Applying SSRO guidance to costs affected by COVID-19

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1. Application

1.1 This note is intended to assist the MOD and contractors in identifying and applying relevant SSRO guidance to qualifying contracts affected by the COVID-19 pandemic. It does not amend or alter the SSRO’s published guidance but aims to promote consistency in the application of the regulatory framework established by Part 2 of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations).

1.2 The SSRO issues the following guidance in support of the regulatory framework:

- **Allowable Costs guidance** issued under section 20(1) of the Act;
- **Guidance on the baseline profit rate and its adjustment** issued under section 18(1) of the Act;
- **Reporting and DefCARS user guidance** issued under regulation 22(9) (contract report guidance) and regulation 33(8) (supplier report guidance); and
- **Referrals Guidance**.

1.3 The SSRO updates its guidance periodically and references in this note to the guidance should be taken to mean the version applicable to the contract or amendment under consideration.

1.4 The COVID-19 pandemic may affect the costs contractors incur under qualifying contracts. Costs may change due to factors such as:

- altered working practices;
- supply chain disruption; or
- unanticipated expenditure on equipment or activities, such as new health and safety equipment.

1.5 We refer to such costs in this note as costs affected by COVID-19.

1.6 The government has issued a range of other guidance in relation to COVID-19, which includes a MOD view on how additional costs as a result of COVID-19 should be dealt with under new and existing contract. This note is not intended to contradict any government guidance.

1.7 We will keep this note under review and may amend it from time to time. We welcome feedback from stakeholders regarding this note and costs affected by COVID-19.

2. Allowable costs

2.1 Costs affected by COVID-19 may only form part of the price of a QDC or QSC if they are Allowable Costs determined in accordance with one of the six regulated pricing methods (regulation 10(1)). A cost will only be Allowable if it is appropriate, attributable to the contract and reasonable in the circumstances (AAR) (section 20(2) of the Act).

2.2 It is a legal requirement to have regard to the SSRO’s guidance when determining whether costs are Allowable under a QDC or QSC. Our Allowable Costs guidance addresses the AAR principles, and how those principles should be applied to specific cost types. We draw attention here to sections of the guidance that are particularly applicable to costs affected by COVID-19.
Showing that costs are allowable

2.3 The SSRO’s guidance proposes that the parties should take a proportionate approach in agreeing the type and standard of information required to show that costs are Allowable (paragraphs 2.5 to 2.8). An instruction or authorisation from the MOD may be a relevant piece of information when considering costs affected by COVID-19.

Determined in accordance with a regulated pricing method

2.4 Allowable Costs, including those affected by COVID-19 must be determined in accordance with one of the regulated pricing methods which have been, or are intended to be, used in the pricing of the contract. The SSRO has not issued allowable costs guidance on the choice or use of regulated pricing methods, however we observe that:

- The allowable costs for five of the regulated pricing methods are estimated at the time of agreement (firm, fixed, estimate-based fee, volume-driven, target pricing), and sometimes subject to specific adjustments (for example, an inflation adjustment). A contractor’s costs affected by COVID-19 will need to be managed within the contract price, subject to any amendments which the parties may agree.

- The same constraint does not apply to the cost-plus pricing method, or to the costs used to determine costs under the estimate-based fee pricing method. For those methods, the allowable costs are the actual allowable costs determined during the contract or after the contract completion date.

2.5 A qualifying contract may have different regulated pricing methods applied to defined components of the contract. For such contracts, it will be relevant to consider the component of the contract to which a cost affected by COVID-19 relates when determining whether it is allowable.

Enabling performance of the contract

2.6 Our allowable costs guidance explains in paragraphs 3.11 to 3.14 the circumstances in which a cost meets the AAR principles. All these matters should be considered in determining whether a cost affected by COVID-19 is Allowable. The extent to which the cost enables the performance of the contract is a consideration relevant to each of the AAR principles. Paragraphs 3.8 to 3.9 of the guidance indicate how this should be interpreted and provide that delivery of a contract may require sustainment of an essential or desirable capability. If contractors have put in place measures in response to the COVID-19 pandemic, it will be relevant, when determining whether the costs are Allowable, to consider whether these enable performance of the contract.

Treatment of government assistance provided in response to COVID-19

2.7 The SSRO’s allowable costs guidance includes principles-based guidance (Part E.4) on the treatment of credits including, but not limited to, reimbursements, grants, discounts, or refunds. This guidance will assist contractors and the MOD to apply the appropriate treatment to government assistance provided in response to COVID-19, such as the Coronavirus Job Retention Scheme (furlough pay), statutory sick pay (SSP) relief, business rates relief, and business support grants. A key principle of the guidance is that an Allowable Cost has not been and is not anticipated to be recovered, directly or indirectly, from another source, since Allowable Costs must only be recovered once (paragraph 3.12).

2.8 Some other types of financial assistance currently identified do not appear to have a specific impact on Allowable Costs. These include deferred VAT payments and low-interest loans.
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Treatment of risk and uncertainty arising from COVID-19

2.9 Part H of the SSRO’s allowable costs guidance applies to costs affected by risk and uncertainty (where the actual amount of costs incurred may be higher or lower than the estimated amount), risk contingency and risk mitigation. This guidance may assist contractors and the MOD to agree Allowable Costs in circumstances where the consequences of COVID-19 on the costs of delivering the contract are unknown.

Treatment of insured events

2.10 Part E.5 of the SSRO’s allowable costs guidance deals with insurance. This guidance may aid the MOD and contractors when considering costs affected by COVID-19, for example:

- E.5.6 addresses costs associated with insured events that are not covered by insurance and may be relevant to contractors that are drawing on their existing insurance policies;
- E.5.2 may help guide a discussion on whether insurance would be beneficial for future contracts; and
- E.5.3 may help in determining whether future insurance premiums are reasonable in the circumstances if the historic price is no longer a good indicator of what is reasonable.

Treatment of other exceptional or abnormal costs

2.11 Part F of the SSRO’s allowable costs guidance deals with exceptional or abnormal costs, which may apply to some costs affected by COVID-19. The guidance encourages a case-by-case review and identifies that additional input may be required from the SSRO. This can be obtained by seeking an opinion or a determination (see 6 below).

3. Profit rate steps

3.1 There is potential for costs affected by COVID-19 to impact on the application of the six-step process for determining the contract profit rate for a QDC or QSC. The impact of COVID-19 on company results may produce inappropriate results for step 6 (capital servicing adjustment (CSA)) unless the principles set out in the SSRO’s guidance on the baseline profit rate and its adjustment are carefully applied.

3.2 The SSRO’s guidance provides for Capital Employed and Cost of Production to be determined to approximate the capital intensity of the contract as closely as is practicable (7.17 of the guidance). This process is not intended to be perfectly precise and the parties should take a proportionate approach (7.22 of the guidance).

3.3 Application of the guidance typically involves using historic financial information for the business unit that will carry out the contract to estimate the capital intensity of future contract performance. We draw attention to the following aspects of the guidance which the SSRO considers may need careful application in respect of COVID-19 impacts:

- The contractor and the Secretary of State should use the information for the unit of business which they agree is most relevant to the contract in question (7.11 of the guidance). There is no requirement to use the same unit of business that has been used for other contracts with the same supplier, and the guidance does not specify a level of granularity.
- The guidance contemplates that the most appropriate year of historic data upon which to base the calculation may not be the year in which the agreement is entered into (7.13 of the guidance). The financial information from a past period unaffected by the
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COVID-19 pandemic may be more appropriate than the most recent period if a unit of business intends to return to previous ways of working.

- Where the contractor uses data from a year which is not the latest financial period as the basis for the CSA calculation, the capital servicing rates to which the relevant parties must have regard are those in force at the time of the agreement, not those relating to any other period (7.13 of the guidance).

- The guidance allows for items whose inclusion would not result in an appropriate Step 6 adjustment to be removed (7.18.c of the guidance). This gives the parties a broad ability to exclude items from the financial information if they are not expected to continue during the life of the contract.

3.4 The guidance allows further adjustments to be made to the data (7.20 and 7.26 of the guidance) where they can be reliably estimated and have a material impact on the result, for example where a pervasive change is expected that will affect the capital employed of the unit of business. The parties can consider how planned alterations to business operations because of COVID-19 will affect the capital intensity of future contracts. Such consideration should be limited to significant known events, which can be reliably estimated.

4. **Amending the contract price due to COVID-19**

4.1 The SSRO does not provide guidance on whether a contract should or should not be amended. If the parties agree that the contract should be amended in response to costs arising from COVID-19, this should be done in accordance with Regulation 14 and the Schedule to the Regulations. When agreeing the amended price, the parties must have regard to the SSRO’s guidance on the baseline profit rate and its adjustment and its allowable costs guidance.

5. **Reporting**

5.1 The SSRO’s contract report guidance assists contractors to submit contract reports required by the regulatory framework. In circumstances where a contract is affected by COVID-19, the following aspects of the SSRO’s guidance on submission of contract reports may be particularly relevant.

5.2 If a contract is agreed with Allowable Costs that include costs affected by COVID-19, those costs will be included in the initial reports for the contract. Section 4 of the SSRO’s guidance deals with the submission of the initial reports and paragraphs 4.13 and 4.53 to 4.57 assist contractors with providing facts, assumptions, and calculations in the Contract Pricing Statement relevant to each element of the Allowable Costs.

5.3 If a contractor’s costs are affected by COVID-19 after entry into contract, this will impact on the information that the contractor provides in any subsequent Quarterly Contract Report, Interim Contract Report, Contract Completion Report, or Contract Cost Statement. The SSRO’s guidance deals with each of these reports, respectively in sections 5 to 8. Potential updates that should be reported include:

- variances from the agreed price and material events and circumstances affecting the contract price (5.45 to 5.48, 6.40 to 6.44 and 7.41 to 7.45);
- details of the latest pricing amendment (5.20, 6.21, 7.17 and 8.15);
- changes to the contract price resulting from any pricing amendments, which will affect the pricing method breakdown (5.23, 6.22, 7.18 and 8.16), the breakdown of costs by
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DPS (6.24 to 6.27 and 7.20 to 7.26), and the summary analysis of price (5.26, 6.30 and 7.30).

5.4 The MOD may direct the submission of an on-demand report to reflect a change in the contract price or the contractor may wish to provide such a submission. Guidance on submission of these reports is covered in chapter 9 of the SSRO’s contract report guidance. If an on-demand Contract Pricing Statement is being submitted the contractor may have to report the calculation of the contract profit rate which relates to the amendment. Any impact on the calculation of the contract profit rate or any individual profit rate step due to COVID-19 changes should be clearly described.

5.5 The SSRO provides supplier report guidance to assist designated persons who are required to submit overhead reports and strategic supplier reports. The overhead reports include the actual and estimated rates claims reports and the actual and estimate QBU cost analysis reports, in which the designated person must set out the indirect costs forming part of the rates claim. Those costs may include indirect costs affected by COVID-19, which will be subject to determination of their allowability by reference to the SSRO’s Allowable Costs guidance in the same manner as other costs. The SSRO’s guidance assists with completing the rates claims reports (sections 3 and 4) and the QBU cost analysis reports (section 5).

5.6 A designated person who submits a Strategic Industry Capacity Report (SICR) is required to provide information that may be affected by COVID-19. Examples include the information required by regulation 43: a description of forecast costs, estimated cost recovery rates, the approximate costs of specified employment policies, material changes in the cost of maintaining industrial capacity, and events and circumstances that may have a material effect on maintaining industrial capacity. The SSRO’s guidance provides detailed assistance with the circumstances in which the SICR is required (sections 2 and 9), but not with the content of such reports.

6. Referrals

6.1 The Regulations set out the matters that can be referred to the SSRO for an opinion or determination. The main pricing matters which may be referred are the extent to which an estimated or actual cost is allowable and the appropriateness of certain adjustments to the baseline profit rate (including the CSA). Other pricing matters which may be referred for determination include the amount of any adjustment in a target price contract and the amount of any final price adjustment. If referrals are made jointly by the Secretary of State and the (proposed) contractor, the SSRO may give an opinion on any matter related to a qualifying contract.

6.2 The SSRO tailors the timeframe for dealing with referrals to the circumstances of each case, and we consider any representations about urgency. We aim to provide opinions within 40 working days, although to date these have typically been delivered more quickly. Determinations, which are legally binding on the parties, are expected to take longer to conclude. The SSRO aims to make determinations within 5 months of a referral being accepted.

6.3 The SSRO provides guidance on its website on referrals procedures. We encourage any party that is considering making a referral to engage with us before doing so in order that we can provide advice on the requirements as necessary.

7. Contact

7.1 Any queries concerning this note, or operation of the regulatory framework should be directed to the SSRO helpdesk.
Email: helpdesk@ssro.gov.uk
Telephone: 020 3771 4785.