EXPLANATORY MEMORANDUM TO

THE SINGLE SOURCE CONTRACT (AMENDMENT) REGULATIONS 2026

2026 No. 510

1. Introduction

1.1 This Explanatory Memorandum has been prepared by the Ministry of Defence ("MOD") and is laid before Parliament by Command of His Majesty.

2. Declaration

2.1 Luke Pollard, Minister for Defence Readiness and Industry, at the Ministry of Defence confirms that this Explanatory Memorandum meets the required standard.

2.2 Charly Wason, SCS1 for Single Source Contract Regulations, at the Ministry of Defence confirms that this Explanatory Memorandum meets the required standard.

3. Contact

3.1 Claire Boylan at the Ministry of Defence can be contacted by email at the following address with any queries regarding the instrument: Claire.boylan100@mod.gov.uk.

Part One: Explanation, and context, of the Instrument

4. Overview of the Instrument

What does the legislation do?

4.1 This Instrument makes changes to the Single Source Contract Regulations 2014 (the 2014 Regulations). The 2014 Regulations are made under Part 2 of the Defence Reform Act 2014 (the 2014 Act). The 2014 Act and the 2014 Regulations make provision for pricing of single source contracts which are defence contracts entered into without competition.

4.2 This instrument will increase the maximum incentive fee payable under the 2014 Regulations from 2 percentage points to 10 percentage points using powers in s.17(2) of the 2014 Act.

4.3 This instrument will also put statutory constraints around the use of the incentive fee payable under the 2014 Regulations, and add the incentive fee adjustment to the list of matters on which the Single Source Regulations Office (SSRO) is required to give an opinion if required by a person specified in s. 35(2) of the 2014 Act.

4.4 The primary aim of the policy is to ensure our single source suppliers perform at a high level. Experience to date suggests that the current 2 percentage point incentive is not large enough to drive the required focus on performance. This instrument therefore increases the available incentive fee to 10 percentage points.

Where does the legislation extend to, and apply?

4.5 The extent of this instrument is the United Kingdom.

4.6 The territorial application of this instrument is throughout England, Wales, Scotland and Northern Ireland.

5. Policy Context

What is being done and why?

Policy Point 1: The incentive fee in Step 3 of the calculation of the Profit Rate for contracts subject to the Single Source Contract Regulations (qualifying defence contracts, "QDCs") will be increased from 2 percentage points to 10 percentage points.

5.1 To meet the challenges set out in the Strategic Defence Review (SDR), our suppliers need to perform at a high level. Experience to date suggests that the current 2 percentage point incentive is not large enough to drive the required focus on performance. Moreover, the financial or security benefits to the UK of achieving things such as quicker delivery may outweigh the increase in contract price. We therefore propose increasing the incentive fee to 10 percentage points.

5.2 Increasing the incentive fee in this way will increase the current typical range of profit to between 7.2% and 22.2%.

Policy Point 2: The regulations will be changed to introduce new constraints.

5.3 Increasing the incentive fee will mean that there will be a greater focus on this element of price in contract negotiations. This is an important part of the intent as we drive supplier focus towards improving delivery. To ensure that we maximise results for Defence, we are putting in place statutory safeguards to mitigate any risk that suppliers will seek to increase profit in return for improvements that are of marginal value or difficult to verify. These safeguards will reduce the time and effort spent on negotiating the contract and any pressure that might be put on delivery teams to agree unnecessarily high rates of profit. The safeguards will also avoid protracted discussions over whether the criteria for paying the fee have been met. The purpose of the regime is to ensure that such decisions are made on the basis of what will provide both good value for money for the public and a fair and reasonable price for the supplier, rather than simply reflecting the parties' relative negotiating strengths. We therefore propose the following constraints:

5.3.1 The incentive fee can only be paid if an objectively verifiable outcome has occurred. The wording of 6A is intended to preclude including the incentive fee in the contract price until after the relevant outcome has occurred i.e. it cannot become payable on expectation that the desired outcome will occur.

5.3.2 The requirement for the outcome to be objectively verifiable is made in 6A a). This is to ensure that the outcome cannot be assessed only on the basis that either or both parties to the contract is content, because to do so would risk commercial leverage determining whether the incentive is payable rather than whether genuine public benefit had been delivered. The wording of 6B achieves this because an assessment of whether either or both parties is satisfied that an outcome has occurred could not be made by an independent third party.

5.3.3 The expected benefit must be reasonable in all the circumstances. The level of incentive fee agreed must take into account the expected public benefit as a result of the additional public expenditure payable through the higher incentive profit. This does not seek to determine the precise value of expected benefits. The Secretary of State will be expected to consider the overall value for money achieved by the use of the incentive fee when deciding whether it can be applied.

5.4 On referral by either party, the Single Source Regulations Office must give an opinion or make a determination on whether an incentive fee meets the above requirements, and/ or make a determination on whether the specified outcome has occurred. They may also issue guidance on the new provisions.

5.5 In addition to these legislative safeguards, we will ensure that we have appropriate governance in place to ensure that the incentive fee is only used as intended. For larger contracts this might be done through existing mechanisms that aim to balance performance, cost and time. Additional arrangements will be put in place for smaller contracts as needed.

5.6 There will be no change for the price of goods works and services already subject to contract. The higher incentive fee will be available for:

5.6.1 New contracts that come into effect after the date the SI comes into force;

5.6.2 Contracts that become QDCs by amendment after the date the SI comes into force; and;

5.6.3 The pricing of new goods, works or services that are added by amendment to existing QDCs after this SI comes into force

5.7 The higher incentive band will be restricted to QDCs. Application of the incentive to qualifying sub-contracts (QSCs) would place prime suppliers in a position of having to assess the applicability of the incentive fee on behalf of Secretary of State. It would also create adverse incentives where prime suppliers could increase their own profit by inappropriate use of the incentive fee. While we believe this is unlikely, we prefer not to place suppliers in this position.

What was the previous policy, how is this different?

5.8 The current policy is embodied in the legislation, which allows for a 2-percentage point increase in profit for QDCs and QSCs in order to drive incentives. Based on industry feedback and experience within the Department since the 2014 Regulations have been in force, this is not sufficient to drive the results required by the Department. The new policy will mean the Department can award up to 10 percentage points of profit to achieve Defence outcomes.

6. Legislative and Legal Context

How has the law changed?

6.1 MOD policy is to procure contracts via an open competitive process wherever possible but there are circumstances where only one contractor is able, or willing, to meet the MOD's requirements or where MOD decides to award a contract without competition for reasons of national security.

6.2 Part 2 of the 2014 Act creates a regulatory framework for "single source contracts" with the detail being set out in the 2014 Regulations. Part 2 does not specify whether a contract should be competed, but applies to contracts that are not competed. Before the Act came into force, there was no legislative framework regulating uncompeted defence contracts. Instead there were voluntary arrangements in place contained in a document called the Government Profit Formula and its Associated Arrangements (usually referred to as the "Yellow Book"). This voluntary framework was superseded by the legislation when the regulations came into effect on 18th December 2014. Substantial parts of the new regulatory framework were set out in the 2014 Regulations rather than in the 2014 Act.

6.3 The framework is engaged when a defence contract is awarded with a value above a threshold specified in the 2014 Regulations (currently £5 million) without any competition, unless one or more of the specific exclusions set out in the 2014 Regulations apply. These contracts are known as qualifying defence contracts (QDCs), with non-competitive sub-contracts made in connection with them and above a specified value threshold known as qualifying sub-contracts (QSCs). Where the framework is engaged it makes provision for the pricing of QDCs and QSCs. It also makes provision for transparency, reporting and record-keeping requirements, from the beginning of a qualifying contract to its completion.

6.4 The Act also created an executive Non-Departmental Public Body, known as the Single Source Regulations Office (SSRO), to support the oversight of the new regulatory framework. The Act sets out the SSRO's functions, which include advising the Secretary of State on setting key rates used in the regulatory framework (including the baseline profit rate), producing guidance on costs and profit that can be included in contract prices, making legally binding changes to contract prices that do not comply with the legislations (on referral by one or more of the contracting parties), and monitoring compliance with statutory reporting requirements

6.5 The 2014 Regulations have been amended four times. The 2014 Act was amended by the Procurement Act 2023, and the most recent amending instrument to the Regulations was made in April 2024, using the amended powers. Further amendments to the 2014 Regulations were planned for September 2024 but were postponed due to the change in Government. These changes are known as 'Tranche 2' and will be considered further through the current review of the Regulations.

The Pricing Process

6.6 The 2014 Regulations specify that profit on single source contracts must be calculated using a four-step process.

Step 1: Take the Baseline Profit Rate (BPR), which is re-calculated every year by the Single Source Regulations Office (SSRO) from the average mark-up earned by companies whose work is similar to the major single-source contracts. This is currently 9.1%.

Step 2: Increase or decrease the profit by up to 25% of the BPR to reflect the financial risk taken on by the supplier. The maximum reduction will usually be applied to contracts where the supplier takes little or no financial risk because the MOD agrees to pay all the supplier's allowable costs. Contracts where financial risks are higher than those typically paid by companies in the SSRO's comparator group can attract higher profit rates. Profit after this step therefore currently ranges between 6.82% and 11.37%.

Step 3: Add an incentive fee of up to 2 percentage points. The 2014 Act currently provides that this incentive fee can be used "to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract or component specified by the Secretary of State". As a result of amendment by the Procurement Act 2023, the 2014 Act now further provides that "in specifying provisions of the contract or component, the Secretary of State must comply with any requirements imposed by the regulations". The purpose of this instrument is to impose such requirements for the first time. Profit after this step is currently between 6.82% and 13.37%.

Step 4: Add or subtract a Capital Servicing Allowance that reflects the amount of their own capital suppliers have invested in a contract. It is determined using a structured

calculation that applies statutory rates to the amount of capital used. There are no statutory limits, but it is generally between 0.8 and 1.5 percentage points. The final profit available is therefore usually between 7.62% and 14.87%.

Why was this approach taken to change the law?

6.7 This is the only possible approach to make the necessary changes.

7. Consultation

Summary of consultation outcome and methodology

7.1 The main stakeholders affected by the Regulations are suppliers in the Defence industry. ADS, the main Defence Industry trade body, have proposed that the incentive fee be increased to 5 percentage points. The MOD has also consulted closely with the SSRO who have raised no concerns about this Statutory Instrument.

8. Applicable Guidance

8.1 Guidance on all aspects of the of the 2014 Regulations, included all implemented changes to date, can be found on the MOD Commercial Toolkit (which is also accessible, on request, by defence suppliers). The Toolkit will be updated to reflect the amendments made by this SI.

8.2 The MOD is the SSRO's sponsoring Department. The MOD will work with the SSRO to provide stakeholders with guidance on how the regulatory amendments contained in this SI will operate. This guidance will be available to the public on the SSRO website.

Part Two: Impact and the Better Regulation Framework

9. Impact Assessment

Impact on businesses, charities and voluntary bodies

9.1 Suppliers will not be required to carry out any additional reporting as a result of this Instrument. There may be minor additional requirements to evidence that they have met the criteria for any incentive fee adjustment. It is assessed that additional costs to industry arising from this amendment will be marginal and any costs of compliance can be reclaimed from MOD as allowable costs under the 2014 Act and 2014 Regulations, providing suppliers can demonstrate that these costs are appropriate, attributable, and reasonable (see s.20(2) of the Act).

9.2 This Instrument only makes provision for the use of a wider incentive band; it does not require its use. It gives the Department the tools to use higher incentives if appropriate. The economic impact of this will be assessed for each contract on a case-by-case basis as it follows the normal approvals process. For significant contracts, this will include Treasury-level assurance. Controls will be put in place so that the increased incentive fee is only used where suppliers deliver on agreed outcomes.

9.3 The legislation applies to activities that are undertaken by small or micro businesses but, as it only applies for qualifying defence contracts with an individual value greater than £5M and qualifying sub-contracts with an individual value greater than £25M, the impact on small businesses from the current legislation is small. It is assessed that the additional impact on small businesses arising from the amendments will therefore be negligible.

9.4 There will be requirements on the public sector to ensure the wider band is being used appropriately and suppliers have evidenced that they have met the criteria for any incentive fee adjustment. These activities will be carried out as part of the usual investment appraisal and contract management processes.

10. Monitoring and review

What is the approach to monitoring and reviewing this legislation?

10.1 Under Section 39 of the 2014 Act, the SSRO has a duty to keep under review the provision made by Part 2 and the 2014 Regulations which are in force, and the Secretary of State has a duty to carry out a review within 3 years of the 2014 Regulations first coming into force and every 5 years thereafter. In carrying out these reviews the Secretary of State must have regard to any recommendations made by the SSRO at least 6 months before the end of the review period.

Part Three: Statements and Matters of Particular Interest to Parliament

11. Matters of special interest to Parliament

11.1 There are no matters of special interest to Parliament in this Instrument.

12. European Convention on Human Rights

12.1 As the instrument is subject to negative procedure and does not amend primary legislation, no statement is required.

13. The Relevant European Union Acts

13.1 This instrument is not made under the European Union (Withdrawal) Act 2018, the European Union (Future Relationship) Act 2020 or the Retained EU Law (Revocation and Reform) Act 2023 ("relevant European Union Acts").