

Research Briefing

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# Defence procurement : The single source contract regulations

## Summary

- 1 About single source procurement
- 2 The regulatory framework
- 3 Reforming the regulations: the 2017 review
- 4 Reforming the regulations: the 2022 review
- 5 The Procurement Act 2023 and secondary legislation
- 6 Annex 1: DSIS proposals for reform

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# Contents

Summary	4
1 About single source procurement	7
2 The regulatory framework	8
2.1 Primary and secondary legislation	8
2.2 When do the regulations apply?	8
2.3 Statutory guidance	10
2.4 What is the role of the SSRO?	10
2.5 Timing of statutory reviews	12
3 Reforming the regulations: the 2017 review	13
4 Reforming the regulations: the 2022 review	14
4.1 Timing of the review	14
4.2 A new strategy	15
4.3 The SSRO recommendations	16
4.4 Industry proposals	16
4.5 Technical changes	17
5 The Procurement Act 2023 and secondary legislation	18
5.1 Primary legislation	18
5.2 Secondary legislation	18
5.3 Amending primary and secondary legislation	19
5.4 Major legislative changes	20
5.5 Qualifying defence contracts	20
5.6 Changes to the profit rate	21
5.7 Contract reporting	23
5.8 Widening range of referrals to the SSRO	23
5.9 Powers of the Single Source Regulations Office (SSRO)	24
6 Annex 1: DSIS proposals for reform	25

## Summary

Historically the Ministry of Defence has awarded a significant proportion of contracts without an open competition. In 2014 the government created a new framework to regulate defence contracts and sub-contracts which have not been competed.

The framework for single set out in the Defence Reform Act 2014 and in secondary legislation.

A review of the single source contract regulations in 2022 prompted recommendations that require changes to legislation. The Procurement Act 2023 amended the Defence Reform Act 2014. Further amendments are expected in secondary legislation in 2024; the first came into force on 1 April. An expected second statutory instrument has not been laid at the time of writing.

## A new regime comes into force

Before 2014 the governance of non-competitive contracts was reliant on a non-legally binding framework dating from 1968, known as the Yellow Book, which was overseen by the Review Board for Government Contracts.

A review by Lord Currie led to the [Better Defence Acquisition](#) White Paper in 2013 and the new framework was brought into effect in part 2 of the Defence Reform Act 2014 (the 2014 Act) and the Single Source Contract Regulations 2014 (the SSCRs).

The single source framework has three main components: the regulations, statutory guidance, and a body to manage and monitor the framework, known as the Single Source Regulatory Office (SSRO).

The SSCRs apply when a defence contract with a value of over £5 million is awarded without being competed, unless it is specifically excluded from the regulations. Exclusions include government to government sales.

## Reviewing the framework

The 2014 Act requires the Secretary of State for Defence to review single source procurement legislation within three years of it coming into force (i.e. 2017) and each subsequent five-year period (i.e. 2022 and thereafter).

The Act also requires the SSRO to keep the single source contract regulations under review, and make recommendations to the Defence Secretary as appropriate.

Following the 2017 review, the Ministry of Defence (MOD) amended the 2014 regulations via three statutory instruments. These changes are discussed briefly in this paper and in more detail in Library paper [The defence single source regulatory framework under review](#) (CBP 8930, June 2020).

The MOD began the next review process in mid-2019, with the SSRO submitting its initial recommendations in 2020 and its final recommendations in 2021. The MOD confirmed its intention to reform the SSCRs and outlined the broad parameters of its proposals in a new [defence and security industrial strategy](#) (DSIS) published in March 2021.

The MOD subsequently published a command paper outlining its [proposed reforms of the regulations](#) in April 2022. The MOD sought to strike a balance between ensuring value for money and a fair price for suppliers. It [set out a reform agenda](#) focused on three main themes:

- providing more choice and flexibility
- speeding up and simplifying how the framework is used
- stimulating innovation and exploiting technology

Professor Luke Butler, who specialises in procurement law and has written at length about the single source contract framework, notes that the regime involves “fundamental public policy questions regarding value for money and transparency”. However, he also says that [“the general impress of the proposals is that there are few, if any, elements of the reforms that could be said to be truly transformational in terms of fundamentally altering the regulatory design.”](#)<sup>1</sup>

## The Procurement Act and secondary legislation

The changes involve amending both primary and secondary legislation.

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<sup>1</sup> Butler, Luke, Reform of the UK Single Source Contract Regulations: A Regulatory Weapon in the Defence and Security Industrial Strategy’s Arsenal, 7 June, 2022. Available at SSRN: <https://ssrn.com/abstract=4130092> or <http://dx.doi.org/10.2139/ssrn.4130092>

The Procurement Act 2023 amends the Defence Reform Act 2014; these changes came into force in January and April 2014.<sup>2</sup>

Changes are also being brought in via secondary legislation to amend the 2014 regulations. The Ministry of Defence has indicated it intends to do this in two separate statutory instruments. The first is the [Single Source Contract \(Amendment\) Regulations 2024](#) which were [laid on 22 January 2024](#) and came into force 1 April 2024. The second tranche has not yet been laid.

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<sup>2</sup> The [Procurement Act 2023 \(Commencement No.1 and Saving Provision\) Regulations 2024](#) bring section 117 and provisions in Schedule 10 into force in part on 19th January 2024 and in part on 1st April 2024.

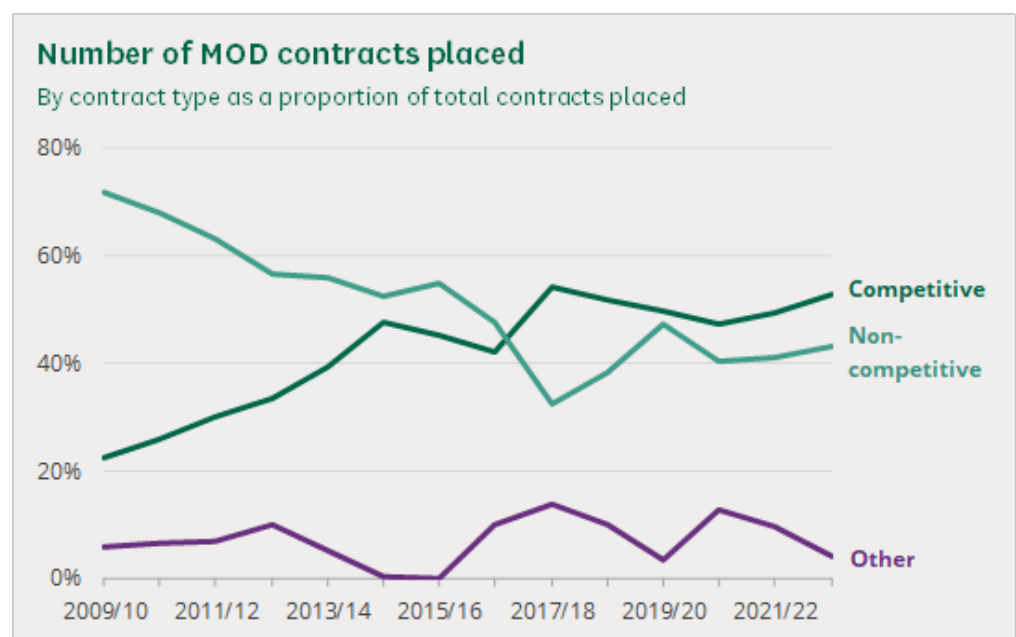
## 1

## About single source procurement

The Ministry of Defence (MOD) spends billions each year buying new equipment and supporting existing equipment for the armed forces.

Historically the MOD has allocated a significant proportion of the defence equipment budget to single source suppliers, without competition. Most commonly this is for national security reasons, or because there is only one specialist supplier available. 39% of contracts placed by the Ministry of Defence in 2022-23 were awarded without competition, amounting to £12.9 billion. By comparison, 37% of contracts were awarded following a bidding process or competition.<sup>3</sup>

The National Audit Office found the proportion of contracts awarded non-competitively between 2013-14 and 2016-17 was around 50%.<sup>4</sup> The table below illustrates the number of contracts placed by contract type.<sup>5</sup>



<sup>3</sup> MOD, [MOD trade, industry and contracts:2023](#), 28 September 2023

<sup>4</sup> National Audit Office, '[Improving value for money in non-competitive procurement of defence equipment](#)', HC 412 2017-19, 25 October 2017, figures 3 and 5

<sup>5</sup> Excluded from data up to 2016/17 are Pan Government Enabling Contracts that will also incur expenditure from other Government departments. From 2017/18 onwards the quality of the data does not allow Pan Government Enabling contracts to be identified so they are included in the totals.

## 2 The regulatory framework

In 2014 the Government reformed the framework for single source procurement.

Before 2014 the governance of non-competitive contracts was reliant on a non-legally binding framework dating from 1968, known as the Yellow Book, which was overseen by the Review Board for Government Contracts.

A review by Lord Currie led to the [Better Defence Acquisition](#) White Paper in 2013 and the new framework was brought into effect in part 2 of the Defence Reform Act 2014 (the 2014 Act) and the Single Source Contract Regulations 2014 (the SSCR).

The single source framework has three main components: the regulations, [statutory guidance](#), and a body to manage and monitor the framework, known as the Single Source Regulatory Office (SSRO).

### 2.1 Primary and secondary legislation

- The [Defence Reform Act 2014](#) (part 2) brought the new single source contracts framework into effect. This has been amended by the Procurement Act 2023 (see section 5 for more detail).
- The [Single Source Contract Regulations 2014](#) is the main piece of secondary legislation. This has been amended by subsequent SIs: [SI 2018/917](#), [SI 2018/1350](#), [SI 2019/1106](#) and [SI 2024/420](#).

### 2.2 When do the regulations apply?

Not all non-competed contracts come under the single source regulatory framework.

The regulations only apply to primary contracts and non-competed sub-contracts if they meet certain criteria.

#### Qualifying contracts

The criteria for a Qualifying Defence Contract (QDC) are:



- the contract is for goods, work or services being procured for defence purposes;
- the contract award is not the result of a competitive process;
- the value of the contract is above £5 million, and
- it is not an excluded contract.

A sub-contract may also be subject to the regulations if it has a value of £25 million or above. This is known as a Qualifying Sub-Contract (QSC).

### Number of qualifying defence contracts

The SSRO [publishes annual statistics](#) on qualifying defence contracts<sup>6</sup>:

- 615 contracts became QDCs/QSCs between 1 April 2015 and 31 March 2024. The total estimated contract price of these was £102 billion. 154 of the 615 contracts have been completed.
- 59 contracts became QDCs/QSCs between 1 April 2023 and 31 March 2024, with a total estimated price of £4.6 billion.

### Excluded contracts

Contracts that are excluded from the regulatory framework include:

- contracts with foreign governments;
- contracts for land/buildings;
- contracts made within the framework of a cooperative international defence programme.

This means, for example, that contracts for equipment bought from the US Government via its Foreign Military Sales programme do not come under the single source regulatory framework.<sup>7</sup> In 2017 the MOD said it had more than 300 Foreign Military Sales agreements amounting to just under \$12 billion.<sup>8</sup> In 2022-23 the MOD spent £733 million on FMS agreements.<sup>9</sup> Major equipment ordered via the Foreign Military Sales route include the P-8 Poseidon maritime patrol aircraft and Apache AH-64E attack helicopters.

During the 2017 review concerns were raised about the level of excluded contacts. The SSRO told the Defence Committee that only 15-20% of MOD single source expenditure fell within the SSRO regime in 2016 and “having

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<sup>6</sup> Single Source Regulations Office, [Annual qualifying defence contract statistics: 2023/24](#), 9 July 2024

<sup>7</sup> The US Defence and Security Cooperation Agency provides an explanation of the [FMS programme](#) on its website.

<sup>8</sup> [PQ4693](#), 12 July 2017

<sup>9</sup> MOD, [MOD trade, industry and contracts:2023](#), 28 September 2023, table 9

over 80 per cent of single source expenditure not subject to the price controls and transparency of the regime runs contrary to the aims of Act”.<sup>10</sup> The committee in turn recommended the SSRO be given the ability to inspect all single source contracts, save for exceptional circumstances.<sup>11</sup>

Secondary legislation (SI 2018/917) modified the categories of contracts that can be excluded. It removed the original exclusion of contracts made wholly for the purposes of intelligence activities and replaced it with an exclusion for those contracts where the Government thinks there is a real risk to national security. The SI also narrowed the criteria for contracts made within the framework of an international co-operative defence programme.

The Secretary of State has the power to exempt a contract from the regulatory framework.<sup>12</sup> This has been used rarely according to the MOD. Between April 2015 and March 2018, fewer than 10 contracts were exempted.<sup>13</sup>

## 2.3 Statutory guidance

Statutory guidance on the SSCRs is available on Gov.uk: [SSRO guidance and regulation](#). This includes:

- [Allowable costs guidance](#)
- [Guidance on the baseline profit rate](#)
- [Reporting guidance and DefCARS](#) (the defence contract analysis and reporting system)
- [SSRO support](#)

## 2.4 What is the role of the SSRO?

The Single Source Regulatory Office was created by the Defence Reform Act 2014 to oversee the single source contract framework.

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<sup>10</sup> Defence Committee, Gambling on ‘efficiency’: Defence Acquisition and Procurement, 17 December 2017, HC 431 2017-19, [Ev ACQ0008](#)

<sup>11</sup> Defence Committee, Gambling on ‘efficiency’: Defence Acquisition and Procurement, 17 December 2017, HC 431 2017-19

<sup>12</sup> Ministry of Defence, “[An Overview: Single Source Procurement Framework](#)”, June 2014, version 1.0

<sup>13</sup> PQ253527 [[Defence: Contracts](#)], 16 May 2019

The SSRO's purpose is to ensure value for money is obtained by the Government and industry is paid a fair and reasonable price.<sup>14</sup>

The SSRO has seven regulatory functions. These include:

- Review: Keeping the operation of the regulatory framework under review and making recommendations for changes to the Secretary of State
- Records: Keeping an up-to-date record of qualifying contracts and receiving statutory reports from defence contractors under the regime
- Baseline Profit Rate: Assessing and recommending the appropriate baseline profit rate and capital servicing rates for use in calculating contract profit rates
- Guidance: Publishing guidance on Allowable Costs, Contract Profit Rate steps, Reporting and Penalties
- Referrals: Giving opinions and making determinations on matters referred to the SSRO concerning the regulatory framework
- Compliance: Keeping under review the extent to which reporting requirements are being complied with
- Analysis: Analysing reported data on request for the Secretary of State.<sup>15</sup>

Until recently the SSRO was funded jointly by the Government, via a grant-in-aid, and industry, via a funding adjustment when calculating the profit rate to be applied to a contract. The Government [proposed removing the funding adjustment](#) in its reform of the SSCRs command paper. The Procurement Act 2023 amended section 17(2) of the Defence Reform Act 2014 to remove the SSRO funding adjustment that had previously been included in the profit rate calculation (step 4). Section 5.4 discusses this further.

The SSRO underwent a tailored review in 2020. The review found there is a continuing need for the SSRO and the current delivery model – as an independent non-departmental public body – was deemed appropriate. The review found the SSRO is performing its statutory duties effectively and efficiently although it did find room for improvement. Specifically, it made several recommendations to improve the relationship between the MOD and the SSRO and to strengthen the MOD's oversight of the SSRO.<sup>16</sup>

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<sup>14</sup> Defence Reform Act 2014, [Part 2](#)

<sup>15</sup> More detail on the SSRO's functions and purpose can be found in the [SSRO's Corporate Plan 2020-23](#), 2 April 2020

<sup>16</sup> "[Tailored review of the Single Source Regulations Office](#)", Ministry of Defence, 7 April 2020

Publications by the SSRO can be found on Gov.uk: [the Single Source Regulations Office](#)

## 2.5

### Timing of statutory reviews

Section 39 of the [Defence Reform Act 2014](#) requires the Secretary of State for Defence to review single source procurement legislation within three years of it coming into force and each subsequent five-year period, and for the SSRO to keep under review the single source contract regulations. A review was conducted in 2017 and ahead of the 2022 deadline. The next statutory review is therefore due in 2027.

## 3

## Reforming the regulations: the 2017 review

For the 2017 review, the SSRO made 14 recommendations to the Defence Secretary.<sup>17</sup> Three statutory instruments were subsequently enacted which amended the 2014 regulations. The first was laid under the affirmative procedure and clarified which contracts cannot be subject to the legislation (are excluded).<sup>18</sup> The second changed the provisions for repricing contracts that fall under the regime when they are amended, and the time limits for referrals to the SSRO. The third clarified some of the terms in the regulations and amended the reporting requirements:

- [The Single Source Contract \(Amendment\) Regulations 2018](#) (SI 2018/917)
- [Single Source Contract \(Amendment\) \(No.2\) Regulations 2018](#) (SI 2018/1350)
- [Single Source Contract \(Amendment\) Regulations 2019](#) (SI 2019/1106)

### Further reading

- Commons Library paper, [The defence single source regulatory framework under review](#), CBP 8930, June 2020
- Butler, Luke, Single source wars: the saga continues, *Public Procurement Law Review*, 2019, 1, 28-38
- Butler, Luke, Single source wars, the saga continues: the Single Source Contract (Amendment) (No.2) Regulations 2018, *Public Procurement Law Review*, 2019, 3, 92-107

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<sup>17</sup> Single Source Regulations Office, "[Recommendations to the Secretary of State: Review of Part 2 of the Defence Reform Act 2014 and the Single Source Contract Regulations 2014](#)", June 2017 (published January 2018)

<sup>18</sup> To go through the 'affirmative procedure' refers to statutory instruments which must be approved by both the House of Commons and the House of Lords to become law. Conversely the 'negative procedure' refers to statutory instruments which automatically become law unless there is an objection from either House.

## 4 Reforming the regulations: the 2022 review

### 4.1 Timing of the review

The statutory review of the legislation is required to be completed by December 2022.<sup>19</sup> The MOD began the formal review of the legislation in mid-2019.<sup>20</sup>

The SSRO consulted on its review of the framework in late 2019 and early 2020, [publishing the outcome](#) in June 2020. The SSRO subsequently revised and re-submitted its [recommendations to the Defence Secretary](#) in June 2021.<sup>21</sup>

In March 2021 the MOD announced plans to “[simplify the regime](#)”.<sup>22</sup> The detailed proposals were laid out in a command paper published in spring 2022. The Government’s response to the consultation on its proposals was published on 23 May 2022.

#### 1 Relevant publications

##### Government publications

- [Defence and Security Industrial Strategy](#), CP 410, 23 March 2021
- [Defence and Security Industrial Strategy: reform of the single source contract regulations](#), CP 647, 4 April 2022
- [The Defence and security industrial strategy: reform of the single source contract regulations, government consultation response](#) (PDF), 23 May 2022
- [Procurement Bill HL 4 2022-23](#)

##### SSRO publications

<sup>19</sup> [Defence and Security Industrial Strategy: reform of the single source contract regulations](#), 4 April 2022; as set out in section 39 of the [Defence Reform Act 2014](#).

<sup>20</sup> [The Defence and security industrial strategy: reform of the single source contract regulations, government consultation response](#) (PDF), 23 May 2022, para 15

<sup>21</sup> [The Defence and security industrial strategy: reform of the single source contract regulations, government consultation response](#) (PDF), 23 May 2022, para 6

<sup>22</sup> [The Defence and security industrial strategy](#), 23 March 2021, CP 410

- [The 2020 review of the procurement framework for single source defence contracts](#) (PDF), December 2019
- [Review of legislation – findings from consultation](#), 17 June 2020
- [Review of legislation recommendations](#), 14 June 2021

## 4.2

### A new strategy

#### The defence and security industrial strategy (DSIS)

The 2021 DSIS outlines a new approach to procurement. It replaces the previous policy of “global competition by default” with “a more flexible and nuanced approach”.

This means defence will use competition “where appropriate” but, when global competition is deemed ineffective or incompatible with the UK’s national security interests, it may use a different approach. It explains the shift is driven in part because for some capability and technology segments there are only a very limited number of companies, which means global competition “is often not possible or inappropriate”.<sup>23</sup> The MOD expects implementing the DSIS will increase the proportion of non-competitive procurement for equipment and services.<sup>24</sup>

The DSIS includes a package of legislative reform, including plans to reform the Defence and Security Public Contracts Regulations.

The DSIS also indicates plans to simplify and speed up the single source regime and introduce new ways of “incentivising suppliers to innovate and support government objectives.”

#### The defence and security industrial strategy: reform of the single source contract regulations

The MOD subsequently published a command paper outlining its proposed reforms to the single source contract regulations: [Defence and Security Industrial Strategy: reform of the single source contract regulations](#) (CP 647). The proposals reflect the three main themes of the DSIS:

1. Choice and flexibility

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<sup>23</sup> [Defence and Security Industrial Strategy](#), March 2021, CP 410

<sup>24</sup> [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations](#), April 2022, CP 647, annex A para 1

2. Speed and simplicity
3. Stimulating innovation and exploiting technology

The MOD says the reforms will ensure the regulations can be applied to a wider range of contracts.

There will be a new way of determining a “fair price for goods or services”, including allowing prices to be set by reference to market prices. The MOD also talks of the need to pay a “fair profit rate”, to ensure the profit rate “accurately reflects the full range of financial risks” that suppliers take on. The profit setting process will be reduced from the current six steps to four.

The reporting requirements will be made “simpler and efficient” to help speed up and simplify how the framework is used. The MOD says it will require suppliers to only produce the information the MOD needs, and it will be clearer about what the information will be used for.

The range of subjects that can be referred to the Single Source Regulations Office will be widened to ensure greater access to statutory dispute resolution mechanisms and to speed up contract negotiations.

The MOD also says it will enact a “raft of technical changes” to clarify and simplify the regime.

A selection of proposals, including those that will require legislative changes, are discussed in section 5 of this paper. All 30 proposals are listed in the annex.

## 4.3 The SSRO recommendations

The SSRO made several recommendations and comments in its submission to the Defence Secretary of June 2021.

The SSRO says its recommendations are consistent with the speed and simplicity objectives in the DSIS.

The Government’s response to each the SSRO’s recommendations is published in annex B of the [Defence and security industrial strategy: reform of the single source contract regulations](#) paper.

## 4.4 Industry proposals

The Government’s response to industry proposals are contained in annex C of the [Defence and security industrial strategy: reform of the single source contract regulations](#) paper. This includes a summary of the proposal, the



source (predominantly ADS, the aerospace, defence and security group which represents industry) and the MOD's response.

## 4.5 Technical changes

The command paper lists a number of technical changes to the regulations. This list also includes issues raised by ADS, and whether the MOD intends to progress with them, or not.

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## 5 The Procurement Act 2023 and secondary legislation

Some of changes set out by the government require legislative changes.

### 5.1 Primary legislation

Section 117 of the Procurement Act 2023 provides that amendments are made in [Schedule 10](#) to the Defence Reform Act to enable reforms to the Single Source Contract Regulations 2014.

The Procurement Act 2023 received Royal Assent in October 2023.

#### Commencement

The [Procurement Act 2023 \(Commencement No.1 and Saving Provision\) Regulations 2024](#) bring section 117 and most of the provisions in Schedule 10 into force on 19th January 2024 (those that relate to the definition and pricing qualifying defence contracts, the contract profit rate, allowable costs, qualifying sub-contracts, reporting requirements and procedures of the SSRO). The provisions relating to the opinions, determinations and guidance made by the SSRO came into force on 1st April 2024.

### 5.2 Secondary legislation

The [Single Source Contract \(Amendment\) Regulations 2024](#) (SI 2024/420) came into force on 1 April 2024. The legal firm Bird & Bird describe the changes as constituting “the most significant reform to the single source regime since it was originally introduced a decade ago”.<sup>25</sup>

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<sup>25</sup> Mark Leach and Amelia Morris, [The Reform of the UK Single Source Contracting Regime - A brief guide to the key changes implemented by The Single Source Contract \(Amendment\) Regulations 2024](#), 12 June 2024

## 5.3

## Amending primary and secondary legislation

## Amending primary legislation: the Procurement Act 2023

The Procurement Act 2023 (the 2023 act) received Royal Assent in October 2023. The act overhauls public procurement in the UK and repeals and replaces four regulatory frameworks with a single public procurement regime. One of the frameworks is the Defence and Security Public Contracts Regulations 2011, which regulates competitive defence procurement. This change is discussed in a separate Commons Library briefing on the Defence and Security Public Contracts Regulations.

Section 117 of the 2023 act provides that amendments are made in Schedule 10 to amend part 2 of the Defence Reform Act 2014 to enable reforms to the Single Source Contract Regulations 2014.

The explanatory notes to the act state: “These regulations strike a balance between ensuring value for money for the taxpayer and a fair price for suppliers for un-competed ‘qualifying defence contracts’”.<sup>26</sup>

## Secondary legislation

While the 2023 act made some changes, many of the reforms will be delivered through secondary legislation.

Lord Coaker (Lab), a former Shadow Defence Secretary, expressed concern that many of the changes will be made in secondary legislation and highlighted the potential lack of parliamentary scrutiny of these changes. He said: “all the Bill does is to introduce primary legislation to allow changes to be made to secondary legislation.”<sup>27</sup>

In 2022 the MOD indicated it expected to introduce secondary legislation in two tranches.<sup>28</sup>

The first changes were made in the [Single Source Contract \(Amendment\) Regulations 2024](#) (SI 2024/420).

## The Delegated Powers and Regulatory Reform Committee and affirmative resolution

The Government originally intended for all the regulatory changes to be made by negative rather than affirmative resolution.<sup>29</sup>

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<sup>26</sup> [Procurement Act 2023 explanatory notes](#)

<sup>27</sup> [HL Deb 25 May 2022 \[Procurement Bill \[HL\]\]](#)

<sup>28</sup> Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations, April 2022, CP 647, para 75

<sup>29</sup> [Procurement Bill Memorandum from the Cabinet Office to the Delegated Powers and Regulatory Reform Committee](#) (PDF), Cabinet Office, 11 May 2022

However, the Delegated Powers and Regulatory Reform Committee recommended that one of the proposed new powers should be “subject to the fuller scrutiny of the affirmative procedure.” This power would amend section 15 of the Defence Reform Act 2014 to allow for an alternative method for determining the price payable under a defence contract and the circumstances in which that method is to be used. The Committee said they were “surprised and disappointed that the Memorandum does not acknowledge that this is, in effect, a power to disapply primary legislation by regulations subject only to the negative procedure.”<sup>30</sup>

The Government amended the Bill at Report Stage (day 1) in the House of Lords to reflect the committee’s recommendation (amendment 165).<sup>31</sup> Lord Coaker welcomed the change.<sup>32</sup>

## 5.4 Major legislative changes

The following sections highlight the major legislative changes brought about either by the Procurement Act 2023 (the 2023 act) or in secondary legislation.

The [explanatory notes to the 2023 act](#) explain in detail the changes being made by the act.

## 5.5 Qualifying defence contracts

Schedule 10 of the 2023 act amends the definition of a qualifying defence contract in section 14 of the 2014 act. These give the Defence Secretary the power to make regulations:

- to specify when a contract is to be treated as “substantially for defence purposes”.
- to specify the circumstances in which an agreement to enter into new work is or is not to be treated as a new contract for the purposes of Part 2 of the Defence Reform Act 2014 and the SSCRs.

In addition, the 2023 act expands the definition of a QDC (qualifying defence contract), from being “a contract under the Secretary of State procures goods, works or services for defence purposes from another person” to “a contract under which the Secretary of State procures goods, works or services **wholly or substantially** for defence purposes from another person”

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<sup>30</sup> [Procurement Bill](#) (PDF), Delegated Powers and Regulatory Reform Committee, HL Paper 15, 14 June 2022, para 62 to 66

<sup>31</sup> [HL Deb 28 November 2022 c1607](#)

<sup>32</sup> [HL Deb 28 November 2022 c1608](#)

(emphasis added by author). The government says this will allow some cross-government single source contracts with a substantial defence element to come under the Defence Reform Act regime.<sup>33</sup> The explanatory notes to the act say this change is necessary because it would usually not be practicable to price the defence component using a different method from the wider contract.<sup>34</sup>

## 5.6 Changes to the profit rate

One of the major changes to the regulations concerns the profit rates.

The DSIS says the regulations will be changed to “avoid paying unjustifiably low or high profit rates for single source contracts”; to ensure that the range of profit rates properly reflect risk and market conditions; and that the MOD can use profit to “properly incentivise suppliers” to support delivery of the Government’s priorities.

For suppliers, this means they can earn higher profits where there is a significant transfer of risk, or they achieve outstanding performance against contract deliverables or wider government priorities. A lower profit rate for low risk work or less challenging performance could apply.<sup>35</sup>

The DSIS: reform of the SSCR paper expands on these ideas. The regulations will be amended to allow prices to be set by reference to market rates, to ensure value for money for off-the-shelf software or engineering commodities.<sup>36</sup>

Schedule 10 of the 2023 act amends sections 15, 17, 18 and 20 of the 2014 act, which concerns the pricing of qualifying defence contracts.

### Establishing a fair price

The price for a single source contract had been reached by calculating the estimated or actual costs attributable to the contract and adding on a profit calculated using a prescribed process (see below).

However, the MOD said that while this approach works well for many “traditional” contracts, it does not work so well for an increasing number of contracts where the costs of production may be relatively low, but the supplier needs to recoup significant initial and ongoing developments costs through the unit price. Software licences are one example.

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<sup>33</sup> Cabinet Office, [Procurement Act 2023 Guidance – defence and security contracts](#), 24 May 2024

<sup>34</sup> [Procurement Act 2023 explanatory notes](#) para 896; [Procurement Bill explanatory notes](#) (PDF), paras 843-847

<sup>35</sup> [Defence and Security Industrial Strategy](#), March 2021, CP 410, p27

<sup>36</sup> [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations](#), April 2022, CP 647, para 4

## The profit rate calculation

The current six-step profit-setting process is being amended to remove two steps.

The six-step process used to calculate the profit rate for individual contracts was as follows:

- Step 1 - The baseline profit rate (BPR) – this is announced by the Secretary of State each year, after considering recommendations from the SSRO. The rate for 2021-22 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.<sup>37</sup>

Step 2 is amended to ensure that contracts better reflect the financial risks involved, and to explicitly state the type of activity that can be taken into account when calculating the level of risk.

Steps 3 and step 4 are removed, to speed up and simplify the agreement of profit rates for individual contracts.

The wording of step 5 (new step 3) is amended to allow regulations to set out how and when the incentive fee can be used.

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<sup>37</sup> [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations](#), April 2022, CP 647, para 9

## 2 Funding of the SSRO

The removal of step 4 removes the requirement for industry to contribute to the funding of the single source regulations office (SSRO). The SSRO had been funded jointly by government, via a grant-in-aid, and industry, by collection of a small downward adjustment to the profit rate of any SSCR contract. The MOD said “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.”<sup>38</sup>

However, Professor Luke Butler questioned the potential impact for this on the level of funding for the SSRO if the industry contribution is removed. He says it is unclear what impact it might have on the dynamics of future engagement of the MOD and industry with the SSRO, and the balance of power in this tripartite relationship. He also questions why the MOD has not explained why a separate levy on industry is not possible.<sup>39</sup>

## 5.7 Contract reporting

The Act requires industry to provide a series of contract and supplier reports. The MOD is proposing several changes to the regime with a view to requiring industry produce only the information that it needs. Schedule 10 of the Procurement Act amends section 25 of the 2014 Act.

## 5.8 Widening range of referrals to the SSRO

One of the SSRO’s functions is to give expert opinions and make determinations on specific questions referred to it by either the Secretary of State for Defence or contractors (specified persons).

However, the SSRO says that in practice, these powers have been rarely utilised because of the current requirements for making such a referral. The SSRO recommends making it easier for either party to make referrals by removing some of the limits and complexities on the circumstances in which referrals can be made.<sup>40</sup>

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<sup>38</sup> [Defence and Security Industrial Strategy: reform of the Single Source Contract Regulations](#), April 2022, CP 647, para 38

<sup>39</sup> Butler, Luke, [Reform of the UK Single Source Contract Regulations: A Regulatory Weapon in the Defence and Security Industrial Strategy’s Arsenal](#), 7 June, 2022, para 5.2.2

<sup>40</sup> [Review of legislation recommendations](#), SSRO, 14 June 2021, paa 6.4-6.5

The MOD intends to widen the range of subjects that can be referred to the SSRO and to make changes to the nature of these referrals. The MOD believes this will help speed up contract negotiations. The MOD will change the legislation to allow the SSRO issue guidance on all aspects of the regime, including making a determination in relation to whether a contract or proposed contract meets the criteria to be a Qualifying Defence Contract or Qualifying Sub-Contract. These are contained in proposals 20 to 24 (see annex for full list).

## 5.9 Powers of the Single Source Regulations Office (SSRO)

Schedule 10 of the Bill amends Section 35 of the 2014 Act to enable the SSRO to give an opinion on any question relating to the SCCRs on the application of either the Secretary of State, an authorised person or the contractor or proposed contractor. This widens the previous regulation that allows the SSRO to give an opinion but only if the Secretary of State and the contractor or proposed contractor refer the matter jointly.

Schedule 10 also inserts a new section into the 2014 act to enable the SSRO to issue such guidance as it considers appropriate in relation to the application or interpretation of part 2 of the 2014 Act where it considers that such guidance would be useful to industry and the Secretary of State. This includes guidance on about allowable costs.



## 6

# Annex 1: DSIS proposals for reform

The [defence and security industrial strategy: reform of the single source contract regulations](#) command paper (CP 647) sets out the Defence Secretary's policy proposals for the single source contract framework. Explanations of the reasons for each proposal can be found in the command paper. The proposals are grouped to reflect the three main themes of the DSIS.

### Choice and flexibility

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.

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.

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.

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.

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.

### Speed and simplicity

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.

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

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 longterm '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.

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.

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.

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.

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.

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

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.

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

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

### Stimulate innovation and exploit technology

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.

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.

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

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