replace "any qualifying defence contract" with "contracts for defence purposes".	ADS	Discussed in industry workshop. MOD does not propose to progress.
12	Regulation 14, amend the title to read **Amendment to contract price**.	ADS	Discussed in industry workshop. Policy intent understood, further discussions to follow.
13	Regulation 25(2)(k), replace "purposes of enabling it to perform its obligations under" with "performance of".	ADS	Discussed in industry workshop. MOD does not propose to progress.

UID	Proposal	Raised by	MOD response
14	Regulation 32(3)(c), (4)(d), replace “purposes” with “performance”.	ADS	Discussed in industry workshop. MOD does not propose to progress.
15	Regulation 32(6)(a)(ii), replace “purpose of enabling” with “performance of”, and delete “,to be fulfilled”.	ADS	Discussed in industry workshop. MOD does not propose to progress.
16	Regulation 37(7), remove bold font on number	ADS	Discussed in industry workshop. MOD does not propose to progress.
17	Regulation 39(4) and (a), remove bold font on number.	ADS	Discussed in industry workshop. MOD does not propose to progress.
18	Regulation 40(3)(b), replace “purposes” with “performance”.	ADS	Discussed in industry workshop. MOD does not propose to progress.
19	Regulation 47(1) amend to read “46(1)(a) to (d)”.	ADS	Discussed in industry workshop. Policy intent understood, further discussions to follow.
20	Regulation 51(2) Add a reference to section 18(3)	ADS	Discussed in industry workshop. Policy intent understood, further discussions to follow in light of proposals relating to referrals (see main body of Command Paper).
21.1 21.2	Regulation 58(3)(a) and (4)(a), replace “to enable the contractor to perform” with “for the performance”. Regulation 58(3)(b) and (4)(b), replace “to enable” with “for”.	ADS	Discussed in industry workshop. MOD does not propose to progress.
22	Regulation 58(5), delete.	ADS	Discussed in industry workshop. Policy intent understood, further discussions to follow.
23	Euro conversion rate for the SME definition threshold should be defined by reference to a Commission document or another defined method for conversion, or the Regs should define an SME for reporting purposes – if the reporting requirements are retained.	ADS	Discussed in industry workshop. Policy intent understood, further discussions to follow.
24	Reg 8(1)(b) – The sentence ‘the material terms of the contract are wholly or substantially the same’ should be amended to read ‘the material terms of the contract are not wholly or substantially different’ to provide more flexibility.	ADS	Discussed in industry workshop. MOD does not propose to progress.
25	‘Unless a direction is given under section 21(5),’ should be added to the start of Reg 17(1) to reflect the provisions that disapply the calculation.	ADS	Policy approach agreed. Considering how to take forward.
26	‘or any other incentive arrangement’ should be added to the end of Reg 17(6)(i) to accommodate ‘gainsharing’ and TCIF.	ADS	Discussed in industry workshop. MOD does not propose to progress.

UID	Proposal	Raised by	MOD response
27	Contractor should be able to report in its functional currency. If this is not permitted, the Regulations should specify how the conversion rate used is to be determined. There should be an ability to set the conversion rate for the whole term of the contract for reporting purposes.	ADS	Policy approach agreed. Considering how to take forward.
28	63(1) – Amend so that the contracting authority can apply for cessation of application of the Regulations to qualifying sub-contracts.	ADS	Policy approach agreed. Considering how to take forward.
29	Section 30(4) of the Act, Reg 62 – The contracting authority should be able to give notice that Part 2 of the Act and the Regulations ceases to apply to a QSC, as well as the subcontractor.	ADS	Policy approach agreed. Considering how to take forward.
30.1 30.2 30.3	Several cases where the word “value” is used when “contract price” or “proposed contract price” would be more correct: R5(5)(c), 5(7), 5(8)(b), 25(2)(k), 26(5), 26(6)(j), (k) & (l), 27(2), 27(4)(j), 27(5), (e) & (f), 28(2)(p) & (q), 42(1)(b)(iv), 44(b) & (f), 61(7) Reg 31(2)(a) and (b), 58(1) the sums of money should be preceded with “a contract price of”. Reg 32(3)(d) & (4)(e) & (5)(f), 35(7)(d) & (e), 37(7)(d) & (e), 39(4)(c) “value” should be replaced with “amount”. Reg 58(3), (4) & (5) replace “value” with “price”	ADS	Policy approach agreed – believe changes have already been made where needed, but will discuss further.
31	PEPL disapplication threshold is £50M, consider exempting higher value contracts from PEPL in certain circumstances	MOD	Discussed in industry workshop. MOD does not propose to progress.
32	25(2)(c)(i) – ‘any’ could mean ‘every’ so consider addition of “material”	MOD	Policy approach agreed. Considering how to take forward.
33	Contract Pricing Statement – Reference to each ‘element’ of allowable costs could be dropped, this creates uncertainty as to what is an ‘element’	ADS	Policy approach agreed – believe changes have already been made where needed, but will discuss further.
34	35(7)(c)(ii) – Update to ‘other MOD Contracts’	ADS	Policy approach agreed. Considering how to take forward.
35	35(8)(b) add ‘material’ before ‘any’ difference	ADS	Policy approach agreed – believe changes have already been made where needed but will discuss further.
36	Consider further amending Regulation 7 to say international defence agreement which specifies how a contract is priced/has an impact on price.	MOD	Discussed in industry workshop. MOD does not propose to progress.
37	Currently the legislation does not allow for contracts placed between 18th Dec 2014 – 31st March 2015 to be converted to QDC on amendment, it is a gap in the legislation as it stands.	MOD	Discussed in industry workshop. Policy intent understood, further discussions to follow.

E02736607
978-1-5286-3283-6