

DEFENCE REFORM ACT 2014

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 2: Single Source Contracts

45. At a number of points in these sections, reference is made to an “authorised person”. This is to allow for the fact that some functions under this Part may in future be performed by a contractor, providing defence procurement services to the Secretary of State by virtue of arrangements mentioned in section 1.

Section 13 and Schedule 4: Single Source Regulations Office (“SSRO”)

46. This section provides for the establishment of the SSRO. The SSRO will be classified as a Non-Departmental Public Body (NDPB) and will replace the existing Review Board for Government Contracts, but will have a much greater remit than the Review Board had. The SSRO will act as the regulator for the new framework.
47. There will be a Framework Document setting out the arrangements between the MOD and the SSRO. This document will be publicly available.
48. The initial set-up costs of the SSRO will be funded by the MOD, and the Department will continue to contribute to its funding. However, once in a steady state, up to half of its funding will be provided by deductions from the price payable under contracts which are subject to Part 2. The amount of funding that will be obtained this way will be determined every year by the Secretary of State on the advice of the SSRO and taken from payments made to contractors (see step 4 of the contract profit rate, under section 17).
49. The functions of the SSRO are set out in various places in Part 2. In summary they are:
- a) advising the Secretary of State on the baseline profit rate, the SSRO funding adjustment, and capital servicing rates (section 19(2));
 - b) keeping the regulatory framework under review and recommending changes to the Secretary of State (section 39(1) and (2));
 - c) keeping records of contracts which are subject to Part 2 (section 36(1));
 - d) keeping under review contractors’ compliance with their reporting obligations (section 36(2));
 - e) analysing reports and other information (section 36(3));
 - f) upon a referral, providing determinations, including on:
 - the amount of any target cost incentive fee (TCIF – this term is explained under section 15 paragraph 59(c) below) adjustment (section 16(2)(b));
 - whether step 2, 3 or 6 of the contract profit rate was appropriately determined at the time a contract was entered into (section 18(3));

*These notes refer to the Defence Reform Act 2014
(c.20) which received Royal Assent on 14 May 2014*

- whether a cost under a contract is an allowable cost (section 20(5));
 - the amount of any final price adjustment for firm or fixed price contracts (these terms are explained under section 15) (section 21(3)(b));
 - whether obligations of confidence were entered into for genuine commercial reasons (section 27(3));
 - whether a sub-contract is subject to Part 2 (sections 29(5) and 30(4));
 - matters relating to a compliance or penalty notice (section 32(8));
 - any matter specified by the regulations and referred to it by the Secretary of State, an authorised person, a contractor or a prospective contractor (section 35(1)(b));
- g) upon a referral, providing an opinion, including on:
- whether the Secretary of State or an authorised person has reasonably exercised functions in relation to contractor records (section 23(6) and (7));
 - any matter specified by the regulations and referred to it by the Secretary of State, an authorised person, a contractor or a prospective contractor (section 35(1)(a));
 - any matter referred by both parties to a regulated contract or a proposed regulated contract (section 35(3)); and
- h) providing statutory guidance on:
- any of the contract profit rate steps (section 18(1));
 - determining whether costs are allowable costs (section 20(1));
 - preparing reports (sections 24(2)(d) and 25(6)(d));
 - how to determine the amount of a penalty (section 33(3)).
50. The SSRO will also have the function of providing other assistance or services to the Secretary of State in accordance with arrangements made with the Secretary of State (section 37(1)), but if it does so those will be paid for by the Secretary of State (section 37(2)). The industry contribution described above, which will be deducted at step 4 of the contract profit rate, will not contribute to this work.
51. *Subsection (2)* sets out the overall aim of the SSRO in carrying out its functions. That aim is to ensure both value for money for the government and a fair and reasonable price for contractors in relation to contracts to which Part 2 applies.
52. *Subsection (3)* gives effect to Schedule 4, which provides for governance aspects of the SSRO. The Schedule describes the members the SSRO will have, their terms of office, and how they may resign or be removed or suspended from office. It allows the SSRO to employ staff and provides for the remuneration and pensions of employees and members. The SSRO may determine its own procedure, subject to a requirement that when it is exercising certain functions listed in paragraph 10(3) (which include making determinations under specified provisions), this must be done by a committee which includes someone who is neither a member nor an employee of the SSRO (paragraph 10(5)). This is to bring an external view to the determination.
53. **Schedule 4** contains other provisions that are standard for an NDPB. It also provides (paragraph 17) that the SSRO is not a servant or agent of the Crown and does not enjoy any Crown status or immunity. Its members and employees are not civil servants.

Section 14: Regulations relating to qualifying defence contracts

54. This section identifies the primary contracts which will be subject to Part 2 and permits the Secretary of State to make regulations in relation to them. Such contracts are called qualifying defence contracts (“QDCs”) (sub-contracts of QDCs may themselves be subject to Part 2 - this is dealt with under sections 28 to 30 below). These regulations are to be called single source contract regulations (“SSCRs”) and it is intended that they will come into force no later than 6 April 2015. The date that the first SSCRs come into force is called the “relevant date”.
55. The criteria for a contract to be a QDC are set out in *subsections (2) to (5)*. They are:
- a) that it is a contract under which the Secretary of State procures goods, works or services for defence purposes. “Defence purposes” will be defined in the SSCRs;
 - b) that the contract value is of or above an amount to be specified in the SSCRs. It is intended that the threshold of a QDC will be set at £5m, but some requirements will only apply to QDCs at a higher level of value;
 - c) that the contract is not of a sort described in the SSCRs. It is intended that this power will be used to exclude contracts which do not require regulation under Part 2 because they are subject to other market pressures or pricing benchmarks (for example, contracts for the maintenance of buildings, which are contracts for services but for which prices may be determined with reference to market prices); and
 - d) the contract falls within any of the three cases described below.
56. There are three cases where contracts which meet these criteria will be QDCs:
- a) contracts entered into on or after the relevant date (*subsection (3)(a)*), which are not the result of a competitive process (*subsection (3)(b)*). These will be the majority of QDCs;
 - b) by agreement between the parties, a contract entered into before the relevant date and amended on or after that date, and which is not the result of a competitive process, may become a QDC (*subsection (4)*); and
 - c) by agreement between the parties, a competitive contract entered into before the relevant date but amended on a non-competitive basis after that date (*subsection (5)*) may become a QDC. Such contracts will only be included when the non-competitive amendment to a competitive contract is not considered to be a new contract in its own right (these will be dealt with under case (a) above).
57. *Subsection (7)* enables the Secretary of State to exempt contracts that would otherwise be QDCs. This power will be exercised on a case-by-case basis.

Section 15: Pricing of contracts

58. QDCs, and amendments to QDCs, must be priced in accordance with the formula provided at *subsection (4)*.
59. There are many different types of commercial arrangement used in QDCs, and *subsection (5)* combined with section 43(2)(b) allows for the formula to be adapted for all contract types. The provisions here allow flexibility in the point in time at which the formula is applied, and whether costs are estimated or actual costs. For common commercial arrangements the formula will be applied as follows:
- a) for firm price contracts (where the price is agreed at the time the contract is entered into and will not change unless the contract is later amended) – at the time the contract is entered into, based on estimated costs in nominal terms (i.e. including inflation);

- b) for fixed price contracts (where the price is agreed at the time of contract subject to specified costs which may vary with inflation) – at the time the contract is entered into, based on estimated costs in real terms (i.e. excluding inflation);
 - c) for target cost incentive fee (TCIF) contracts (which have a “target cost” agreed at the time the contract is entered into, and agreed mechanisms for sharing any variation between actual costs and that target cost) – at the time the contract is entered into, based on estimated costs (section 16 separately provides for this) and again as required throughout the contract and at the end of the contract, based on actual costs; and
 - d) for cost-plus contracts (which are not priced at the time the contract is entered into, rather a profit rate is agreed which will be charged on actual allowable costs that arise under the contract) – as required throughout the contract and at the end of the contract, based on actual costs.
60. There are two elements in the formula – the “contract profit rate” (CPR) which is calculated by a six step process described at section 17, and the “allowable costs”, for which provision is made at section 20.

Section 16: Pricing of contracts: supplementary

61. This section makes specific provision for the use of the pricing formula at section 15(4) when it is used for TCIF contracts. For such contracts *subsection (1)(a)* allows for the price determined in accordance with section 15 to be taken as the target price for the contract and *subsection (1)(b)* allows for the total price payable to be determined by the terms of the contract between the parties, or in the absence of such agreement, by the SSRO. A similar price adjustment mechanism also exists for other contract types (provided for by section 21), so *subsection (3)* disapplies section 21 for TCIF contracts.

Sections 17 and 18: Contract profit rate

62. The SSCRs must make provision for determining the CPR for each QDC, and that determination must be taken by following the six steps that are set out in *subsection (2)* of section 17. The SSRO may issue guidance as to any of the steps (section 18(1)). Some of these steps themselves have further provision in other sections. The steps are:
- a) *Step 1* - the “baseline profit rate” (BPR) is the starting profit rate for all QDCs before other adjustments are applied at steps 2 to 6. The BPR will be determined annually, as provided for in section 19.
 - b) *Step 2* - (*cost risk adjustment*) – an adjustment to reflect the residual cost risk retained by the contractor under the QDC, within a range to be specified in the SSCRs. The contractor and the Secretary of State will each be able to refer this adjustment to the SSRO for an opinion, as this will be a matter to be specified under section 35(1)(a). This adjustment **may increase or decrease** the CPR.
 - c) *Step 3* - (*profit on cost once*) – QDCs often have complex commercial supply chains involving sub-contracts that may themselves also have further sub-contracts etc. This adjustment is to ensure that where a QDC has single source sub-contracts, profit is only charged once upon allowable costs. The contractor and the Secretary of State will each be able to refer this adjustment to the SSRO for an opinion, as this will be a matter to be specified under section 35(1)(a). This adjustment **may decrease** the CPR.
 - d) *Step 4* - (*SSRO funding adjustment*) - the SSRO will be funded equally by industry and the Secretary of State. This step provides for an adjustment to the CPR to fund the SSRO, and is the means whereby industry funding is intended to be equitably shared across contractors based upon the value of their QDCs. The SSRO funding

adjustment will be determined annually, as provided for in section 19. This adjustment **will decrease** the CPR.

- e) *Step 5 - (incentive payment)* – there are circumstances in which it is appropriate to provide additional financial incentives to a contractor under a QDC, where such incentives are related to the performance of specific provisions (to be specified by the Secretary of State). This adjustment allows for an incentive element in the CPR, subject to a maximum amount to be specified in the SSCRs. This adjustment **may increase** the CPR.
 - f) *Step 6 (capital servicing allowance (CSA))* – in performing a QDC a contractor may make use of both fixed capital (buildings, plant and equipment etc) and working capital. This adjustment allows for the contractor to receive an appropriate and reasonable return on this capital employed in performing the contract. The contractor and the Secretary of State will each be able to refer this adjustment to the SSRO for an opinion, which will be provided for under section 35(1)(a). This adjustment **may increase or (exceptionally) decrease** the CPR.
63. Steps 2, 3 and 6 provide for amounts to be agreed, and section 17(4)(a) provides that “agreed” means agreed by the Secretary of State (or an authorised person) and the contractor. The reference to an “authorised person” is to allow for the fact that a contractor or the employee of a contractor under arrangements mentioned in section 1 of this Act may be authorised by the Secretary of State to exercise this function.
64. In some cases the Secretary of State will have many similar QDCs with one contractor (for example when let under a framework agreement). In these cases it may be more efficient to determine one CPR to be used for a group of contracts, rather than make an individual assessment for each QDC. This is provided for by section 18(2)(c).
65. Either party may ask the SSRO for a determination if they consider that an adjustment under step 2, 3 or 6 was not appropriately determined in accordance with this section, based upon information available to either party at the time the QDC was entered into (section 18(3)(a)). Where the SSRO determines that a different adjustment under step 2, 3 or 6 should have been made, it may further determine a price adjustment to the extent that that adjustment varies from the one made at the time the contract was entered into (section 18(3)(b)). Enforcement of this price adjustment is provided for by section 22.
66. The SSCRs may allow for some of the six steps to be disapplied for lower value QDCs (section 18(2)(a)) or for those steps to be applied in a modified way (section 18(2)(b)). This means that, for low value QDCs, the SSCRs will be able to make provision for a simplified process of determining the CPR.

Section 19: Rates etc relevant to determining contract profit rate

67. Certain standard rates will be used in the determination of the CPR. These are:
- a) Step 1 - the baseline profit rate, which is the starting point for the CPR of all QDC and is expected to be in the order of 10%;
 - b) Step 4 - the SSRO funding adjustment, which reflects industry’s share of the costs of the SSRO and is expected to be a reduction in the order of 0.05%; and
 - c) Step 6 - the capital servicing allowance, which is the adjustment allowing contractors a fair and reasonable return on their capital costs (typically between 0%-3%). There are two capital servicing rates: one for fixed capital such as buildings, and the other for working capital such as cash.
68. All of these standard rates will be set annually by the Secretary of State (*subsection (1)*), and will be set for each financial year (beginning on 1 April).

69. To support the Secretary of State in determining these standard rates, the SSRO has a duty to recommend these annually to the Secretary of State (*subsection (2)*). In making its assessment, the SSRO must have regard to guidance issued by the Secretary of State (*subsection (3)(b)*).
70. Having received the assessment of the SSRO, *subsection (4)* requires the Secretary of State to publish the rates in the London Gazette no later than 15 March of the preceding financial year, along with (*subsections (5) and (6)*) reasons for any differences from the SSRO's assessment.

Section 20: Allowable costs

71. This section makes provision for the allowable cost element of the formula for pricing QDCs (section 15(4)(b)). There are three requirements which the Secretary of State and contractor must be satisfied are met for a cost to be allowable. These requirements are specified at *subsection (2)*.
72. In determining whether a cost is an allowable cost, *subsection (3)* provides that the Secretary of State and contractor must have regard to guidance which may be issued by the SSRO under *subsection (1)*.
73. *Subsection (4)* provides the Secretary of State with power to require a contractor to show that a cost claimed as an allowable cost meets those requirements specified at *subsection (2)*.
74. Either party may refer a cost to the SSRO for a determination as to whether it is an allowable cost under a contract (*subsection (5)*). Where the SSRO determines that a cost, or part of a cost, is (or is not) an allowable cost, the SSRO may further determine a price adjustment to the extent that that cost was (or was not) included in the price of the contract (*subsection (6)*). Enforcement of this price adjustment is provided for by section 22.

Section 21: Final price adjustment

75. *Subsection (1)* allows for the SSCRs to make provision for adjustment to the price of QDCs. It is intended that this will only be used for certain types of contract ("fixed" and "firm" price contracts – described under section 15 above), in reliance on *subsection (4)(a)*.
76. The procedure for determining the amount of this adjustment will be set out in the SSCRs (*subsection (2)*). In most cases the determination of any adjustment under this section is expected to be made by agreement between the Secretary of State (or an authorised person) and the contractor (under *subsection (3)(a)*), but *subsection (3)(b)* enables one of the parties to refer the matter to the SSRO for determination, in which case enforcement is provided for by section 22.
77. *Subsection (5)* gives the Secretary of State a power, on a case by case basis, to direct that this adjustment does not apply to a QDC, so long as the value of that QDC is within a range to be specified in the SSCRs. *Subsection (6)* provides that, in exercising this power of exemption, the Secretary of State must have regard to matters specified in the SSCRs.

Section 22: Recovery of unpaid amounts

78. The SSRO may make determinations that result in an adjustment to the price payable under a QDC – in relation to specific elements of the contract profit rate (section 18(3)(b)), the allowable costs under a QDC (section 20(6)), or as a result of a final price adjustment (section 21(3)(b)). Section 22 provides for the enforcement of these determinations by allowing for the amount due from one party to the other to be treated as a debt due (*subsection (4)*).

79. Where any amount is not paid by its payment date (determined by the SSRO in making its determination) then interest will be charged from that date (*subsection (2)*).

Section 23: Records

80. *Subsection (1)* requires the SSCRs to contain provision requiring contractors to keep relevant records (whether in hard or electronic form). The records required to be kept include those that enable the MOD to verify the estimates used in pricing, to ensure that contractors are complying with their Part 2 obligations (in particular in relation to reports made under sections 24 and 25 and in relation to sub-contracts) and to better understand how costs are being managed and whether performance indicators are being met. The Secretary of State (or an authorised person) will have access to those records (*subsection (5)*). This underpins many other provisions of this Part, for example for contractors to demonstrate under section 20(4) that a cost claimed is an allowable cost, or in the event of a referral to the SSRO under section 32(8).
81. The period which those records should cover will be specified in the SSCRs (*subsection (4)*) and, for records relevant to pricing (as set out in the SSCRs), will include the period before the QDC was entered into. This is necessary to allow for the auditing of the contract pricing procedure. The persons who will be subject to this duty are contractors who are party to a QDC, but also persons other than contractors who are subject to the reporting requirements of section 25.
82. The SSCRs will make provision for the inspection of these records by the Secretary of State (or an authorised person), including the times at which such examination may be made and the notice that must be given, and the right to require copies (*subsection (5)*).
83. Failure to comply with this section may lead to a financial penalty under sections 31(3)(a)(i) and 32.
84. A person who is required to keep records, and to provide access to those records, may ask the SSRO to review the way that the Secretary of State (or the authorised person) has exercised their functions under this section. If the SSRO is of the view that the Secretary of State or the authorised person has behaved unreasonably, it may make a declaration to that effect (*subsections (6) and (7)*).

Section 24: Reports on qualifying defence contracts

85. This section enables standard reporting on QDCs. The SSCRs will contain provision as to the matters that must be covered in the reports, the times at which reports must be made, and the form of the reports (*subsection (2)*). The wide variety of QDCs means that reports will need to vary in some circumstances, and this is allowed for in *subsection (4)*. It is intended that *subsection (4)(a)* will be used to vary the level of reporting such that only contracts of a significant value will be subject to the full reporting requirements specified under *subsection (2)*. Some reports will not be required at fixed intervals or for all contracts, so will only be required upon request by the Secretary of State or authorised person – this is provided for in *subsection (3)*.
86. The reporting requirements are likely to change over time as the SSRO recommends refinements to them. However, it is intended that the first SSCRs will provide for three reports which are designed to enable the MOD, over time, to compare the costs of comparable projects, allowing the Department to improve its independent estimates in both budgeting and in challenging contractor cost estimates. The reports, one due at the beginning of the contract, one at the end, and one either annually or at key contract events (such as material amendment or significant milestones), will split out costs (both actual and forecast at completion) in a standard set of cost categories which will vary by the type of equipment being procured or maintained. The final report at the end of the contract will also include a variance analysis against the initial forecasts which will be used to help improve estimating capability and improve understanding of the causes of cost growth.

87. Two other reports will also be required at the beginning of the contract. One, the contract reporting plan, will identify the reports due for that contract under the regulations, and when each report will be due – this information will be used to support the compliance process. The other (the contract pricing statement) will contain information supporting the pricing of the contract, such as key assumptions.
88. There will also be one report that will be required more frequently - a quarterly contract report will be required on the largest QDCs, which splits out costs in accordance with the contractor's own project reporting, and is designed to enable the MOD to improve their contract management and identify project issues, such as cost growth, in a timely manner.
89. One further report will be specified, the contract costs report. This information is required when the actual allowable costs under a contract need to be agreed, for example to determine payments under a TCIF contract or to enable calculation of any final price adjustment under section 21.
90. Failure to comply with reporting requirements imposed under this section, or making a misleading report, may lead to a financial penalty under sections 31(3)(a)(ii) and (b), and 32.

Section 25: Reports on overheads and forward planning etc

91. Most single source contractors are members of larger corporate groups. This section enables reporting on overhead costs and planning issues by those corporate groups, in addition to the reports on specific QDCs that will be provided under section 24. The information that must be included in the reports will be set out in the SSCRs.
92. As with the contract reports, it is likely that reporting requirements will change over time as the SSRO recommends refinements to them. However, it is intended that the first SSCRs will provide for eight reports. Four of the reports, required for each of a contractor's business units in which costs are incurred which are recovered by allowable costs in a QDC, will split out a contractor's overhead costs in a standard set of categories. These four reports are very similar, with one providing for reporting of actual costs and another for estimated costs. For process reasons, each of these two reports will be required twice – once reflecting a contractor's claim, and then again once costs have been agreed with the MOD. This will allow the MOD to benchmark comparable business units against each other and will identify areas where costs are at odds with typical value. Another report will capture the key assumptions used in providing estimated overheads. A further report will compare actual overhead costs incurred on QDCs with the forecasts used to price these overheads, and will allow the MOD to identify any systematic over- or under-recovery of overhead costs by contractors.
93. Two more reports will be required annually and at the contractor-level (only one report per year per corporate group). The first of these will be a strategic planning report that requires details of the key industrial infrastructure that is being paid for out of QDC prices. Any forecast investment and rationalisation plans will also be provided where the contractor expects to recover consequential costs from the MOD, as well as current throughput compared with capacity. This will allow the MOD to check that it is not paying for unnecessary capacity, and to be advised of significant costs and the risk of losing key industrial capability before this occurs. The second contractor-level report will contain information about key small to medium sized enterprises (SMEs), and the extent to which their subcontracting procurement processes are open to SMEs.
94. The duty to provide reports under this section will be on contractors who have an ongoing QDC in the relevant financial year ("the ongoing contract condition"). Where the contractor is associated with one or more other persons, the obligation to report will be on their ultimate parent undertaking rather than on the contractor itself (*subsection (3)*). The purpose of this is to ensure that the duty to provide these reports

is only placed upon a group of companies once as opposed to placing the duty upon multiple companies within the same group – this simplifies the reporting duty, as for some reports only one instance of the report will be required for the whole group of companies.

95. Finally, *subsection (8)* gives the Secretary of State a power to direct that a particular contract is not to be taken into account for the purposes of deciding if the ongoing contract condition is met that year. It is intended that this power will be used where the reporting duty upon a designated person under this section could otherwise lead to the whole contract being exempted under the Secretary of State’s power under section 14(7) or 28(6) – rather than exempt a contract from this Part, this subsection allows the Secretary of State to exempt a contract only from this reporting requirement.
96. Failure to comply with reporting requirements imposed under this section may lead to a financial penalty under sections 31(3)(a)(ii) and 32.

Section 26: Duty to report relevant events, circumstances and information

97. *Subsection (1)* requires contractors to notify the Secretary of State when they become aware of events, circumstances or information that are likely to have a material effect upon the costs, price or performance of their QDC (*subsection (3)*),.
98. Failure to comply with this section may lead to a financial penalty (under sections 31(3)(c) and 32).

Section 27: Records and reports: restrictions

99. This section allows the SSCRs to disapply a requirement to provide access to records (section 23(5)) or information in standard reports (sections 24 and 25), or to report relevant events, circumstances and information (section 26) when such information is subject to an obligation of confidentiality. The obligation of confidentiality must be with another person outside of the same corporate group, who has not given consent for the release of the information. This restriction only applies to the provision of the information subject to an obligation of confidence. The requirement to provide, for example, a report that is due under section 24 or 25, would remain, although the specific information subject to an obligation of confidence would not be included within the report.
100. This provision could make it possible for broad obligations of confidentiality to unreasonably prevent compliance with the recording and reporting requirements. *Subsection (3)(a)* therefore enables the Secretary of State or an authorised person to refer an obligation of confidentiality to the SSRO and *subsection (3)(b)* provides the SSRO a power to investigate and override a restriction under *subsection (1)* if it has not been entered into for genuine commercial reasons. *Subsection (4)* further provides that where the obligation of confidentiality has been entered into wholly or partly to avoid providing information under sections 23(5), 24, 25, or 26, this is not to be considered a genuine commercial reason.

Sections 28 to 30: Sub-contracts

Introduction

101. Defence contracts are often large and complex, and it is common for aspects of them to be sub-contracted, and there may be more than one level of sub-contract. These sub-contracts may themselves be of very substantial financial value. The cost of sub-contracts will be an allowable cost under a QDC. Since primary contractors are invariably private sector bodies, they are not subject to any legal obligation to advertise or compete their sub-contracts.

102. The purpose of these sections is to ensure that if sub-contracts are awarded on a non-competitive basis, they will be subject to the regulatory framework created in Part 2 in the same way as primary contracts (i.e. those between the Secretary of State and the primary contractor) are, with appropriate modifications to be set out in the SSCRs. In other words, the obligations to which a QDC is subject are intended to “flow down” to its sub-contracts if those sub-contracts are themselves not competed. Sub-contracts which are subject to Part 2 are called “qualifying sub-contracts”.
103. **Part 2** and the SSCRs apply to qualifying sub-contracts (and sub-contractors) as they apply to QDCs (and primary contractors), subject to any modifications set out in the SSCRs (section 30(1) and (2)(a)).

Section 28: Qualifying sub-contracts

104. This section permits the SSCRs to make provision in relation to qualifying sub-contracts, and sets the conditions that must be met in order for a sub-contract to be a qualifying sub-contract. A sub-contract will be a qualifying sub-contract if it meets all of the following conditions:
- a) it involves provision for the purposes of another qualifying contract – *subsection (3)(a)* relates to sub-contracts entered into directly under a primary contract and *subsection (4)(a)* relates to further sub-contracts entered into under any other qualifying sub-contract (to allow for flow-down to more than the first tier of sub-contractors);
 - b) it is not the result of a competitive process. The SSCRs will make provision for determining whether the award of the contract is the result of a competitive process (which will mean resulting from a transparent procurement process in which it is reasonably considered that more than one offer will be capable of acceptance);
 - c) it is of or above a value to be specified in the SSCRs (which will initially be £25m); and
 - d) it meets any other requirements that may be specified in the SSCRs.
105. As with primary contracts (see section 14(7)), the Secretary of State may direct that a sub-contract is not a qualifying sub-contract even though it otherwise meets the conditions for being a qualifying sub-contract (*subsection (6)*). This power will be exercised on a case by case basis.

Section 29: Determining whether a contract is a qualifying sub-contract

106. The primary contractor must assess whether a prospective sub-contract would be a qualifying sub-contract, and give the prospective sub-contractor notice of that fact, before that sub-contract is entered into. This is to allow the prospective sub-contractor to consider the implications of being subject to Part 2 and whether they are willing to be party to a qualifying sub-contract before finally committing to the contract.
107. *Subsection (1)* allows the SSCRs to require a primary contractor of a QDC, who is proposing to enter into a sub-contract, to make an assessment of that prospective sub-contract and (*subsection (2)(a)*) to keep a record of that assessment. When the contractor makes a positive assessment (i.e. that the prospective sub-contract meets the conditions of section 28) then, under *subsection (2)(b)*, the contractor must notify the Secretary of State, an authorised person and the prospective sub-contractor of that assessment.
108. One possible way a contractor could deliberately avoid flowing down the obligations to a sub-contractor that would otherwise be subject to them would be to enter into a conditional sub-contract or similar arrangement prior to the signing of the primary QDC. *Subsections (3)* and *(4)* are designed to address this possibility, and provide equivalent provision to *subsections (1)* and *(2)*.

109. The SSCRs will contain provision allowing a prospective sub-contractor, where they have been informed that their contract would be a qualifying one, to appeal this decision to the SSRO who may determine whether or not it qualifies (*subsection (5)*). The process the SSRO should follow in making this assessment will be set out in the SSCRs (*subsection (6)*).
110. There are three potential compliance failures under this section which may be subject to a civil penalty. These are:
- a) failure to make an assessment under subsection (1) or (3) (section 31(3)(d));
 - b) failure to give notice of a positive assessment under subsection (2)(b) or (4)(b) (section 31(3)(f)); or
 - c) making a negative assessment under subsection (1) or (3) which the Secretary of State considers should have been positive (section 31(3)(e)).

Section 30: Application of Part to qualifying sub-contracts

111. **Part 2** and the SSCRs apply to qualifying sub-contracts (and sub-contractors) as they apply to QDCs (and primary contractors), subject to any modifications set out in the SSCRs (*subsections (1) and (2)(a)*). *Subsections (3) and (4)* provide for circumstances in which Part 2 shall cease to apply to a sub-contract and this includes enabling sub-contractors to give notice to the SSRO that in their opinion one or more of the conditions for the application of this Part are no longer met, though the SSRO may overrule such a notice if it disagrees with the sub-contractor's opinion.
112. *Subsection (5)* provides that if notification has not been provided under section 29(2)(b) or (4)(b) then, despite the conditions for being a qualifying sub-contract being otherwise met by a sub-contract, Part 2 and the SSCRs shall not apply to it. This is because a sub-contractor must be aware before it enters into a qualifying sub-contract that it will be subject to the regulatory framework.

Sections 31 to 34: Compliance

113. These sections create a civil compliance regime to ensure compliance with key aspects of the regulatory framework. A person may be liable to a penalty if they do any of the following:
- a) fail to comply with specified reporting, record keeping, or access to record requirements (sections 23, 24 and 25);
 - b) provide a specified report under section 24 which is misleading in a material respect (knowing it to be misleading or being reckless as to that);
 - c) fail to comply with the duty to notify the Secretary of State of the occurrence of a relevant event etc (section 26);
 - d) in circumstances where the person is required to make an assessment as to whether a sub-contract is a qualifying sub-contract (section 29(1) or (3)), fail to make that assessment;
 - e) incorrectly make a negative assessment in respect of a proposed sub-contract (section 29(1) or (3)); or
 - f) fail to provide the required notification of an assessment (section 29(2)(b) or (4)(b)).
114. The procedure will be as follows. The Secretary of State may issue a compliance notice, which will describe the contravention and set out the steps that must be taken to remedy it (section 31(1) and (2)), but a compliance notice will only be issued if there are steps which the person can take to remedy the contravention (section 31(1)(b)). If the

contravention cannot be remedied, there will be no compliance notice, just a penalty notice (section 32(3)).

115. The SSCRs will set out different time limits for the issue of a compliance notice depending on the type of contravention (sections 31(5)) and 42(2)). These are likely to change over time as the SSRO recommends refinements to them. However, it is intended that the first SSCRs will provide that for failures to make reports on time (section 31(3)(a)(ii)), the time limit within which a compliance notice may be issued will be 12 months from the due date. This allows for a period of local negotiation before the Secretary of State may decide to issue a formal compliance notice. For other failures it is not possible to determine a specific due date. It is also possible that the Secretary of State may only become aware of a failure after the contract has been completed, for example during a post-contract cost investigation. So for these failures, it is intended that the time limit within which a compliance notice may be issued will be set at 24 months after the end of the contract.
116. If the person who receives the contravention notice fails to take the steps specified in it, a penalty notice will be issued, which will state the amount of the penalty. If the matter cannot be rectified, this penalty notice will be issued without the compliance notice being issued first (section 32(3)(b)).
117. The due date for the payment of a penalty will be 6 months after the date of the penalty notice (section 32(4)), subject to any amendment of that time period by the SSCRs (section 32(10)). This is to allow a person a reasonable period in which to consider whether or not to exercise their right to apply to the SSRO for a determination under section 32(8).
118. The SSRO has the power to review and make a determination in relation to relevant matters upon the application of a person who has been issued with a penalty notice (section 32(8)). The SSRO may review:
 - a) whether the person has committed the contravention, or failed to take the steps required in the compliance notice (or both);
 - b) whether the person had a reasonable excuse for the contravention or failing to take those steps (or both); and
 - c) the amount of the penalty.
119. The determination of the SSRO is final. Such decisions will be open to judicial review, but there is no appeal mechanism.
120. A penalty notice may specify circumstances in which a penalty of a reduced amount specified in the notice is payable. This allows the Secretary of State to create measures to encourage compliance even after a penalty notice has been issued (for example by reducing a penalty should the person subsequently take the steps specified in the compliance notice within a specified time period).

Section 33: Amount of penalty

121. For most contraventions, the amount of the penalty will be a tariff up to a maximum to be set out in the SSCRs (*subsection (1)*).
122. However, for two kinds of contraventions - providing a misleading report under section 24 and failure to comply with the duty to notify under section 26 - the amount of the penalty will be calculated as if the contravention were a breach of the QDC, and is to be calculated accordingly (no upper limit is set) (*subsection (2)*). Under these circumstances, the loss to the Secretary of State as a result of the contravention could vary substantially and could be in excess of an upper tariff penalty, where such a limit has been set at a level appropriate for other contraventions.

123. The calculation of a penalty under *subsection (2)* is to be made in accordance with the general law of contract having effect in England and Wales. Part 2 extends to all of the United Kingdom and it is possible that QDCs may be made under the law of Scotland. Nevertheless, the penalty under this section will be calculated in accordance with the contract law of England and Wales, to ensure consistency of penalty.

Section 34: Enforcement

124. Where any penalty is not paid by its due date (whether as set out in the penalty notice or as varied by the SSRO following a determination) then interest will be charged from the due date, and the Secretary of State may recover unpaid amounts as a debt due to the Secretary of State.

Section 35: Opinions and determinations

125. *Subsection (1)* provides for a duty on the SSRO to give an opinion or make a determination on matters specified in SSCRs, where such matters are referred to the SSRO by the Secretary of State, an authorised person, a contractor or a prospective contractor.
126. *Subsection (3)* gives the SSRO a general power to give an opinion on any matter which is referred to it by both the Secretary of State and either a contractor or prospective contractor.
127. *Subsection (4)* allows the SSRO, when giving an opinion or making a determination, to determine that one party must pay appropriate costs to the other. For example, on a referral to the SSRO by a contractor for unreasonable use of rights in relation to access to records (see section 23(6)), the SSRO could determine that the MOD must repay some or all of the costs incurred by the contractor in fulfilling such requests.
128. The SSRO is the successor body to the existing Review Board for Government Contracts. Where a contract was entered into before the relevant date (which is likely to be 1 October 2014) and that contract required the Review Board to make a determination or give an opinion on any matter, then after the relevant date a party to that contract may refer the matter to the SSRO instead (*subsections (6) and (7)*). Due to the length of some single source contracts, it is expected that for many years there will continue to be live contracts let prior to the relevant date, that are not QDCs, which contain contractual provisions allowing for referrals to the Review Board. This provision allows the SSRO to take over that function.

Section 36: Recording, review and analysis functions

129. The SSRO is required to keep an up-to-date record of QDCs and qualifying sub-contracts and their duration (*subsection (1)*). It is also required to keep under review the extent to which persons subject to reporting requirements are complying with them (*subsection (2)*).
130. *Subsection (3)* requires the SSRO to analyse reports provided to it under sections 24 and 25, together with any other information it considers relevant (for example other industry benchmarks, information from company accounts, etc), and to provide the results to the Secretary of State.

Section 37: Provision of other services to Secretary of State

131. This section enables the SSRO and the Secretary of State to agree that the SSRO will provide assistance or other services to the Secretary of State or an authorised person. This is not a duty as the SSRO will consider the provision of any such further work in the context of its overall resource capacity. The SSRO may separately charge the Secretary of State for any work undertaken as a result of a request under this section

(*subsection (2)(b)*), and any such costs will be excluded from the SSRO's assessment of the funding adjustment under section 19(2).

Section 38 and Schedule 5: Disclosure of information

132. **Section 38** gives effect to Schedule 5. Schedule 5 applies to information relating to an individual or business, which is obtained by the Secretary of State, an authorised person, or the SSRO under or by virtue of Part 2, and which is of a kind specified in the SSCRs (Schedule 5, paragraph 1) ("protected information").
133. **Schedule 5** creates a criminal offence of disclosing protected information (paragraph 2).
134. It is not a criminal offence to disclose protected information in certain circumstances (specified in paragraphs 3 to 5), including in response to a request under the Freedom of Information Act 2000.
135. **Paragraphs 2(3) and (4)** define the maximum penalty for the offence on both summary and indictable conviction.
136. **Paragraph 2(5)** relates to the Legal Aid, Sentencing and Punishment of Offenders Act 2012. When that Act comes into force, penalties for offences which are punishable on summary conviction by a fine not exceeding the statutory maximum will be set by reference to the new levels provided for by section 85 of that Act.
137. **Paragraph 6** gives the Secretary of State the power by order to create a statutory bar on the disclosure of protected information. Should this power be used, disclosure of protected information under the Freedom of Information Act 2000 would be prohibited but the other permitted disclosures would not be affected. Such an order would be subject to the affirmative resolution procedure (sub-paragraph (6)).

Section 39: Review of Part and regulations under it

138. The SSRO has a duty to keep under review the provision made by Part 2 and SSCRs which are in force (*subsection (1)*). *Subsections (3) and (4)* provide for a duty on the Secretary of State to carry out a review within 3 years of the first SSCRs coming into force and every 5 years thereafter. In carrying out this review the Secretary of State must have regard to any recommendations made by the SSRO (*subsection (2)*).

Section 40: Power to repeal Part

139. This section provides the Secretary of State with a power to repeal this Part by an order made by affirmative resolution procedure. This power could be used if a review under section 39 recommended that the overall regulatory framework, including the SSRO, be removed.

Section 41: Single source contract regulations: time limits and determinations

140. **Part 2** allows for various applications, references and appeals to be made to the SSRO. These include an application to determine appropriate adjustments to the contract profit rate (section 18(3)), an application to determine the extent to which a cost is an allowable cost (section 20(5)), a reference to determine the amount of a TCIF adjustment (section 16(2)(b)), or an appeal by a prospective sub-contractor as to whether a proposed contract would be a qualifying sub-contract (section 29(5)).
141. *Subsection (1)* provides for the time period in which any such application, reference or appeal may be made to be specified in the SSCRs.
142. *Subsection (2)* provides that where the SSRO makes a determination it must have regard to any matters specified in the SSCRs, though this does not restrict the SSRO from considering any other matter it considers relevant in making a determination.

Section 42: Single source contract regulations: general

143. *Subsection (4)* provides that the first SSCRs, provision made in the SSCRs by virtue of section 14(2), (6) and (8) (which determine the contracts to which the SSCRs apply), and provision made in the SSCRs by virtue of section 33 (amount of penalty) must be made by the affirmative resolution procedure. Any other instrument containing SSCRs may be made by the negative resolution procedure (*subsection (5)*).

Section 43: Interpretation etc

144. *Subsection (2)(a)* provides that the value of a contract is to be determined in accordance with the SSCRs. Part 2 includes references to the value of a QDC, for example in section 14(2)(b), which states that a contract can only be a QDC if the value is of or above an amount specified in the SSCRs. However it may not always be straightforward how to determine the value of a contract, for example some amounts may be specified in a foreign currency, or linked to future inflation indices, and so subsection (2)(a) allows the SSCRs to contain provision for how to determine the value of a contract for the purposes of Part 2. This value may not be the same as the price of the contract as other factors may be taken into account. It is expected that similar provision will be made under this provision as in regulation 9 of the Defence and Security Public Contracts Regulations 2011.¹

¹ SI 2011/1848.