These notes refer to the Defence Reform Bill
as introduced in the House of Commons on 3 July 2013[Bill 84]

DEFENCE REFORM BILL

EXPLANATORY NOTES

1. These explanatory notes relate to the Defence Reform Bill as introduced in the House of Commons on 3 July 2013. They have been prepared by the Ministry of Defence (MOD) in order to assist the reader of the Bill and to help inform debate on it. They do not form part of the Bill and have not been endorsed by Parliament.

2. The notes must be read in conjunction with the Bill. They are not, and are not meant to be, a comprehensive description of the Bill. So where a clause or part of a clause does not seem to require any explanation or comment, none is given.

SUMMARY AND BACKGROUND

3. The Bill is intended to improve procurement and support of defence equipment and to strengthen the reserve forces. The Bill contains four Parts and seven Schedules.

4. Part 1 relates to the reform of the Defence Equipment and Support (DE&S) organisation. This is the part of the MOD which is responsible for the procurement and support of defence equipment and the supply of logistics to the Armed Forces. The Part makes provision in relation to certain arrangements made by the Secretary of State for a company to provide defence procurement services under contract with the Secretary of State. That may be a two company structure comprising a managing company and an operating company, or a one company entity. The Bill makes provision in relation to transfer of employees to that contractor, the provision of financial assistance to the contractor, financial claims against the contractor, exemptions relating to premises used by the contractor, jurisdiction of the MOD Police, 'transfer schemes' (provisions for the transfer of property, rights and liabilities where the contractor is in breach of contract or where the contract has come to an end) and disclosure and use of information and intellectual property rights.

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5. Part 2 creates a regulatory framework for "single source contracts" (that is, contracts which are not subject to a legal obligation to be advertised and competed) in the defence area. This framework will apply both to primary contracts (those to which the Secretary of State is party) and to non-competed sub-contracts of those primary contracts. EU law requires most government contracts to be procured via an open process that involves publicly advertising the fact that the contract is available for tender, and then a competitive process to select the successful contractor. There is an exemption in Article 346 of the Treaty of the Functioning of the EU for measures which a Member State considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions or war materiel. Currently, there is no legal framework regulating defence single source contracts, although there are voluntary arrangements in place which are contained in a document called the Government Profit Formula and its Associated Arrangements (usually called the "Yellow Book"[1]). Much of the statutory framework will be set out in regulations made by the Secretary of State, to be known as the single source contract regulations (SSCRs).

6. Part 2 creates a new Non-Departmental Public Body (NDPB), called the Single Source Regulations Office (SSRO), to oversee that regulatory framework. The SSRO will replace an existing NDPB, the Review Board for Government Contracts, which currently monitors the Yellow Book arrangements. Part 2 sets out how the SSRO will support the regulatory framework, advise the Secretary of State on setting key rates to be used in pricing contracts (including the baseline profit rate), monitor single source procurement, undertake analysis, and keep the regulatory framework under review and recommend changes to it.

7. Part 2 creates a civil compliance regime to ensure compliance with key aspects of the regulatory framework, and the SSRO will have an important role in this. The SSRO will have the power to determine whether contractors have committed particular contraventions relating to provisions of Part 2, and to review any penalties imposed in relation to these contraventions. Part 2 also creates a new criminal offence relating to unauthorised disclosure of information to deal with the possibility of any person releasing commercially sensitive information obtained under this Part.

8. Part 3 makes changes to reserve forces by extending the powers to "call out" members of the reserve forces; giving the Secretary of State a new power to make regulations to provide for the making of payments by him to employers whose reservist employees are called out, undertake certain training or perform certain other duties of members of the reserve forces; and disapplying the statutory qualification period for the purposes of claiming unfair dismissal from civilian employment where the reason for dismissal is connected with the employee's membership of a reserve force. It also renames the Territorial Army and the Army Reserve.

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[1] General review of the profit formula for non competitive government contracts, February 2013

9. A green paper on reserve forces (*Future Reserves 2020: Delivering the Nation's Security Together, Cmd 8475*) was published in November 2012. The reform of DE&S was the subject of a major report by Bernard Gray[2] (the current head of DE&S) that was published in October 2009. The need for reform was confirmed by Lord Levene in his review of the structure and management of the MOD, which was published in June 2011. Single source contracting was the subject of an independent report by Lord Currie of Marylebone published in October 2011 (*Review of Single Source Pricing Regulation*). A white paper on DE&S reform and single source contracting (*Better Defence Acquisition: Improving how we Procure and Support Defence Equipment* (Cm 8626) was published on 10 June 2013, and a white paper on reserves reform was published on 3 July 2013.

TERRITORIAL EXTENT AND APPLICATION

10. The Bill extends to (i.e. forms part of the law of) the whole of the United Kingdom. The amendments and repeals made by Part 3 have the same extent as the provisions amended or repealed (ignoring extent by virtue of an Order in Council). Subsections (3) to (5) of clause 46 make it clear that the amendments made by clause 42 to the Reserve Forces Act 1980 can be extended to the Isle of Man under section 158(3) of the 1980 Act; the amendments made by this Bill to the Reserve Forces Act 1996 can be extended to the Channel Islands and the Isle of Man under section 132(3) of the 1996 Act; and the amendments made by clause 42 to the Armed Forces Act 2006 can be extended to the Channel Islands under section 384(1) of the 2006 Act.

11. This Bill does not contain any provisions falling within the terms of the Sewel Convention. Because the Sewel Convention provides that Westminster will not normally legislate with regard to devolved matters in Scotland without the consent of the Scottish Parliament, if there are amendments relating to such matters that triggers the Convention, the consent of the Scottish Parliament will be sought for them. At introduction, no legislative consent motions are required for this Bill.

COMMENTARY ON CLAUSES

PART ONE: DEFENCE PROCUREMENT

Clause 1: Arrangements for provision of defence procurement services

12. Clause 1 sets out the circumstances when Part 1 will apply, namely, when the Secretary of State makes initial and (when required) follow on arrangements for a contractor ("the contractor") to provide "defence procurement services" to the Secretary of State under contract. A "contractor" is defined in clause 1(8) as meaning a company which provides (or is to provide) defence procurement services to the

[2] Review of Acquisition for the Secretary of State for Defence, October 2009

Secretary of State under contract by virtue of the arrangements, or a company which, by making premises, property and employees available, enables (or is to enable) those defence procurement services to be provided. "Defence procurement" and "defence procurement services" are also defined in clause 1(8). These are the services that are currently provided by DE&S. The provisions in Part 1 of the Bill will not apply to any services which the contractor provides to anyone other than the Secretary of State.

13. *Subsection (1)* provides that Part 1 applies where the contractor acquires rights over premises and property (in the form of leases or tenancy agreements) used by DE&S and becomes the employer of civil servants working in or in connection with DE&S.

14. *Subsection (2)* provides that Part 1 also applies if arrangements are made at a later date ("the new arrangements") and the new arrangements are the successor to the old arrangements, although the contract with the former contractor in respect of the old arrangements may not have terminated.

15. *Subsection*s *(3)* and *(4)* explain when the new arrangements are the successor to the old arrangements. This could arise in a number of situations, for example, where the new contractor is the same as the old contractor (subsection (3)(a)); or where under the contract the property, rights or liabilities of the old contractor are to be or have been transferred to the new contractor (subsection (3)(b)); or where property, rights or liabilities are to be or have been transferred to a new contractor by means of a transfer scheme made under clause 10 (subsection (3)(b)); or where property, rights or liabilities of the old contractor have been transferred to the Secretary of State (whether under the terms of the contract or by a transfer scheme) and the new contractor acquires rights in premises from the Secretary of State to be used for the new arrangements and becomes the employer of civil servants carrying out defence procurement (*subsection (4)*).

16. Arrangements for a contractor to provide defence procurement services may take effect in phases over a period of time (*subsection (5)*). A contractor may be a publicly-owned company, as defined in clause 12 (subsection (6)).

17. *Subsection (7)* provides that the arrangements may permit a contractor to exercise to any extent any discretion of the Secretary of State in connection with the exercise by the Secretary of State of a function involving defence procurement. The Secretary of State will remain responsible for defence procurement but, given the scale of the activities that the contractor may be required to undertake under the arrangements, it may be necessary for the contractor to exercise a discretion of the Secretary of State in respect of the Secretary of State's procurement functions.

Clause 2: Financial Assistance

18. This clause provides that the Secretary of State may provide financial assistance to a contractor in the form of loans, guarantees, indemnities or other financial assistance on terms and conditions as he thinks appropriate.

Clause 3: Financial claims against contractors or former contractors

19. Clause 3 provides that the MOD is liable for financial claims made against a current or former contractor, whether claims are brought in the UK or in a foreign court, subject to certain exceptions. The exceptions are where a claim is made by an "excluded person" or a claim is an "excluded claim" as defined in *subsection (7)*. A person is excluded if it is a contractor under an old arrangement bringing a claim against a contractor under a new arrangement, or in a two company structure, one contractor bringing a claim against another; or the claim is brought against the contractor by a government department or a government Minister (i.e. where the MOD has a claim against the contractor, or where the contractor has carried out services for another government department). Claims which are excluded are those relating to services the contractor provides to any one other than the Secretary of State for Defence; employment claims; claims relating to provision of services to the contractor (e.g. the provision of IT services); those relating to health and safety; and claims relating to the time before or after a company was a contractor. Because liability will only transfer in respect of financial claims, the contractor will remain liable for, for example, claims brought against it for specific performance or injunctive relief.

20. The Secretary of State may make payments to settle claims (*subsection (2)*). A contractor (or former contractor) must provide the Secretary of State with assistance in connection with the claim and that obligation imposed on a company to provide assistance is enforceable as if contained in a contract between the Secretary of State and the contractor (*subsection*s *(3)*, *(4)* and *(5)*). This section does not affect any provision the Secretary of State may make in a contract with a contractor for the contractor to compensate the Secretary of State for any liability which transfers to the Ministry of Defence or in respect of any payment which the Secretary of State may make to settle a claim *(subsection (8)*).

Clause 4: Exemptions relating to premises used by a contractor and Schedule 1: Exemptions relating to premises used by a contractor

21. Clause 4 gives effect to Schedule 1, which makes provision exempting the contractor from some legislative obligations and enforcement regimes where the Crown, and therefore MOD, is currently exempt. These are particularly relevant to DE&S because DE&S manages safety and environmental functions and currently occupies a wide range of sites for the purpose of carrying out its functions. Exemptions may only be given to a contractor in respect of the sites which will be used by it for carrying out defence procurement services for the Secretary of State under the clause 1 arrangements.

22. The exemption in respect of the Landlord and Tenant Act 1954 ensures that when the lease or tenancy of any premises let by the Secretary of State to a contractor has come to an end, the contractor cannot claim a statutory right to a new lease or tenancy on relevant sites. Similarly, any sub-tenant of the contractor in relation to such premises will also not have security of tenure.

23. The exemption from the Nuclear Installations Act 1965 will enable the Secretary of State to designate a site used by the contractor as a site to be treated as one used by a government department. That site would otherwise require a nuclear site licence.

24. Under paragraph 4 of the Schedule, in relation to the Health and Safety at Work Etc. Act 1974, the Secretary of State can exempt a contractor from the enforcement provisions in Part 1 of the 1974 Act. Further, the Secretary of State can exempt a contractor from any other provisions in Part 1, save for sections 33 to 42, which contain provisions in relation to offences, in the interests of the safety of the State. An exemption would be conferred by a negative resolution statutory instrument.

25. There are a number of areas where MOD has the benefit of Crown exemptions from subordinate legislation and the Secretary of State will have the power under paragraph 7 to extend such exemptions to the contractor where required. This will be done by means of a negative resolution statutory instrument. This provision gives the Secretary of State flexibility to consider on a case by case basis whether to extend an exemption to the contractor.

Clause 5: Jurisdiction of the Ministry of Defence Police

26. This clause provides authority for the MOD Police (MDP) to continue to exercise its police powers on premises which will be used by the contractor for the purpose of providing defence procurement services to the Secretary of State under the clause 1 arrangements. This also ensures that MDP powers extend to any new site utilised by the contractor for those purposes and that MDP officers are able to effectively investigate allegations of fraud and other criminal offences relating to the provision of defence procurement services. Since any contracts between the contractor and third party contractors will be publicly funded, it also extends the MDP's jurisdiction so MDP officers are able to exercise police powers to investigate any potential crime, fraud or thefts in relation to contracts between these parties.

Clause 6: Status of Contractor

27. This clause applies in relation to contracts entered into by the Secretary of State before the vesting date. The vesting date is defined in clause 12 as the day appointed by the Secretary of State by order made by statutory instrument. It is anticipated that this will be the day on which the contractor first assumes responsibility for defence procurement services under the clause 1 arrangements and DE&S employees engaged in the provision of those services first transfer to the contractor in accordance with the TUPE regulations (see paragraph 38 below).

28. A procurement or support contract made prior to the vesting date may be silent on whether a contractor is permitted to carry out the contract on behalf of the Secretary of State. Therefore this clause provides that any right or power of the Secretary of State under any such contract may be exercised by the contractor on behalf of the Secretary of State and any duty or liability of the Secretary of State may be discharged by the contractor on behalf of the Secretary of State. The Secretary of State cannot be prevented or penalised for arranging for the contractor to exercise his rights or powers or discharge his duties or liabilities under any such contract.

Clause 7: Restrictions on disclosure or use of information and Schedule 2: Restrictions on disclosure or use of information

29. Clause 7 gives effect to Schedule 2, which contains provisions to overcome restrictions on the disclosure to and use by the contractor of confidential information (currently held by MOD and DE&S). Confidential information may be contained in, for example, technical / design information, tender documentation, contracts, performance data, and quotations. The contractor will need this information in order to carry out defence procurement services under the clause 1 arrangements.

30. These provisions allow the Secretary of State to provide the contractor with access to confidential information ("relevant information") obtained under or in connection with a contract (the "relevant contract") with a third party entered into for the purposes of defence procurement before the vesting date (as referred to in clause 12). The contract itself may have come to an end before the vesting date but an obligation of confidence may nevertheless continue.

31. Paragraph 2(1) provides that the Secretary of State will not be prevented or penalised from disclosing relevant information to the contractor or a service provider to the contractor (defined in paragraph 6 as someone who performs ancillary services for the contractor); the contractor will not be prevented or penalised from disclosing that information to his employees or service provider; and in a two company structure, between one company and the other and their employees or service providers, where it is necessary or expedient for the purpose of the arrangement. Paragraph 2(2) permits disclosure of relevant information by a former contractor or its employees or service providers to the Secretary of State, or to a new contractor or its own employees or service providers if that disclosure is necessary for the purposes of arrangements made under clause 1. Paragraph 2(3) permits the use of relevant information by a contractor, employees or service providers if the Secretary of State could have used the information and if the use of the information is necessary or expedient for the purposes of the clause 1 arrangements.

32. Paragraph 3 ensures that the contractor, its employees or its service providers are not prevented by any obligations of confidence from disclosing relevant information for audit purposes.

33. Paragraphs 4 and 5 make provision to deal with unauthorised disclosures and unauthorised use of information by a contractor. Paragraph 4 provides that where a

person discloses information otherwise than in accordance with paragraphs 2 and 3, that is an unauthorised disclosure and the person making that disclosure will be treated as if he were subject to the original obligation of confidence. If he is an employee of the contractor or service provider, the contractor or service provider will be treated as having made the unauthorised disclosure. Paragraph 5 makes the same provision in respect of unauthorised use of information.

Clause 8: Intellectual Property Rights

34. This clause relates to protected works, which are defined in *subsection (4)* as copyright or data base rights as further defined in that subsection. Databases are a collection of independent works, data or other materials which are arranged in a systematic or methodical way, and are individually accessible by electronic or other means. DE&S hold a large number, the majority of which will have been provided to the Secretary of State from contractors.

35. *Subsection (1)* allows the Secretary of State to provide a protected work to the contractor or a service provider to a contractor in certain circumstances without infringing copyright or database rights. The circumstances are where the Secretary of State has acquired the right to use the work in connection with a contract entered into before the vesting date (as defined in clause 12) and where it is necessary or expedient for the contractor to be provided with the work for the purposes of the clause 1 arrangements. This clause also enables a protected work to be copied for the purposes of providing it to a person *(subsection (5)*).

36. *Subsection (2)* allows the contractor or former contractor or a service provider who has received a protected work under this clause to provide it to another contractor or service provider or the Secretary of State where it is necessary or expedient for the purposes of the clause 1 arrangements.

37. *Subsection* (3) allows the contractor or service provider to use the protected work to the same extent that the Secretary of State is entitled to as long as it is necessary or expedient for the purposes of the clause 1 arrangements.

Clause 9: Transfer of employees: application of TUPE regulations

38. This clause ensures that the Transfer of Undertakings (Protection of Employment) Regulations 2006[3] ("TUPE regulations") apply to the transfer of DE&S staff from their employment in the civil service to employment by the contractor.

39. *Subsection (2)* ensures that the TUPE regulations apply to relevant employees where the contractor is a two company entity i.e. where the Secretary of State makes arrangements with a management company for the provision of defence procurement

[3] SI 2006/246.

services, whilst a separate operating company is responsible for delivery of those services.

Clause 10: Transfer Schemes, and Schedule 3: Transfer Schemes under clause 10

40. *Subsection (1)* gives the Secretary of State the power to make a scheme to transfer property, rights and liabilities (referred to as a "transfer scheme") in two circumstances. First, where the contractor is in breach of a services contract (defined in *subsection (6)* as a contract for the provision of defence procurement services by virtue of the section 1 arrangements) where the breach occurs in certain circumstances or is of a certain specified kind. Or secondly, where the contract has come to an end e.g. where the term has expired.

41. *Subsection (2)* provides that property, rights and liabilities may be transferred to the Crown, the Secretary of State, or another contractor providing defence procurement services.

42. *Subsection (3)* provides that the property, rights and liabilities which may be included in a transfer scheme are property, rights and liabilities of the contractor, securities in the contractor and any property, or rights of a third party acquired from a contractor and any liabilities of third parties relating to such property or rights.

43. *Subsection (4)* provides that the Secretary of State may agree in the terms of the contract with the contractor that certain property, rights and liabilities are not to be included in a transfer scheme.

44. *Subsection (5)* gives effect to Schedule 3, which contains supplementary provisions relating to transfer schemes. Paragraph 1 makes further provision for the effect of a transfer scheme and for what the things that may be transferred under a transfer scheme may include. Paragraph 2 provides that a transfer scheme may make certain kinds of provisions. Paragraph 3 provides that a transfer scheme may contain provision for payment of compensation by the Secretary of State to any person whose interests are adversely affected by it. Paragraph 4 makes provision to address the situation where a transfer scheme transfers foreign property or a foreign right or liability. Paragraph 5 provides that a transfer scheme may make incidental, supplementary and consequential provisions. Paragraph 6 provides that the Secretary of State may modify a transfer scheme but if a transfer under the scheme has taken effect, any modification requires the agreement of the person affected by the modification.

Clause 11: Financial Provisions

45. This clause gives the Secretary of State authority to make payments out of money provided by Parliament for certain expenditure which may be incurred in respect of the arrangements including taking on liabilities of the contractor should the arrangements come to an end.

PART TWO: SINGLE SOURCE CONTRACTS

46. At a number of points in these clauses, 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 clause 1.

Clause 13 and Schedule 4: Single Source Regulations Office ("SSRO")

47. This clause 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 in the new framework.

48. There will be a Framework Document setting out the arrangements between the MOD and the SSRO. This document will be publicly available.

49. The initial set-up costs of the SSRO will be funded by the MOD, and the Department will continue to provide its funding. However, 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 clause 17).

50. The functions of the SSRO are in several clauses throughout 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 (clause 19(2));
b) keeping the regulatory framework under review and recommending changes to the Secretary of State (clause 38(1) and (2));
c) keeping records of contracts which are subject to Part 2 (clause 35(1));
d) keeping under review contractors' compliance with their reporting obligations (clause 35(2));
e) analysing reports and other information (clause 35(3));
f) upon a referral, providing determinations, including on:
   - the amount of any target cost incentive fee (TCIF – this term is explained under clause 15 paragraph 60(c) below) adjustment (clause 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 (clause 18(3));
   - whether a cost under a contract is an allowable cost (clause 20(5));
   - the amount of any final price adjustment for firm or fixed price

contracts (these terms are explained under clause 15 (clause 21(3)(b));

- whether obligations of confidence were entered into for genuine commercial reasons (clause 25(3));
- whether a sub-contract is subject to Part 2 (clauses 28(5) and 29(4));
- matters relating to a compliance or penalty notice (clause 31(8)(j));
- any matter specified by the regulations and referred to it by the Secretary of State, an authorised person, a contractor or a prospective contractor (clause 34(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 (clause 22(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 (clause 34 (1)(a));
- any matter referred by both parties to a regulated contract (clause 34(3)).

h) Providing statutory guidance on:
- any of the contract profit rate steps (clause 18(1));
- determining whether costs are allowable costs (clause 20(1));
- preparing reports (clauses 23(2)(d) and 24(6)(d));
- how to determine the amount of a penalty (clause 32(3)).

51. 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 (clause 36(1)), but if it does so those will be paid for by the Secretary of State (clause 36(2)). The industry contribution described above, which will be deducted at step 4 of the contract profit rate, will not contribute to this work.

52. *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.

53. *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), that must be done by a committee which includes someone who is neither a member nor employee of the SSRO (paragraph 10). This is to bring an external view to the determination.

54. 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.

Clause 14: Regulations relating to qualifying defence contracts

55. This clause 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 clauses 27 to 29 below). These regulations are to be called single source contract regulations ("SSCRs") and it is intended that they will come into force on 1 October 2014. The date that the first SSCRs come into force is called the "relevant date".

56. 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 initially 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, the sale of land and buildings, for which prices may be determined with reference to market prices);
d) the contract falls within any of the three cases described below.

57. 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).

58. *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.

Clause 15: Pricing of Contracts

59. QDCs, and amendments to QDCs, must be priced in accordance with the formula provided at *subsection (4)*.

60. There are many different types of commercial arrangement used in QDCs, and *subsection (5)* combined with clause 41(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 (clause 16 separately provides for this) and again as required throughout the contract and at the end of the contract, based upon 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 upon actual costs.

61. There are two elements in the formula – the "contract profit rate" (CPR) which is calculated by a six step process described at clause 17, and the "allowable costs", for which provision is made at clause 20.

Clause 16: Pricing of contracts: supplementary

62. This clause makes specific provision for the use of the pricing formula at clause 15(4) when it is used for TCIF contracts. For such contracts *subsection (1)(a)* allows for the price determined in accordance with clause 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 clause 21), so *subsection (3)* disapplies clause 21 for TCIF contacts.

Clauses 17 and 18: Contract profit rate

63. 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)*. The SSRO may issue guidance as to any of the steps (clause 18(1)). Some of these steps themselves have further provision in other clauses. 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 clause 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 under clause 34(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, which will be provided for under clause 34(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 clause 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 clause 34(1)(a). This adjustment **may increase or (exceptionally) decrease** the CPR.

64. Steps 2, 3 and 6 provide for amounts to be agreed, and clause *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 clause 1 of this Bill may be authorised by the Secretary of State to exercise this function.

65. 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 clause 18(2)(c).

66. 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 clause, based upon information available to either party at the time the QDC was entered into (clause 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 (clause 18(3)(b)).

67. The SSCRs may allow for some of the six steps to be disapplied for lower value QDCs (clause 18(2)(a)) or for those steps to be applied in a modified way (clause 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.

Clause 19: Rates etc relevant to determining contract profit rate

68. 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 around 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 of around 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.

69. 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).

70. 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)*). For the baseline profit rate, and fixed capital servicing allowance, this guidance will be to set rates in accordance with the "principle of comparability", which is used in the current non-statutory approach. The aim of the principle of comparability is to give contractors a return equal to on average the overall return earned by British industry in recent years, by reference to both capital employed and cost of production.

71. Having received the assessments 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 assessments.

Clause 20: Allowable Costs

72. This clause makes provision for the allowable cost element of the formula for pricing QDCs (clause 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)*.

73. 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)*.

74. *Subsection (4)* provides the Secretary of State with a power to require a contractor to show that a cost claimed as an allowable cost meets those requirements specified at subsection (2).

75. 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) 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)*).

Clause 21: Final price adjustment

76. *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 clause 15 above), in reliance on *subsection (4)(a)*.

77. 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 clause 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.

78. *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.

Clause 22: Records

79. *Subsection (1)* requires the SSCRs to contain provision requiring contractors to keep relevant records. The records that will need 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 clauses 23 and 24 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 clause 20(4) that a cost claimed is an allowable cost, or in the event of a referral to the SSRO under clause 31(8).

80. 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 clause 24.

81. 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)).

82. Failure to comply with this clause may lead to a financial penalty under clauses 30(3)(a)(i) and 31.

83. A person who is required to keep records may ask the SSRO to review the way that the Secretary of State or the authorised person has exercised their functions under this clause. 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)*).

Clause 23: Reports on qualifying defence contracts

84. This clause 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 (3)*. It is intended that subsection (3)(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).

85. 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 that are designed to enable the MOD, over time, to compare the costs of comparable projects, allowing the MOD 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 only if there are material contract amendments, 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.

86. There will also be two reports 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. There will also be an interim report that allows the

MOD to keep track of the baseline assumptions for long projects at points other than at the very beginning and very end.

87. Failure to comply with reporting requirements imposed under this clause, or making a misleading report, may lead to a financial penalty under clauses 30(3)(a)(ii) and (b), and 31.

Clause 24: Reports on overheads and forward planning etc

88. Most single source contractors are members of larger corporate groups. This clause 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 clause 23. The information that must be included in the reports will be set out in the SSCRs.

89. 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 five reports. Two of the reports, required for each of a contractor's business units in which costs are incurred that are recovered by allowable costs in a QDC, will split out a contractor's overhead costs in a standard set of categories. 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. A third 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.

90. 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 long-term overhead 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 lost 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.

91. The duty to provide reports under this clause 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.

92. 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 clause could otherwise lead to the whole contract being exempted under the Secretary of State's power under clauses 14(7) or 27(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.

93. Failure to comply with reporting requirements imposed under this clause may lead to a financial penalty under clauses 30(3)(a)(ii) and 31.

Clause 25: Records and reports: restrictions

94. This clause allows the SSCRs to disapply a requirement to provide access to records (clause 22(5)) or information in standard reports (clauses 23 and 24) 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 to 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 clause 23 or 24, would remain, although the specific information subject to an obligation of confidence would not be included within the report.

95. 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 with 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 clauses 22(5), 23, or 24, this is not to be considered a genuine commercial reason.

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

96. *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, (at *subsection (3)*), the costs, price or performance of their QDC.

97. Failure to comply with this clause may lead to a financial penalty (under clauses 30(3)(c)) and 31.

Clauses 27 to 29: Sub-contracts

Introduction

98. 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. Because primary contractors are invariably private sector bodies, they are not subject to any legal obligation to advertise or compete their sub-contracts.

99. The purpose of these clauses 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".

100. 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 which will be set out in the SSCRs (clause 29(1) and (2)(a)).

Clause 27: Qualifying sub-contracts

101. This clause 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;
c) it is of or above a value to be specified in the SSCRs; and
d) it meets any other requirements that may be specified in the SSCRs.

102. As with primary contracts (see clause 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.

Clause 28: Determining whether a contract is a qualifying sub-contract

103. 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.

104. *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 clause 27) then, under subsection (2)(b), the contractor must notify both the Secretary of State and the prospective sub-contractor of that assessment.

105. 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).

106. 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)*).

107. There are three potential compliance failures under this clause which may be subject to a civil penalty. These are:

a) failure to make an assessment under subsection (1) or (3) (clause 30(3)(d));
b) failure to give notice of a positive assessment under subsections (2)(b) or (4)(b) (clause 30(3)(f)); or
c) making a negative assessment under subsections (1) or (3) which the Secretary of State considers should have been positive (clause 30(3)(e)).

Clause 29: Application of Part to qualifying sub-contracts

108. 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.

109. *Subsection (5)* provides that if notification has not been provided under clause 28(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.

Clauses 30 to 33: Compliance

110. These clauses 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 (clauses 22, 23 and 24);
b) provides a specified report under clause 23 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 (clause 26);
d) in circumstances where the person is required to make an assessment as to whether a sub-contract is a qualifying sub-contract (clause 28(1) or (3)), fail to make that assessment.;
e) incorrectly make a negative assessment in respect of a proposed sub-contract (clause 28(1) or (3)); or
f) fail to provide the required notification of an assessment (clause 28(2)(b) or (4)(b)).

111. 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 (clause 30(1) and (2)). But a compliance notice will only be issued if there are steps which the person can take to remedy the contravention (clause 30(1)(b)). If the contravention cannot be remedied, there will be no compliance notice, just a penalty notice (clause 31(3)).

112. The SSCRs will set out different time limits for the issue of a compliance notice depending on the type of contravention (clause 30(5)) and 40(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 (clause 30(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,

the time limit within which a compliance notice may be issued is intended to be 24 months after the end of the contract.

113. 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 could not be rectified, this penalty notice will be issued without the compliance notice being issued first (clause 31(3)(b)).

114. The due date for the payment of a penalty will be 6 months after the date of the penalty notice (clause 31(4) – note this time period may be amended in the SSCRs (clause 31(9)). 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 clause 31(8).

115. 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 (clause 31(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);
c) the amount of the penalty.

116. The decision of the SSRO is final. Such decisions will be open to judicial review, but there is no appeal mechanism.

117. 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).

Clause 32: Amount of penalty

118. For most contraventions, the amount of the penalty will be a tariff up to a maximum to be set out in regulations (*subsection (1)*). These regulations will be separate from the SSCRs, and will be made by the affirmative resolution procedure (*subsection (7)*).

119. However, for two kinds of contraventions - failure to comply with the duty to notify under clause 26 and providing a misleading report under clause 23 - 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)*). In 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.

120. 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 clause will be calculated in accordance with the contract law of England and Wales, to ensure consistency of penalty.

Clause 33: Enforcement

121. 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.

Clauses 34: Opinions and determinations

122. *Subsection (1)* provides for a duty on the SSRO to give an opinion or make a determination on matters that may be specified in SSCRs and referred to the SSRO by the Secretary of State, an authorised person, a contractor or a prospective contractor.

123. *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.

124. *Subsection (4)* allows the SSRO, when giving an opinion or making a determination, to determine that one party may have to pay the 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 clause 22(6)), the SSRO could determine that the MOD must repay some or all of the costs incurred by the contractor in fulfilling such requests.

125. 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.

Clause 35: Recording, review and analysis functions

126. 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)*).

127. *Subsection (3)* requires the SSRO to analyse reports provided to it under clauses 23 and 24, 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.

Clause 36: Provision of other services to Secretary of State

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

Clause 37 and Schedule 5: Disclosure of information

129. Clause 37 gives effect to Schedule 5. Schedule 5 applies to information relating to an individual or business, which is obtained by the Secretary of State or the SSRO under or by virtue of Part 2, and which is of a kind specified in the SSCRs (paragraph 1) ("protected information".)

130. Schedule 5 creates a criminal offence of disclosing protected information (paragraph 2).

131. 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.

132. Paragraphs 2(3) and (4) define the maximum penalty for the offence on both summary and indictable conviction.

133. 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.

134. 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)).

Clause 38: Regulations: Review of Part and regulations

135. The SSRO has a duty to keep under review Part 2 and any regulations in force and made under it (*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)*).

Clause 39: Power to repeal Part

136. This clause 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 clause 38 recommended that the overall regulatory framework, including the SSRO, be removed.

Clause 41: Interpretation

137. *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 clause 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.[4]

PART 3: RESERVE FORCES

138. Part 3 contains provisions which make changes relating to the reserve forces. Clause 42 renames the Army's volunteer reserve force and the Army's ex-regular reserve force. Clause 43 extends the powers in the Reserve Forces Act 1996 which allow members of a reserve force to be called out for permanent service. Clause 44 amends the Reserve Forces Act 1996 to give the Secretary of State a new power to make regulations which provide for the making of payments by him to employers whose reservist employees are called out, undertake certain training or perform certain other duties. Clause 45 amends the Employment Rights Act 1996 to disapply the statutory qualification period for the purposes of claiming unfair dismissal if the reason for the dismissal is connected with the employee's membership of a reserve force.

Clause 42: Renaming of Army Reserve and Territorial Army

139. The armed forces include both regular forces (the Royal Navy, the Royal Marines, the regular army and the Royal Air Force) and reserve forces. The reserve forces include both ex-regular reserve forces (the Royal Fleet Reserve, the Army Reserve and the Royal Air Force Reserve) and volunteer reserve forces (the Royal Naval Reserve, the Royal Marines Reserve, the Territorial Army, and the Royal Auxiliary Air Force). Broadly speaking, the regular forces are full-time service personnel in permanent service; the volunteer reserve forces are civilians who accept

[4] SI 2011/1848.

an annual training commitment and a liability to be called out for permanent service; and the ex-regular reserve forces are ex-regular forces personnel who, on leaving the regular forces, retain a liability to be called out for permanent service.

140. Clause 42(1) changes the name of the Army's ex-regular reserve force from the Army Reserve to the Regular Reserve. Clause 42(2) changes the name of the Army's volunteer reserve force from the Territorial Army to the Army Reserve. Clauses 42(3) to (5) make consequential provision with respect to references to these forces in legislation and other documents.

Clause 43: Call out of members of reserve forces

141. The obligations of members of a reserve force to attend for duty are covered mainly by the Reserve Forces Act 1996 ("the 1996 Act"). These obligations include a duty to serve if "called out" in accordance with an order made under the 1996 Act. When such an order is in force, the Secretary of State may call out individual reservists by serving a notice on them requiring them to present themselves for service at a specified time and place. Failure to comply with such a notice is an offence under section 96 of the 1996 Act.

142. Sections 52, 54, 56(1) and 56(1A) of the 1996 Act each contain a separate power to make a call-out order in particular circumstances. Broadly speaking, an order may be made under section 52 if national danger is imminent; an order may be made under section 54 if warlike operations are in preparation or progress; an order may be made under section 56(1) if it is necessary to use armed forces on operations for the protection of life or property; and an order may be made under section 56(1A) where the Defence Council have authorised use of members of the armed forces for urgent work of national importance.

143. The intention is to extend the call-out powers in the 1996 Act so that members of the reserve forces may be called out for any purpose for which regular forces may be used. Accordingly, clause 43(4) replaces subsections (1) and (1A) of section 56 of the 1996 Act with new subsection (1B). This allows the Secretary of State to make a call-out order under section 56 where it appears to the Secretary of State that it is necessary or desirable to use members of a reserve force for any purpose for which members of the regular forces may be used.

144. Reservists called out under an order made under section 56(1) or (1A) of the 1996 Act may be required to serve under that order for up to 9 months. Reservists called out under an order made under section 54 of the 1996 Act may be required to serve under that order for up to 12 months (or longer if an extension order is made under section 55(11)). To align the period for which a reservist may be required to serve under an order made under new section 56(1B) with the period for which a reservist may be required to serve under an order made under section 54 (in circumstances where an extension order under section 55(11) has not been made), clause 43(6) amends section 57 of the 1996 Act.

145. A separate call-out power in section 32 of the 1996 Act applies only to members of the reserve forces who have entered into a "special agreement" under Part 4 of the 1996 Act (such reservists are also known as 'High Readiness Reservists'). To align the period for which such reservists may be required to serve on call out under section 32 of the 1996 Act with the period for which reservists may be required to serve under an order under new section 56(1B), clause 43(1) amends section 28(3) of the 1996 Act.

146. It is intended that the circumstances in which the powers in sections 52, 54 and new 56(1B) may be exercised may overlap. Clause 43(8)(b) inserts a new subsection (2) into section 64 of the 1996 Act to make this clear.

Schedule 6: Call out of members of reserve forces: transitional classes

147. Provision is made in section 129 of, and Schedule 9 to, the 1996 Act so that persons serving in the reserve forces immediately before that Act came into force have the option to remain in a class of persons ("the transitional class") in relation to whom certain provisions in the 1996 Act do not apply and in relation to whom provisions in the Reserve Forces Act 1980 continue to apply. Provision is also made in section 129 and Schedule 9 so that persons serving in the regular forces immediately before the 1996 Act came into force may become a member of the transitional class on transfer to the reserve.

148. The intention is to make similar provision for persons serving in the reserve forces and regular forces immediately before the changes made by clause 43 come into force. Accordingly, Schedule 6 amends section 129 of, and Schedule 9 to, the 1996 Act so that such persons remain in a class of persons ("the second transitional class") in relation to whom the changes made by clause 43 do not apply, but can elect to cease to be members of that class. The transitional class in relation to whom provisions in the Reserve Forces Act 1980 continue to apply is renamed "the original transitional class".

149. Paragraph 4(7) of Schedule 6 inserts new Parts 3 and 4 into Schedule 9 to the 1996 Act. New Part 3 of Schedule 9 makes provision with respect to membership of the second transitional class. New Part 4 of Schedule 9 makes provision so that, in effect, the amendments made by clause 43 do not apply in relation to members of the second transitional class.

Clause 44: Payments to employers etc of members of reserve forces

150. Section 84 of the 1996 Act gives the Secretary of State a power to make regulations which provide for the making of payments by him to employers in respect of financial loss suffered by them and attributable to any of their employees being called out or recalled for service. Regulations under section 84 may also provide for the making of payments to the partners of a person carrying on business in partnership in respect of financial loss suffered by them and attributable to that person being called out or recalled for service. Section 83 of the 1996 Act gives the Secretary of State a power to make regulations which provide for the making of payments by him

to any persons in respect of financial loss suffered by them and attributable to their being called out or recalled for service. The Reserve Forces (Call-out and Recall) (Financial Assistance) Regulations 2005 (SI 2005/859) were made in exercise of the powers conferred by sections 83 and 84 of the 1996 Act.

151. The purpose of clause 44 is to allow the Secretary of State, by regulations, to provide for the making of additional payments to employers whose reservist employees are called out, undertake certain training or perform certain other duties. Such regulations may also provide for the making of payments to persons carrying on business in partnership whose partners in that business are called out, undertake certain training or perform certain other duties. Accordingly, clause 44(1) inserts new section 84A into the 1996 Act.

152. The effect of subsection (3) of the new section 84A is that regulations made under that section may only provide for the making of such payment to employers or partners as the Secretary of State considers would (or would, in combination with other measures) be likely to encourage people to employ members of reserve forces or to carry on business in partnership with them. The new section 84A does not enable payments to be made in respect of training undertaken, or any other voluntary duties performed, by special members of a reserve force (also known as "Sponsored Reserves" (see the references in *subsection (2)(b) and (c)* to an "ordinary member" of reserve force and the definition of that term in *subsection (7))*.

153. *Subsection (5)* of new section 84A ensures that regulations made under new section 84A may not provide for the same kind of actual financial loss recovery scheme as may be provided for in regulations under section 84. It also ensures that payments may be made to an employer (or person in partnership) under regulations under new section 84A in respect of relevant reserve force activities whether or not the employer (or person in partnership) has suffered financial loss as a result of those activities.

154. A person making a claim under regulations under section 83 or 84 of the 1996 Act who is dissatisfied with the determination of their claim may appeal to a reserve forces appeal tribunal (Part 9 of the 1996 Act makes provision with respect to these tribunals). *Subsection (6)* of new section 84A provides for the same route of appeal against any determination of a claim under regulations under new section 84A.

Schedule 7: Payments to employers etc of members of reserve forces: supplementary

155. Section 85 of the 1996 Act provides that regulations made under section 83 or 84 of that Act may make provision with respect to matters including the descriptions of persons who are entitled to claim payments and the sums, or the method of determining the sums, to be paid. Paragraph 4 amends section 85 so that regulations made under new section 84A may also make provision with respect to such matters.

156. Section 85(3) of the 1996 Act imposes an obligation on the Secretary of State to consult various bodies before making any regulations under section 83 or 84. Paragraph 4(4) amends section 85(3) so that this obligation to consult extends to the making of regulations under the power in new section 84A.

157. Paragraph 4(5) adds a new subsection (3A) to section 85 of the 1996 Act to ensure that the making of a payment to an employer (or person in partnership) under regulations under new section 84A may not be taken into account when calculating the financial loss suffered by that employer (or person in partnership) for the purposes of regulations under section 84.

158. Regulations under new section 84A may not make provision for claims in respect of recall for service. Accordingly, paragraph 5(6) amends section 85(5) of the 1996 Act so that it continues to apply only to regulations under section 83 or 84.

159. The Secretary of State has the power under section 86 of the 1996 Act to suspend the operation of regulations under section 83 or 84 where a call-out order under section 52 of the 1996 Act, or a recall order under section 68 of that Act, is in force. Paragraph 6 amends section 86 so that the Secretary of State may also suspend the operation of regulations under new section 84A where a call-out order under section 52 is in force.

160. Section 87 of the 1996 Act creates criminal offences in connection with claims for payments under regulations under section 83 or 84. Paragraph 7 extends these offences so that they also apply with respect to claims for payments under new section 84A.

161. Paragraphs 10 to 12 of Schedule 7 make transitional provision in connection with changes to penalties on conviction in the magistrates' court that have yet to be commenced. When commenced, these changes would affect the level of fines and period of imprisonment made available for offences under section 87 of the 1996 Act in connection with claims under regulations under sections 83 and 84. Paragraphs 10 to 12 make clear that the changes are also to have effect in relation to offences under section 87 in connection with claims under regulations under new section 84A of the 1996 Act.

Clause 44: Unfair dismissal of reserve forces: no qualifying period of employment

162. Clause 44 amends section 108 of the Employment Rights Act 1996 thereby disapplying the statutory qualifying period for the purposes of claiming unfair dismissal from a reservist's civilian employment where the reason (or principal reason) for dismissal is connected with the employee's membership of the Reserve Forces.

163. This provision does not replace section 17 of the Reserve Forces (Safeguard of Employment) Act 1985 which makes it a criminal offence for an employer to dismiss a reservist because he or she is called out or likely to be called out. This provision does not mean that a member of a reserve force who is dismissed will automatically be treated as having been unfairly dismissed.

164. This provision will only extend to England and Wales and Scotland.

FINANCIAL EFFECTS

165. The provisions of this Bill have no direct impact on the level of public expenditure. The Bill does not introduce new costs (as funded within the Defence Request for Resources) and does not generate new income. The provisions enable the delivery of benefits which could reduce defence costs in the future or enable better use of existing funds. The implementation of the provisions will however enable delivery of significant benefits to the Department over a period of time.

Part 1: Defence Procurement

166. If the Part 1 arrangements are made, they are expected to deliver a net benefit of £934m over 10 years. The new arrangements will be established in stages and steady state is expected by 2024/2025. Should the public-sector comparator (DE&S+) option be chosen, savings are estimated to be a third lower.

167. Whether the arrangements under Part 1 or 'DE&S+' option is selected, it is too early so say what proportion of any benefits figure will be cashable i.e. reduced overall expenditure, and what proportion will be in the form of improved value-for-money. The Bill also contains a number of provisions which could result in new contingent liabilities being recognised.

Part 2: Single source contracts

168. The single source contract measures are expected to deliver a net benefit of £1,712m over 20 years, with steady state benefits of circa £190m/year. As with Part 1, it is too early to say what proportion of any benefits figure will be cashable and what will be in the form of improved value-for-money.

169. The annual cost of the SSRO, which is the successor body to the existing Non-Departmental Public Body known as the Review Board for Government Contracts, has been estimated to be £4m per year, with the total setup costs associated with the SSRO over 13/14 and 14/15 estimated to be around £3.1m. In the steady state, half of the running costs of the SSRO will be recovered from industry via a small reduction in the profit rate applied to single source contracts (estimated to be less than 0.05%).

Part 3: Reserve forces

170. The reserve forces measures may result in some additional costs to the MOD and employers. The direct cost to employers of the expansion of call-out powers is

estimated at £293k a year. The costs associated with mobilising reservists for military operations will vary dependent upon the current operational requirements. Costs will be met from within the existing defence budget, though some elements may be reclaimed from the Treasury reserve where they are related to use of reservists on contingency operations.

171. The estimated cost to employers of changes to the legislation on unfair dismissal is assessed as one off costs of £231k. Both of these measures have been assessed as low cost by the Regulatory Policy Committee.

172. The cost incurred by the MOD in making payments to employers in respect of call out, training or other duties (clause 44) and the benefit gained by businesses from receipt of these payments will vary in relation to the number of reservists who are undertaking call-out, training or other duties at any one time. The Best Estimate of the most likely costs and benefits in relation to these payments are set out in full in the Impact Assessment. The assumption has been made that the payment will be limited to a maximum award of £500 per month (capped at a total maximum payment of £6000 per annum) to the employer for each reservist they employ who is undertaking relevant service. Regulations made under this power may set out further qualifying criteria as to the type of employer who will be eligible to receive this payment. Current estimates suggest the direct benefit to employers could be in the region of £5m per annum. Assumptions are set out in full in the Impact Assessment.

173. Monetised costs are not yet known and will be met from within existing MOD budgets. Cost will represent one-off additional costs for re-branding activities - including signage, website changes and publicity. Future recruitment campaigns etc. represent part of normal budgeted MOD operating costs.

174. The costs of the scheme will be met from within the existing defence budget though some elements may be reclaimed from the Treasury reserve where it is related to use of reservists on contingency operations.

PUBLIC SECTOR MANPOWER

Part 1: Defence Procurement

175. The establishment of Part 1 arrangements would result in existing DE&S (and potentially other MOD) Civil Service staff transferring to the new organisation under TUPE regulations. This could result in a significant reduction in the number of Civil Service posts in the South West of England.

Part 2: Single source contracts

176. The impact of the measures concerning single source procurement will not have a significant impact on public sector manpower. The measures will abolish one NDPB, and although another (the SSRO) will be created, this is expected to be small (approximately 30 staff).

Part 3: Reserve Forces

177. The Future Reserves 2020 programme as set out in the Defence Green Paper 'Future Reserves 2020: Delivering the Nation's Security Together' and the white paper published on 3 July, makes a commitment to increase the overall size and strength of the reserve forces. The measures introduced in this Bill will help to ensure conditions exist to support this.

SUMMARY OF IMPACT ASSESSMENTS

178. An Impact Assessment has been published for the Bill and it will be updated as required.

179. The MOD considered three options for Part 1 and Part 2; do nothing, non legislative action, and legislative action. Part 3 of the Impact Assessment considered two options; do nothing or take legislative action.

180. The Impact Assessment covers the estimated costs and benefits for Part 1, 2 and 3.

181. The Impact Assessment shows that the MOD has considered the effect of the Parts of the Bill on Micro and Small businesses. For Part 1 of the Bill, if the solution chosen is to contract out for procurement services, the Governmental equipment and industrial policy will be applied to that entity. Part 2 of the Bill is designed to enable the creation of a simplified single source procurement process for smaller contracts and contractors. The Impact Assessment for Part 3 has been submitted to the RPC for its consideration.

182. The Bill will have no effect on carbon emissions.

183. Overall there is no net increase in the regulatory burden on business (or other sectors) as a result of the Bill.

184. The Impact Assessment will be available through the Vote Office, the House of Lords Printed Paper Office, and the government website at: https://www.gov.uk/government/organisations/ministry-of-defence

EUROPEAN CONVENTION ON HUMAN RIGHTS

185. There are two ECHR issues arising from the Bill. The first is that Part 1 makes provision to allow the disclosure of confidential information held by MOD to the contractor and its use by the contractor (including employees and service providers) which may involve an interference with property which is protected under Article 1 of the First Protocol to the ECHR. To the extent that the provisions in Part 1 impact on ECHR rights, the impact is assessed as proportionate to the benefits that are likely to derive from the proposals and provision has been made to ensure that the legislation is ECHR compatible. The second is that Part 2 creates a civil compliance regime to enforce the single source regulatory framework and whether the lack of protections under Article 6(2) and 6(3) which would have been available under a criminal regime is an issue. It has been assessed that the essential nature of the liabilities created is civil, and so Articles 6(2) and 6(3) are not engaged.

186. Section 19 of the Human Rights Act 1998 requires the Minister in charge of a Bill in either House of Parliament to make a statement before Second Reading about the compatibility of the provisions of the Bill with the Convention rights (as defined by section 1 of that Act). The Secretary of State for Defence, the Rt Hon Philip Hammond, has made the following statement:

"In my view the provisions of the Defence Reform Bill are compatible with the Convention rights."

187. The Government has provided the Joint Committee on Human Rights with a separate memorandum with its detailed assessment of the compatibility of the Bill's provisions with the Convention rights.

COMMENCEMENT DATES

188. Parts 1 to 3 are to come into force by commencement order and Part 4 comes into force on Royal Assent. It is intended that Part 1 will be commenced no sooner than 2 months after Royal Assent. It is intended that Part 2 (single source contracts) will be commenced on 1 October 2014. It is anticipated that individual clauses in Part 3 may have separate commencement dates, but that this Part will be commenced in full by the end of December 2014.

DEFENCE REFORM BILL

EXPLANATORY NOTES

These notes refer to the Defence Reform Bill as introduced in the House of Commons on 3 July 2013 [Bill 84]

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