SSRO

Single Source
Regulations Office

*Assuring value, building confidence*

# Consultation on recommendations

## Review of Part 2 of the Defence Reform Act 2014 and the Single Source Contract Regulations 2014

January 2017

# Contents

# Introduction

## 1. The single source regulatory framework

1.1 The regulatory framework for single source defence contracts was introduced by Part 2 of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations) and came fully into effect in December 2014. It establishes a scheme of regulation that:

- controls the prices of covered contracts (qualifying defence contracts and contracts in the supply chains of those contracts); and
- requires transparency on the part of defence contractors regarding their prices and capacity to continue to meet the government's requirements.

1.2 These measures are imposed on contracts that have not been the subject of competition. The clear intention of the regulatory measures is to ensure that in the absence of competition:

- the government obtains good value for money in its expenditure on qualifying defence contracts; and
- contractors are paid a fair and reasonable price under those contracts.

1.3 These are the aims that the SSRO is expressly required to achieve when carrying out its functions. The SSRO was established as the independent regulator and its functions extend into all the operative provisions of the framework. Its statutory functions include:

- assessing the appropriate rates for use in pricing contracts;
- issuing statutory guidance on pricing contracts, reporting and penalties;
- providing expert opinions and determinations on the functioning of the framework;
- analysing matters relevant to the operation of the framework;
- monitoring the extent to which reporting requirements are complied with; and
- keeping the operation of the framework under review and making recommendations for change to the Secretary of State.

## 2. Review by the Secretary of State

2.1 The Secretary of State is required to complete periodic reviews of the framework, with the first review to be completed by December 2017. Subsequent reviews by the Secretary of State are to be carried out in five-year cycles. In carrying out a review, the Secretary of State must have regard to any recommendations made by the SSRO, provided these are submitted six months before the date on which the review is to be completed. The SSRO intends to make its recommendations to the Secretary of State by June 2017 in order to meet the statutory deadline.

2.2 The SSRO committed to the following procedure in its framework document with the Ministry of Defence (the MOD):

- Formulate recommended changes to the Regulations (and potentially the Act) and consult with the primary users.
- Publish the draft recommendations in a publicly available document to form the basis of a public consultation. The consultation period should be a minimum of two months to ensure an appropriate level of engagement and enable any interested party to contribute (in line with the government's 'Code of Practice on Consultation').
- Publish recommendations to the Secretary of State for Defence. This must happen at least six months in advance of the Secretary of State's duty to review the legislation.

2.3 This procedure has been followed and supplemented with additional engagement, as outlined below.

## 3. Developing the recommendations

3.1 The SSRO has engaged actively with relevant stakeholders since its inception, in order to evolve its approach to regulation. The resulting broad programme of engagement has enabled it to develop its understanding of how the provisions of the legislation are being applied and to shape that application in appropriate ways. The SSRO's approach has included:

- extensive engagement with the MOD, including attendance at Abbey Wood, Navy Command and the MOD Finance Conference;
- regular meetings with individual contractors to promote compliance, responding to contractor queries through a help desk and monthly publication of SSRO Answers;
- site visits to contractor premises and facilities and industry forums such as the Farnborough International Airshow, DSEI 2015, DPRTE 2015 and DVD 2016s;
- establishing the SSRO's Senior Stakeholder Forum and Operational Working Group and holding regular meetings;
- participating in the UK Regulators' Network and meeting with a diverse range of other regulators, agencies and organisations;
- meeting representatives from comparable organisations in other countries, including Australia, Canada, France, Germany and the United States; and
- consulting with stakeholders to develop the SSRO's guidance, its assessment of the baseline profit and capital servicing rates and its compliance methodology.

3.2 The SSRO began the formal preparation of its recommendations with a detailed examination of the existing statutory provisions to consider the extent to which they deliver the intentions of Parliament. This examination was conducted by reference to broad themes in the Act and the Regulations, with the aim of focusing attention on the key operative provisions of the scheme.

**Figure 1: Review themes**

| Themes | Content |
|---|---|
| **Coverage** | • Definitions of QDC and QSC<br>• Thresholds<br>• Exclusions |
| **Price control** | • Formula<br>• Allowable Costs<br>• Contract profit rate |
| **SSRO and its operations** | • Governance<br>• Funding<br>• Miscellaneous functions |
| **Referrals and enforcement** | • Opinions<br>• Determinations<br>• Compliance |
| **Transparency** | • Record-keeping and open book<br>• Reports<br>• Duty to notify<br>• Protection of sensitive information |

3.3 A number of potential issues were identified from the initial thematic reviews, from which the SSRO developed a shortlist for the purposes of formally calling for input from stakeholders. The SSRO's formal calls for input for the review of legislation were conducted as follows:

- the first call for input (23 May to 15 July 2016) covered all of the above themes, but with a limited focus on transparency; and
- the second call for input (12 September to 4 November 2016) focused specifically on transparency.

3.4 The SSRO shaped its calls for input by reference to the experience gained in delivering its statutory functions and from its engagement with stakeholders. This enabled the SSRO to seek targeted input from stakeholders, at the same time as inviting stakeholders to address such other matters of concern as they considered appropriate. The SSRO delayed calling for input on transparency as it sought to allow more time for stakeholders to gain experience of the reporting process, following the initial low volume of reporting of qualifying defence contracts. The SSRO has separately published a summary of the responses to its calls for input.

3.5 Throughout the calls for input the SSRO has continued to engage with stakeholders in the manner outlined in paragraph 3.1. The SSRO has also:

- held a working group discussion with stakeholders on the review of legislation, on 29 June 2016;
- held a series of meetings with both the MOD and industry representatives;
- participated in the Regulatory Futures Review on best practice regulation and held meetings with the Better Regulation Delivery Office; and
- reviewed key elements of the regulatory framework and conducted associated consultations, including on the Single Source Cost Standards statutory guidance on Allowable Costs (20 April to 1 June 2016), the profit rate methodology (8 July to 18 August 2016) and the SSRO's compliance and review methodology (27 September to 8 November 2016).

3.6 The SSRO has sought to increase understanding of the regulatory framework and its operation, supporting interested persons to contribute to the overall body of knowledge. In addition to the matters outlined above, this has included:

- speaking at several events about the regulatory framework and the work of the SSRO, for example in speeches delivered to the Defence Acquisition Conference and to the Defence Academy of the United Kingdom;
- publishing statistical bulletins with information relevant to the review; and
- publishing the document Perspectives on Single Source Defence Procurement on 15 September 2016, and participating in a subsequent discussion event organised with RUSI.

3.7 In developing the proposals in this consultation document, the SSRO has taken into account all its engagement with a wide variety of stakeholders. The SSRO has prioritised the matters it considers most likely to deliver significant benefits to the regulatory framework at this time and these are outlined in section 5 below. In developing each proposed recommendation, the SSRO has considered a range of policy options.

3.8 The SSRO will continue to consider the other matters on which it called for input and whether these require changes to the framework at a later stage. In some cases this will be a matter of gathering additional evidence as the scheme of regulation continues to mature. The SSRO has drawn attention to these matters, as appropriate, throughout the consultation document.

## 4. Purpose of consultation and next steps

4.1 The SSRO is now consulting and inviting submissions from interested persons regarding proposed recommendations for change to the Secretary of State. Input is particularly sought on the benefits and impacts of the proposals, to ensure these are fully taken into account before making firm recommendations.

4.2 In any case where submissions are made, the SSRO asks that respondents provide such evidence and examples as may support their submissions. This is necessary to enable the SSRO to understand the significance of any representations made and properly assess the relevant benefits and impacts on all stakeholders.

4.3 The consultation document includes a number of areas in which the SSRO is not yet persuaded of the case for change. The SSRO will consider any further responses and evidence in relation to these matters before making final recommendations as part of this review.

4.4 The SSRO is consulting on the matters addressed in this document. However, it remains open to any additional recommendations for change that respondents consider should be made to improve the scheme of regulation.

4.5 The time period for this public consultation is eight weeks. The consultation will be open from 30 January 2017 until 24 March 2017. Stakeholders are requested to provide written responses to this paper by **5.00pm on 24 March 2017**. Responses should be completed online using the secure link provided: Review of Regulations response or via our website. If you have any difficulty in accessing the online response form, please let us know at the email address provided below.

4.6 All communications in respect of the review should be directed as follows:

**Email:** reviewofregulation@ssro.gov.uk

**Telephone:** 020 3771 4767

# Overview of the recommendations for consultation

## 5. Introduction

5.1 The SSRO has focused its proposed recommendations for change in three key areas:

- ensuring that single source spending is appropriately covered by the regime;
- enhancing transparency; and
- providing effective enforcement of the regime.

5.2 These recommendations are targeted at enhancing the existing provisions of the regulatory framework so that it is better placed to achieve the objectives of Parliament.

5.3 The price control and transparency provisions of the regulatory framework are dependent on contracts becoming qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs).[1] As the legislation is currently framed, there are a number of factors that prevent contracts being brought within the regime and the SSRO has developed recommendations targeted at removing these.

5.4 A key feature of the regulatory framework is the greater transparency it requires on the part of defence contractors to both the MOD and the SSRO. The standardised reports provide the SSRO with a range of information needed to discharge its statutory functions. However, there are circumstances in which the information provided needs to be supplemented; the SSRO proposes means by which this can be achieved.

5.5 The Act relies partly on self-regulation and partly on a system of compliance and penalty notices to ensure that its provisions are complied with. The SSRO may give expert opinions and make determinations, but only if required by the contracting parties. The nature of the single source defence market may make it difficult for the MOD to carry out an enforcement role and the SSRO is consulting on proposals to improve the available enforcement mechanisms.

1 Sub-contracts that are not QSCs are subject to a limited form of price control and transparency, but only if they are subordinate to a QDC or QSC. See paragraphs 7.2 to 7.4 below.

| Theme | Content |
|---|---|
| Coverage | • Contract amendments, section 6<br>• Definition and assessment of QSCs, section 7<br>• QSC thresholds, section 8<br>• Exclusions, section 9 |
| Transparency | • Reporting of sub-contracts and QSC assessments, section 7<br>• Access to information, section 10 |
| Referrals and enforcement | • Grounds for referral, section 11<br>• Compliance and penalty notices, section 12 |

**Figure 2: Recommendations and themes**

5.6 There are two issues on which the SSRO is consulting, but in respect of which it has not yet prepared specific recommendations. These are:

- exclusion of government-to-government contracts (section 14); and
- enforcement of price controls (section 15).

5.7 The SSRO may still make recommendations in these areas, subject to the results of consultation.

5.8 The SSRO has received a number of suggestions from stakeholders for changes to the Act and Regulations and has been asked to consult on some of these. To the extent that the suggestions relate directly to the SSRO's own recommendations, these have been addressed in the relevant sections of this consultation document. The remaining matters are addressed for the purposes of consultation in sections 16 to 20 of this document.

5.9 The SSRO has not developed a recommendation for changing the approach to pricing single source contracts, but this remains an area of significant interest. The SSRO intends to keep the costs-plus price formula under review, including the six steps required for determining the contract profit rate and whether there is a better approach to the treatment of capital employed.

5.10 It is essential that the SSRO is able to function independently from those who are subject to the regulatory framework. Independence backed by financial autonomy ensures that the SSRO is able to strike the balance between good value for money for the government and fair and reasonable prices for contractors. It is appropriate that those who are regulated should fund the SSRO, but enshrining independence requires careful consideration of who should make decisions about appointments to the SSRO Board and the SSRO's finances.

5.11 The Act regulates defence spending in limited circumstances where it is permissible to single source a contract of significant value. It is fundamental that competition should be the first choice when awarding contracts and that the regulatory framework is intended to provide a credible alternative only in the limited range of cases in which competition is not feasible for some permitted reason. The SSRO is concerned at the extent to which procurement decisions may result in:

- contracts being single-sourced in circumstances where they should have been competed; and
- associated pressure to exclude such contracts from the regime or to devise mechanisms for treating them differently.

5.12 In general the SSRO has sought to avoid recommending changes to address such matters and intends to keep under review the impacts of procurement decisions on the regulatory framework.

# Recommendations on coverage of the regime

## 6. Contract amendments

6.1 The regulatory framework relies on contracts becoming QDCs or qualifying sub-contracts (QSCs). As a consequence, the amount of single source defence spending captured by the regime is determined by the scope of the definitions of QDC and QSC and how these are applied. A particular issue in this context is the treatment of contracts that are not QDCs or QSCs when they are awarded, but which are subsequently amended such that the resulting contract satisfies the basic elements of one of the definitions.

### Qualifying defence contracts

6.2 Section 14 of the Act defines when a contract is a QDC. It must be a contract under which the Secretary of State procures goods, works or services for defence purposes, it must have a value of £5 million or more (except for contracts entered into from 18 December 2014 to 30 March 2015, for which the threshold value is £500 million) and it must not be within an excluded category. The contract must also be one of the following:

- a contract entered into on or after 18 December 2014 where the award is not the result of a competitive process;
- a contract entered into before 18 December 2014 where the award is not the result of a competitive process and the contract is amended on or after 18 December 2014, if the parties agree that it is to be a QDC; or
- a contract entered into at any time as a result of a competitive process that is amended on or after 18 December 2014, where the amendment is not the result of a competitive process, if the parties agree that it is to be a QDC.

6.3 The application of the QDC definition to contract amendments creates a number of issues that may impede the application of the regime to amended contracts, namely that:

- no consideration is given to when an amendment is sufficiently material that it should be treated as a new contract award for the purposes of the regime;
- the additional requirement that the parties to the contract must agree that the amended contract should become a QDC means that the application of regulatory controls is subject to the decision of those who would be regulated; and
- the definition does not deal with the situation in which a contract valued below £5 million is entered into on or after 18 December 2014 and is subsequently amended so that the price becomes £5 million or more.

6.4 In each case the consequence of the way the definition is drafted means that there may be single source defence contracts with values of or above the £5 million threshold that are not brought within the regime. The SSRO does not have complete evidence on such contracts, because they are not required to be reported.

6.5 Based on the feedback received from stakeholders, the SSRO understands that the requirement for mutual agreement to an amended contract becoming a QDC may have been a response to concerns as to:

- proportionality, due to the time required to agree an amendment in line with the regulatory framework; and
- fairness, by reason of retrospective application of the regulatory framework.

6.6 The SSRO accepts that the application of the legislation must be proportionate, but considers that the value threshold is the principal mechanism by which this should be ensured. Contract amendments that are significant should be priced in accordance with the price controls imposed by the Act.

6.7 The SSRO recognises that as the legislation is presently framed price control will apply retrospectively when an amended contract becomes a QDC. This is because the whole contract price must comply with the price formula, even the part that pre-dated the amendment. This impedes amended contracts becoming QDCs for at least the following reasons:

- the contract profit rate agreed prior to the amendment, either under the Yellow Book arrangements or as a result of a competitive process, may exceed the profit rate available under the Defence Reform Act at the time of amendment;
- costs incurred prior to the amendment may not be Allowable under the Defence Reform Act;
- there may be significant resource required to assess whether the costs are Allowable; or
- the parties may not wish to carry a risk that elements of the price may not conform to the price formula.

6.8 The SSRO's Single Source Cost Standards published in July 2016 recommend an approach that parties may take to sunk costs when amending a contract. However, the SSRO recognises that its guidance does not remove the legislative requirement that all costs forming part of the contract price must satisfy the test of being Allowable (i.e. appropriate, attributable to the contract and reasonable in the circumstances). It does not prevent one of the parties from referring a cost to the SSRO to determine the extent to which it is Allowable, even though it may have been incurred prior to the amendment and the parties may have agreed between themselves that it should not be referred.

### Qualifying sub-contracts

6.9 The requirements for a contract to be a QSC are set out in section 7 below. Part 2 of the Act and the Regulations do not apply to a contract that meets the QSC definition unless it has been positively assessed as qualifying and notification has been given to that effect to the sub-contractor and the Secretary of State. The purchasing party under the relevant contract is obliged to make an assessment in circumstances where it is proposed to enter into a contract to provide something for a QDC or QSC (Regulation 61).

6.10 There is no express provision for dealing with amendments to sub-contracts in either the QSC definition or the requirement for QSC assessment. The SSRO's view is that, in the absence of any definition of the terms "contract" and "sub-contract" for the purposes of Section 28 of the Act or Regulation 61, these terms must be understood in their ordinary common law sense. As a matter of principle, the effect of agreeing to amend the terms of an existing contract is to enter into a new contract on the amended terms. There may be exceptions to this conclusion but only to the extent that the agreed amendment could be described as immaterial or minor. On this basis, Regulation 61 requires that an amended contract should be assessed to determine whether it is a QSC unless the amendments are not material.

6.11 The MOD has taken a different approach from the SSRO to construction of the legislation. The MOD's view is that material contract amendments do not require assessment and provides advice to contractors to this effect. The consequence of this approach being applied is that amended sub-contracts will not become subject to the regime, even though they may be single source contracts valued at £25 million or more. In the SSRO's view, this may restrict the application of the regime to sub-contracts.

### Recommendation

6.12 The SSRO proposes to recommend that material contract amendments are brought within the regime. This should be achieved by ensuring that material contract amendments are treated as if they involve entry into a new contract. To ensure proportionality, the question of materiality should be judged by reference to the same threshold that applies to the award of a new contract. The same approach should be taken in respect of material sub-contract amendments.

**Proposed amendment:**

A new section 14(10) should be inserted in the Act to specify that if a contract is amended in a way that affects its price and the value of the amendment is of or above £5 million (the amount specified in single source contract regulations for the purpose of section 14(2)(b) of the Act), then for the purposes of the Act and the Regulations, a new contract will be taken to have been entered into on the amended terms.

A new section 29(7) should be inserted in the Act to specify that if a contract is amended in a way that affects its price and the value of the amendment is of or above £5 million, then for the purposes of the Act and the Regulations, a new contract will be taken to have been entered into on the amended terms.

6.13 The SSRO proposes to recommend that where a contract becomes a QDC or QSC by reason of a contractual amendment, neither the price controls nor the transparency obligations under the Act will apply to costs and associated profit that have been committed by reason of performance of the contract up to the time of agreement.

**Proposed amendment:**

A new section 15(6) should be inserted in the Act to permit the regulations to provide that the price formula may be applied to only a defined component of a contract.

A new regulation 10(1a) should be added to specify that where a contract becomes a QDC by reason of an amendment, the price payable under the amended contract must be determined in accordance with the formula but excluding any amount committed by reason of performance of the contract up to the time of agreement.

### Justification

6.14 The SSRO's proposed recommendations would ensure that contract amendments are appropriately and proportionately captured by the Act and the Regulations. This is achieved by:

- requiring material amendments to be treated as entry into new contracts;
- defining what is material for this purpose by reference to the existing value thresholds; and
- providing that price controls and transparency obligations do not apply to costs committed prior to the amendment nor to the associated profit.

6.15 This approach responds to representations made by stakeholders regarding the treatment of committed costs and the need for some treatment of when an amendment is material. It was proposed by some respondents that the question of whether a contract amendment is material should be judged by reference to regulation 72 of the Public Contracts Regulations 2015, which deals with when a contract may be modified without the need for a new procedure under Part 2 of those Regulations. The SSRO has not adopted this approach to materiality, on the basis that the thresholds specified for the purposes of the QDC and QSC definitions provide a clear indication of when a contract is sufficiently substantial to be covered by the regime.

### Benefits and impacts

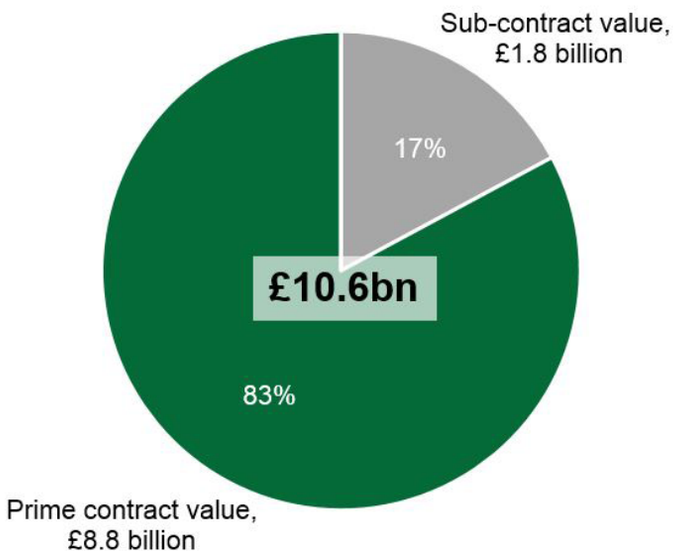
6.16 The proposed changes are expected to bring more contracts within the regime and subject a higher proportion of single source defence spending to price control and transparency obligations. In the impact assessment for introducing the current regime, benefits of £1,837 million were estimated against costs of £125 million. Capturing increased single source defence spending is expected to result in a commensurate increase in benefits and costs.

## 7. Definition and assessment of QSCs

### Background

7.1 A significant amount of the value of QDCs and QSCs is sub-contracted. This appears clearly from the limited set of information on sub-contracts reported to the SSRO, which it analysed and published in a bulletin on 28 July 2016.

**Figure 3: Total value of reported sub-contracts as a proportion of total QDC/QSC contract value, 2015/16[2]**




7.2 The Act and Regulations extend price control and associated transparency obligations into the supply chains of QDCs:

- The regime subjects all sub-contracts to a degree of price regulation and transparency. The overall price of a sub-contract must satisfy the test of being appropriate, attributable to the contract and reasonable in the circumstances (the AAR test) before it can be included in the price of a QDC or QSC. Additionally, some transparency is required, as the contract reports for a QDC or QSC must provide basic details of the top 20 sub-contracts valued at £1 million or more.

- Significantly greater scrutiny is applied to sub-contracts that are also QSCs, including application of the price formula and full transparency.

7.3 Figure 4 summarises the differences between the treatment of ordinary sub-contracts and QSCs.

**Figure 4: Comparison of regulatory requirements for QSCs and other sub-contracts**

| | Sub-contracts | QSCs |
|---|---|---|
| Price | Price must satisfy the AAR test in order to be an Allowable Cost. | Price must satisfy the formula (CPR x AC) + AC. |
| Transparency | Basic details of the top 20 sub-contracts valued at £1 million or more are described in contract reports for the QDC or QSC. | Contract reports must be submitted in accordance with the Regulations. |

2 Note: one QDC has been excluded from the analysis, so the total QDC/QSC value does not align with the £11.1 billion value reported for 34 QDCs in previous SSRO statistical bulletins.

7.4 The key differences in the level of regulation applied to QSCs compared with other sub-contracts are that:

- the component costs are exposed to more scrutiny;
- the contract profit rate is known and controlled, being calculated by reference to the baseline profit rate determined by the Secretary of State; and
- contract reports provide detailed, comparable information about costs and profit as well as other matters related to performance of the contract.

7.5 The greater scrutiny and control that applies to QSCs supports achievement of the correct balance between value for money and fair and reasonable prices in the supply chains of QDCs.

7.6 The application of the price formula and full transparency to sub-contracts is dependent on definition, assessment and notification as summarised in Figure 5.

**Figure 5: Pre-conditions to regulation of QSCs**

| | |
|---|---|
| **Definition:** | The sub-contract must satisfy the QSC definition. |
| **Assessment:** | The person proposing to enter the sub-contract must assess whether it satisfies the QSC definition. |
| **Notification:** | The assessor must notify a positive assessment to the sub-contractor and the MOD. |

## Definition of QSCs

7.7 A contract may be a QSC if it involves the provision of anything for the purposes of a QDC or another QSC (Section 28 of the Act). The award of the contract must not be the result of a competitive process, the value of the contract must be £25 million or more and the contract must not fall within one of the excluded categories specified in the Regulations. An additional control is imposed by the Regulations, in that at least 50 per cent by value of the obligations under the contract must be required to enable the performance of QDCs and QSCs.

7.8 The SSRO received representations that the reference to “the provision of anything” renders the definition too broad, but we are seeking supporting evidence to that effect. In practice what is provided under a QSC will ultimately be for the provision of goods, works or services for the defence purposes of the QDC to which it relates. This seems straightforward and, in the absence of contrary evidence, the SSRO does not propose to recommend limiting the definition.

7.9 The 50 per cent value requirement is an additional threshold, ensuring that contracts largely unconnected with defence work do not become QSCs. It was suggested that this should be raised to 100 per cent, but doing so would exclude contracts involving substantial single source defence spending if even a small part of the value was for a different purpose. The SSRO would like to see evidence that the 50 per cent threshold is leading to the inappropriate application of price control, before considering a recommendation for change in this area.

7.10 In its compliance report published 28 January 2016, the SSRO reported an instance in which a contractor declined to assess a contract as being a QSC on the basis that: the definition of a QSC hinges on whether a subcontract involves the provision of anything "for the purposes of a QDC"; and a subcontract cannot be a QSC if it was entered into prior to the QDC being signed. The argument being that if a QDC technically did not exist at the time the subcontract was entered into, the subcontract could not be for the purposes of a QDC and could not therefore be deemed to be a QSC.

7.11 The SSRO considers that this interpretation of the legislation is incorrect. The fact that a subcontract was signed before the QDC does not have the effect that the contract fails to satisfy the definition of a QSC. Any other approach would expose the framework to avoidance. Indeed, the explanatory notes to Section 29 of the Act specify that the section was intended to address this possibility. The fact that the argument has nevertheless been made provides a reason for an amendment to place the position beyond doubt.

### QSC assessments

7.12 The circumstances in which a QSC assessment is required are set out in Regulation 61, as is the duty to notify positive assessments. There is limited transparency in respect of QSC assessments, which impedes enforcement action by the MOD and review by the SSRO of how the provisions are being applied (which is the SSRO's duty). There are three key issues:

- no notification of negative assessments and poor transparency;
- no deadline for QSC assessments; and
- incomplete reporting.

7.13 The contractor carrying out the QSC assessment is required to keep a record of the assessment, which the MOD may examine to determine for itself whether a contract is a QSC. This has the potential to support enforcement action by the MOD in cases where there has been an incorrect negative QSC assessment. There is no duty, however, to notify negative QSC assessments to the MOD, which limits the extent to which the MOD is made aware of cases in which compliance may be an issue.

7.14 In addition, in cases where the QSC assessment is reported in one of the contract reports, the only requirement is to specify the outcome of the assessment, which arguably means that the only information provided is whether or not the contract is considered a QSC. In the case of a negative assessment no transparency is provided as to the reasons why the contract was not considered to be a QSC. There may be several reasons why a contract is reported as not being a QSC, including the following:

- the contract was entered at a time when the contract it supports was not a QDC or QSC;
- the way in which contract value has been calculated;
- the value of the contract obligations required to enable a QDC or QSC being less than 50 per cent;
- the contract resulting from a competitive process; or
- the contract falling into an excluded category.

7.15 The legislation does not set a deadline for completing a QSC assessment, leaving it to the contractor to decide when to carry out the assessment. This has the potential to delay or frustrate entirely the application of regulatory controls to contracts that should be QSCs. The absence of a deadline may also present a barrier to enforcement action by the MOD for failure by a contractor to make a QSC assessment, as the point at which failure has occurred cannot be fixed. These are significant potential implications for the effectiveness of the regime that may be addressed by setting a reasonable deadline.

7.16 The reports submitted for QDCs and QSCs, notably the contract notification report and, as applicable, the quarterly contract report and interim contract reports, provide a limited and partial view of the QSC assessments undertaken as:

- the information is only required in respect of the 20 highest value sub-contracts under the QDC, provided the sub-contract value exceeds £1 million; and

- the absence of any deadline for conducting a QSC assessment means that assessments may be conducted after the reports are submitted and the reports will not include information on those assessments.

7.17 The SSRO drew attention to the first of these limitations when it published its first bulletin on sub-contracts on 28 July 2016. In relation to the second limitation, it may be noted that at the time the bulletin was prepared, the reported information showed that almost 20 per cent of the reported sub-contracts had not been the subject of QSC assessment.

7.18 The absence of clear deadlines and restrictions on transparency regarding QSC assessments is not helpful to industry and impedes understanding of whether the regulatory controls are being correctly applied to sub-contracts. In particular it is difficult to determine the extent to which a QSC assessment has been carried out in accordance with the requirements of the Act and Regulations.

7.19 The MOD may supplement the information it holds by inspecting relevant records, but the required transparency should not be dependent on the examination of records in every case. The SSRO receives only the limited reported information and has no power to supplement any lack of information by requiring the contractor to provide a copy of the QSC assessment. This limits the SSRO's ability to discharge its statutory duty to keep the provision of Part 2 of the Act and the Regulations under review. In turn this restricts the SSRO's ability to recommend action to the MOD.

### Recommendation

7.20 The SSRO proposes to recommend that the definition of QSC is amended to make it clear that a contract may be a QSC if it provides anything for a proposed QDC or QSC. This was Parliament's intention, but the matter has nevertheless been subject to question and amendment is intended to remove the potential for further disputation.

| **Proposed amendment:** |
| --- |
| Section 28(3)(a) of the Act should be amended to also refer to a proposed QDC to which the primary contractor will be a party. Section 28(4)(a) of the Act should be amended to include a proposed contract in the definition of Contract A. |

7.21 The SSRO proposes to recommend a number of amendments to the Regulations to ensure that the QSC assessments are carried out in a timely manner and that there is greater transparency in respect of QSCs. The Regulations should be amended to require that:

- QSC assessments are completed within 30 days of the time of agreement of the sub-contract;
- QSC assessments that are not reported as part of the contract notification report are notified to the Secretary of State and the SSRO within 30 days of assessment;
- reasons for any negative assessment are specified when the assessment is notified or reported; and
- details of all sub-contracts valued at £1 million or more are included in the contract reports, rather than just the top 20.

7.22 The SSRO should also be able to access copies of QSC assessments if required. The need for the SSRO to have access to information in order to discharge its statutory functions is discussed in more detail in section 10 below. Information gathering powers would allow the SSRO to require access to QSC assessments.

**Proposed amendment:**

Regulations 25(2)(l), 26(6)(k), 27(5)(e) and 28(2)(p) should be amended to: (a) omit the 20 contract restriction, deleting the words "(or, if there are more than 20 such sub-contracts, each of the 20 which have or are expected to have the highest value)"; and (b) add to paragraph (ix) in each Regulation a requirement to specify the reasons for any negative assessment.

Regulation 61 should be amended to add the following requirements: (a) that a QSC assessment must be completed within 30 days of the time of agreement of a sub-contract; and (b) that the outcome of QSC assessments must be notified to the Secretary of State and the SSRO within 30 days of assessment unless they have already been reported in the contract notification report.

### Justification

7.23 The recommendation to change the QSC definition is necessary to deal with a misconstruction of the legislation that has already been applied and which may lead to avoidance.

7.24 The proposed deadline for QSC assessments will significantly strengthen the treatment of QSCs in the regime, ensuring that price controls and transparency obligations are applied as intended. It will avoid delay in sub-contracts being assessed and thus delay, or frustration of the application of regulatory controls to QSCs. It will provide a foundation for enforcement action in cases of genuine failure to assess. This is considered necessary given the substantial value covered by sub-contracts.

7.25 The recommendations will provide greater transparency over the assessments that are carried out, providing insight into whether the judgments being made are correct but also into the basis on which sub-contracts do not become QSCs, for example the extent to which sub-contracts are competed. Greater transparency will enable the SSRO to effectively discharge its duty to keep the assessment of QSCs under review and support the MOD to take enforcement action when appropriate.

## Benefits and impacts

7.26 The proposed changes are expected to:

- promote correct coverage of QSCs by the regime;
- improve visibility over a larger number of subcontracts that form part of a QDC value chain; and
- support effective review by the SSRO and enforcement action by the MOD.

7.27 The benefits and impacts of the measures to promote correct coverage should be in line with those contemplated when the Act was introduced. Clarifying the QSC definition avoids a potential legal ambiguity or uncertainty and in that way avoids the cost of disputation without adding any costs associated with administration. Imposing a deadline for QSC assessments is also not expected to add any costs as the assessments must be carried out in any event.

7.28 The SSRO does not anticipate that the increased transparency requirements in respect of QSC assessments would be onerous, as contractors are already required to produce and to keep a record of the assessments. As such, the requirement to specify the reasons for negative assessment should not result in any significant additional cost.

7.29 The SSRO recognises that removing the 20-contract limit on reporting will in some cases require descriptions to be provided of a larger number of sub-contracts than is currently the case. Any additional costs associated with this change are considered to be proportionate for the following reasons:

- Based on the SSRO's published analysis of sub-contacts reported in QDCs,[3] only two of 33 QDCs entered into from 1 April 2015 to 31 March 2016[4] reported the maximum 20 contracts, both of which QDCs are at the upper end of reported contract values. It may be anticipated that removal of the 20-contract limit would affect a small number of high value contracts, where increased transparency is appropriate and proportionate.
- The descriptions of sub-contracts required to be reported in the contract reports are not detailed and consist of information that contractors are expected to have readily to hand: see Regulations 25(2)(l), 26(6)(k), 27(5)(e) and 28(2)(p)). Examples are the name of sub-contractor, whether the sub-contractor is an SME or the price payable under the sub-contract. On this basis, the SSRO does not consider that it would be a long or complex exercise to provide the additional descriptions.

3 See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/541453/Sub-contracts_reported_in_Qualifying_Defence_Contracts_2015-16_-_28_July_2016.pdf

4 Based on data extracted from the database on 4 July 2016.

## 8. QSC thresholds

### Background

8.1 A significant amount of single source defence spending is paid to sub-contractors in the supply chains of QDCs and QSCs. This is demonstrated by Figure 3, which shows that the value of such sub-contracts was more than £1.8 billion in the financial year from 1 April 2015 to 31 March 2016. Due to the limited transparency in respect of sub-contracts, the SSRO does not know how much of this figure was single-sourced.

8.2 The threshold value for a contract to become a QSC is £25 million, which is considerably higher than the £5 million threshold for prime contracts to become QDCs. The SSRO questions why there should be a discrepancy between the thresholds. If a contract is assessed and notified as being a QSC, then it is subject to the same regulation in respect of price and transparency as a QDC. Accordingly, the same considerations of cost and benefit should arise when determining the value thresholds for QDCs and QSCs.

8.3 A contract may be a QSC if it provides something that enables the performance of a QDC or QSC. In order to ensure proportionality, 50 per cent or more of the value of the obligations under the sub-contract must be for a QDC or QSC before the sub-contract may itself become a QSC. The SSRO can see some justification for taking the 50 per cent threshold into account when setting the value threshold for QSCs. The SSRO does not have evidence of the proportion of sub-contracts with value contributions to QDCs or QSCs as low as 50 per cent. Taking a cautious approach, a QSC threshold of £10 million would ensure that no contract becomes a QSC unless its value contribution is at least as high as the QDC threshold of £5 million.

8.4 It has been suggested that a high price threshold may serve some purpose in supporting SMEs. This does not explain either the level at which the QSC price threshold has been set or the differential between QDC and QSC thresholds, for a number of reasons:

- SMEs may equally be interested in being awarded QDCs;
- the available evidence does not support a conclusion that significant numbers of SMEs would be affected by aligning the thresholds; and
- the MOD does not have a policy of limiting the size of contracts awarded to SMEs to any particular level.

### Recommendation

8.5 We propose to recommend that the current price threshold for QSCs is reduced to £10 million. This brings the threshold closer to alignment with that which applies for QDCs, but makes allowance for up to 50 per cent of the value of a QSC potentially being for purposes other than enabling the performance of a QDC or another QSC. This is designed to ensure that contracts of significant value are subject to an appropriate level of scrutiny and control.

| **Proposed amendment:** |
| --- |
| Regulation 58(1) should be amended to replace £25 million with £10 million. |

### Justification

8.6 The proposed changes will reduce the current differential between the price thresholds for QDCs and QSCs. This will remove some of the existing discrepancy in the treatment of prime and other contracts, pursuant to which prime contracts may be subject to full regulation while larger sub-contracts are not. At the same time, the level of the proposed threshold means that the regime will continue to focus upon contracts of significant value.

8.7 The application of the price formula and greater transparency to more contracts and a higher proportion of single source defence spending will help to ensure the correct balance is struck between value for money and fair and reasonable prices. Lowering the threshold will place a legal obligation on more contractors to provide information about their costs and profit. This will help to address an issue raised by some prime contractors that they experience difficulty in obtaining such information from sub-contractors who are also competitors. With more sub-contract value being subject to reporting, the MOD will have greater visibility of Allowable Costs within the supply chain.

8.8 Lowering of the threshold will assist the SSRO and the MOD to more effectively keep under review the flow-down of regulation to sub-contracts. This will be supported by the SSRO's recommendations in respect of QSC assessments, setting the deadlines for completing assessments and requiring that regular reporting on sub-contracts should include information on whether or not they were competed.

### Benefits and impacts

8.9 The SSRO considers that a reduction of the threshold to £10 million would extend the benefits of the regime to a larger proportion of the sub-contracting value chain and will also ensure that the rights and obligations of single source provisions are available for these significant value single source sub-contracts. A reduction in threshold will result in enhanced price control and transparency being applicable to a larger number of QSCs.

8.10 The increased coverage may result in additional costs by reason of the need to subject QSC costs to greater price control and to submit contract reports. This impact is not considered to be disproportionate, given that the price threshold for QSCs will remain double that which is acceptable for QDCs. The costs are also expected to be incremental as all sub-contracts are presently subject to some form of regulation; in particular their prices must satisfy the AAR test.

8.11 Analysis of the available data on sub-contracts does not suggest any disproportionate impact by reason of the change. Figure 6 below illustrates the spread of sub-contracts to QDCs/QSCs reported in 2015/16 in bands of £5 million. This includes contracts that were the result of a competitive process. The data is considered to be most reliable above £10 million, based on the numbers and values of sub-contracts reports.

**Figure 6 – 2015/16 sub-contract analysis**

| Sub-contract Value | Number of sub-contracts | Total reported value (£million) | Number of SME contracts |
|---|---|---|---|
| £25 million + | 18* | 1,314.9 | 1 |
| £20 – 25 million | 3 | 65.1 | 0 |
| £15 – 20 million | 3 | 50.6 | 0 |
| £10 – 15 million | 10 | 127.9 | 0 |
| £5 – 10 million | 20 | 128.2 | 1 |
| £1 – £5 million | 57 | 130.0 | 3 |
| **Total** | 111 | 1,816.9 | 5 |

* Includes three QSCs.

8.12 In 2015/2016 there were only three QSCs out of 18 sub-contracts valued at £25 million or more. The reports do not disclose the reasons as to why these contracts did not become QSCs, but further investigation suggests that some were competed, some pre-dated the head contract becoming a QDC or QSC by amendment and one was exempted by the Secretary of State. It is likely that only a proportion of contracts valued at £10 million or more would actually become QSCs.

8.13 Some contractors have expressed concern that lowering the QSC threshold could delay contract award and delivery, as the prime contractor will have to undertake QSC assessments for an increased number of sub-contractors. The SSRO would question this assessment, as the requirement to carry out QSC assessments is not presently limited by reference to a value threshold. It may be that assessments in the £10 million to £25 million band will require greater consideration than previously but this is not considered to be a significant impact.

8.14 Figure 6 assists in considering the impact of the SSRO's proposal on SMEs. In 2015/2016, lowering the threshold to £10 million would have had no impact, as only one SME contract was captured and this was above the £25 million threshold in any event. The indication is that a threshold of £10 million will continue to capture larger companies.

8.15 Overall, the SSRO considers it appropriate to take steps to extend the regime to a larger proportion of the value chain of QDCs. The proposals are considered to strike the right balance between the costs and benefits of improved transparency and increased reporting.

# 9. Exclusions

## Background

9.1 The Act excludes prescribed categories of contracts from being QDCs or QSCs. The excluded categories are prescribed in Regulation 7 for QDCs and Regulation 58(2) for QSCs and cover:

- contracts to which the government of another country is a party (QDC only);
- contracts made within the framework of an international cooperative defence programme;
- contracts wholly for the acquisition of land, or the management or maintenance of land or buildings; and
- contracts wholly for the purposes of intelligence activities.

9.2 These are referred to as "excluded contracts" for the purposes of the review. Excluded contracts should be differentiated from contracts that would fall within the regulatory framework but for a direction from the Secretary of State that they are not QDCs or QSCs. Contracts that are the subject of such a direction are referred to for the purposes of the review as "exempt contracts".

## Intelligence activities and international cooperative defence programmes

9.3 Since the Regulations came into force in December 2014, the SSRO has received a number of queries regarding the description of the categories of excluded contracts and whether proposed contracts should therefore be subject to exclusion or not. These queries have focused primarily on contracts made within the framework of an international cooperative defence programme and contracts made wholly for the purposes of intelligence activities.

9.4 The exclusions may be open to different interpretations and the SSRO is concerned there should be sufficient description to ensure contracts are appropriately brought within the regime and exclusions are neither incorrectly used nor applied inconsistently. Although there was a diversity of views, many respondents to the SSRO's call for input called for greater clarification as to when a contract might be subject to these exclusions. It would be helpful to receive further evidence on this point in the consultation.

9.5 The SSRO had further discussions with MOD officials as to how the intelligence exclusion could be clarified. It is proposed that contracts are not excluded if they are sufficiently generic that they do not indicate the MOD's operational intentions. For example, a contract for standard aircraft which are subsequently customised or fitted with particular equipment may disclose nothing meaningful about intelligence activities. Such an approach would result in fewer single source contracts being automatically excluded.

9.6 The exclusion of contracts made within the framework of an international cooperative defence programme avoids the regulatory framework presenting any barrier to UK participation in such programmes. It is difficult to see, however, why this should result in whole contracts being excluded if only a small part of the contract was made within the framework of an international cooperative defence programme. In such a case only the affected component of the contract should be excluded. For example, if equipment is developed in collaboration but the UK subsequently procures quantities for its own use, the latter purchase should not be excluded.

### Recommendation

9.7 The SSRO proposes to recommend that:

- the international cooperative defence programme exclusion is restricted to contracts made wholly within the relevant framework; and
- contracts wholly for the purposes of intelligence activities are not excluded if the subject matter of the contract does not disclose the associated operational purpose.

**Proposed amendment:**

Regulations 7 and 58(2) should be amended to specify that:

(a) contracts are only excluded in circumstances where they are made wholly within the framework of an international cooperative defence programme; and

(b) contracts made wholly for intelligence activities are excluded only where the operational purpose for which the contract is required may be discerned if the contract became a QDC or a QSC.

9.8 As set out in section 6 above it is proposed that a new section 15(6) should be inserted in the Act to permit the regulations to provide that the price formula may be applied to only a defined component of a contract.

### Justification

9.9 The SSRO's proposed recommendations would reduce the extent to which single source defence contracts fall outside the regime and provide for more contracts, currently automatically excluded, to be appropriately and proportionately captured by the Act and the Regulations.

9.10 The proposed amendment to the international cooperative defence programme exclusion will ensure no impact on a contract that wholly relates to collaboration with another government. This means that it will not be an impediment to the MOD entering into or establishing such programmes with other governments.

9.11 The proposed amendment to the intelligence activities exclusion creates a presumption that such contracts will be a QDC unless the Secretary of State determines that for the contract to be subject in particular to the transparency provisions of the Regulations creates a risk of revealing the operational intentions of the MOD and in so doing compromising the security of its operations.

### Benefits and impacts

9.12 The proposed changes are expected to increase the amount of non-competitive spend to the application of the pricing controls and transparency obligations and independent oversight of the regulatory regime.

# Recommendations on transparency

## 10. Access to information by the SSRO

### Background

10.1 The SSRO's statutory functions cut across all operative provisions of the regulatory framework. Figure 7 summarises the SSRO's key functions established by Part 2 of the Act and the Regulations. In carrying out these functions the SSRO is charged with aiming to ensure that good value for money is obtained in government expenditure on qualifying defence contracts and that contractors are paid a fair and reasonable price.

**Figure 7: Key SSRO functions**

| | |
|---|---|
| **Assessment:** | The SSRO assesses the appropriate rates and adjustment for use in calculating the profit rate for QDCs and QSCs. |
| **Compliance:** | The SSRO keeps under review the extent to which persons subject to reporting obligations are complying with them. |
| **Review:** | The SSRO keeps under review the provision of the Act and the Regulations and makes recommendations for change to the Secretary of State. |
| **Guidance:** | The SSRO issues guidance on how the provisions of the Act and the Regulations should be applied, including the principles by which costs are assessed as Allowable. |
| **Referral:** | The SSRO provides expert opinions and determinations on the application of the Act and the Regulations to individual contracts. |
| **Analysis:** | The SSRO analyses matters of value for money and fair and reasonable prices both for the MOD and in support of its own functions. |

10.2 The SSRO maintains a database of information for the purposes of discharging its functions, generated from the reports that defence contractors are required to submit under the Act. The reports provide a substantial body of standardised information relevant to the operation of the regime, but there are some key limitations:

- the information collected is prescribed by the Regulations and thus fixed and inflexible;
- the information is provided for the purposes of both the SSRO and the MOD, so not all of it is targeted to the SSRO's functions; and
- the reports are the only formal mechanism for the SSRO to access information to fulfil its responsibilities under the Act.

10.3 If the SSRO needs additional information to discharge its functions, it may request the information from the MOD or the contractor but is dependent on their willingness to provide the information. The SSRO requests information in support of its duty to keep under review the provision of Part 2 of the Act and the Regulations. The SSRO may be interested in an issue for a variety of reasons, including:

- where it has identified a potential issue from the submitted reports, for example in relation to the way in which price control has been applied;
- where a contracting party has approached the SSRO to express a view about a contract-specific matter which raises an issue of potential significance;
- where the SSRO has chosen to examine an aspect of the legislation to review for the proper discharge of its duty;
- where an understanding of some aspect of the legislation is required to inform one of the SSRO's other functions, such as the giving of guidance.

10.4 The SSRO has experienced circumstances in which the reports have not provided it with sufficient information to enable it to carry out its statutory functions. There have been occasions on which the SSRO has requested information that has either not been provided or something incomplete has been provided.

10.5 For example, the SSRO received a contract report disclosing group sub-contracts where the profit-on-cost-once (POCO) adjustment appeared not to have been applied in accordance with either the requirements of regulation 11 or the SSRO's statutory guidance. The SSRO raised its concern and sought additional information to understand the issue fully. This was not forthcoming and the SSRO has been left with an incomplete understanding with which to assess the functioning of the legislation and guidance.

10.6 Another example is where the SSRO was requested to provide guidance on the valuation of a proposed contract, specifically as to the correct approach to the aggregation provisions in regulation 5. The SSRO was provided with insufficient information about related contracts in order to be able to identify whether there was another contract relating to the same requirement for goods that might have to be reflected in the overall calculation. As a result, the SSRO was not in a position to form an independent, concluded view as to whether the legislation was correctly applied.

10.7 The conduct of analysis is another area in which the SSRO has encountered difficulty in obtaining information. For example, the SSRO entered into an arrangement to provide research and analysis for the Secretary of State but only a limited number of defence contractors agreed to participate. The SSRO was able to rely to some extent on publicly available information in order to complete its study but more information from industry would have provided a more complete picture.

10.8 The above cases have specifically concerned the SSRO's review, guidance and analysis functions. However, there is no reason to think the limitation on accessing information may only be felt in respect of these functions. It may, for example, become an issue when assessing whether the profit formula results in prices that are value for money and fair and reasonable, which may in turn impact the assessment of the baseline profit rate. It may also be an issue when dealing with referrals if a party does not cooperate and the SSRO is left in the unsatisfactory situation of making a determination or giving an opinion based on incomplete information. This could have consequences for the unwilling party and is unlikely to be conducive to proper functioning of the scheme.

10.9 The standard reports that the SSRO receives are both relevant and critical to the carrying out of its functions. The SSRO does not consider, however, that all its future information requirements may be met by further specifying the contents of reports. There is too much potential for unforeseen questions to arise that require additional information. It is nevertheless possible to identify some types of information that the SSRO may require access to, including:

- copies of contracts and relevant additional supporting information, which may be required to understand how price controls are being applied in contracts;
- QSC assessments, in order to determine how the Regulations are being interpreted and applied; or
- information on exemptions, in order to fulfil our statutory function of keeping the Regulations under review, it is important for the SSRO to understand how the regime is functioning and how issue of exemptions works in practice.

10.10 The SSRO considers that it is impractical to expect the information it requires to be supplied in every instance by the MOD. In the first instance the MOD may not hold the information. The MOD may be required to access the information through open book accounting, which seems inefficient when the SSRO could access the information directly. If the MOD accessed the information in that way, it would then need to comply with the requirements of Schedule 5 of the Act, which restricts disclosure except in specified circumstances.

10.11 It is common for regulatory bodies to have powers to access information for the purposes of carrying out their functions. The table below provides some relevant examples of powers held by other bodies. In each case the power to access information is tailored to the work that the organisation is required to carry out.

**Figure 8: Information powers held by regulators**

| | |
|---|---|
| **Ofcom:** | Ofcom may require certain persons to provide the information it considers necessary for the purpose of carrying out its functions. Ofcom is required to prepare and publish a policy statement as to the exercise of the powers and proposed use of information obtained. |
| **Competition and Markets Authority:** | For the purposes of its functions the CMA may require the production of specified documents or information, question individuals, enter premises without a warrant, and enter and search premises with a warrant. |
| **Civil Aviation Authority:** | CAA may by notice require information or documents that it reasonably requires to carry out its functions, if it is something a person could be compelled to provide in evidence in civil court proceedings. |
| **Office of Rail and Road:** | ORR may by notice require the production of documents, the supply of specified information such as estimates, forecast and returns and may require individuals to attend to give evidence. |

### Recommendation

10.12 The SSRO proposes to recommend that the Act is amended to empower it to require by notice in writing that contractors provide the SSRO with information. This should apply in circumstances where:

- the information is needed to enable discharge of the SSRO's statutory functions;
- the request is proportionate, having regard to the purpose for which it is required and the likely time and cost of compliance; and
- the information is neither included in reports under the Act nor publicly available.

10.13 The information obtained as a result of issuing a statutory notice should be information to which Schedule 5 of the Act applies. Disclosure of the information would be a criminal offence, except in the limited circumstances provided in that Schedule. This is designed to ensure that the information obtained is handled securely and confidentially.

10.14 To ensure that notices are complied with, the SSRO should be empowered to impose compliance and penalty notices (see section 12 of this paper) in cases where the recipient of a notice:

- fails to provide the requested information by the specified deadline; or
- provides false or inaccurate data.

10.15 The SSRO's use of the power to require information should be transparent and consistent. The Act should require the SSRO to publish a policy statement on how it will exercise the power to request information powers and use the information obtained. This should address the manner in which the SSRO will first engage with contractors regarding any information requests before issuing a statutory notice. The SSRO should be required to publish an overview of its use of information powers in its Annual Report and Accounts.

**Proposed amendment:**

A new section 37A should be inserted in the Act to empower the SSRO to issue requests for information and should include provisions specifying that –

(1) The SSRO may issue a request by notice in writing for information that the SSRO reasonably considers necessary for the purpose of carrying out its functions under Part 2 of the Act.

(2) The persons to whom the SSRO may issue notices are primary contractors in respect of QDCs, either party to a QSC, or the ultimate parent undertaking of such a person.

(3) The information, explanation or documents must be provided or produced before the end of such reasonable period not less than 30 days as may be specified in the notice.

(4) A person required to provide information under this section must provide it in such manner as the SSRO may reasonably require.

(5) The SSRO must publish a statement of policy on how it will exercise its functions under this section.

(6) The SSRO must publish an annual account of how it has exercised its functions under this section.

(7) A request for information may include a request for an explanation.

Section 31(3) of the Act should be amended to include failure to comply with a notice issued under the new section 37A as a circumstance in which section 31 is contravened.

Regulation 56 should be amended to include information provided in response to a notice issued under the new section 37A as information to which Schedule 5 applies.

### Justification

10.16 The proposed amendments will address the SSRO's present difficulty in accessing the information it needs to carry out its statutory functions. Proper discharge of those functions is essential if the regulatory framework is to operate optimally and achieve the aims of value for money for the government and fair and reasonable prices for contractors.

10.17 Greater access to information will allow the SSRO to more effectively discharge its duty to review how the provisions of Part 2 of the Act and the Regulations are being applied. Coupled with standardised reporting, the power to require information will also improve the analytical capabilities that underpin the SSRO's work. Enhanced review and analysis capabilities will support all of the SSRO's functions, including giving guidance, providing analysis to the MOD, and dealing with referrals.

10.18 Access to data will help the SSRO in producing research and recommendations which the MOD may use to negotiate and manage contracts. Additional information provided by stakeholders can be key in understanding the trends in defence procurement. This will help to address recurring issues in the regime, for example highlighting areas where suppliers consistently spend more than others for comparable goods or services and therefore where efficiency may be improved.

### Benefits and impacts

10.19 The recommended change is intended to increase the range of data available to the SSRO and improve its ability to carry out its statutory functions. In particular, access to information will:

- increase visibility in terms of how the regime is functioning; and
- improve the SSRO's analytical capabilities;

10.20 An appropriately informed SSRO is more likely to be able to promote an effective regime that delivers value for money and fair and reasonable prices.

10.21 The SSRO recognises that access to information will come at a cost. The main cost to business would arise from the collection, management and transfer of the data sets. However, the SSRO believes the selected approach will be the least onerous for the following reasons:

- it is targeted to the SSRO's functions and the particular data requirements that may arise from time to time;
- it does not require routine collection of data, as would be the case with further standard reports; and
- it does not preclude a continued focus on cooperation to the extent possible.

10.22 The SSRO believes that the information it is likely to require will most often involve access to existing records or information held by contractors. To the extent that the information is already prepared and held, requests are unlikely to impose a significant additional burden.

10.23 The level of cost would depend on the number and nature of requests. It is not possible to predict in advance the number of requests the SSRO would make per year and the nature of these requests. The need for information is likely to depend on the extent to which issues arise for investigation, which will result from reported information and issues raised with the SSRO.

10.24 Conscious of the cost that information requests can place on business, the SSRO will publish a policy statement of the circumstances in which it will exercise the power. This should emphasise:

- consideration of alternative sources of information;
- cooperation, to the extent possible;
- engagement as to the terms of a proposed request;
- clear, focussed and proportionate requests with realistic timeframes for response; and
- where practicable, cost-benefit assessment.

# Recommendations on referrals and enforcement

## 11. Grounds for referral

### Background

11.1 The SSRO provides independent expert opinions and determinations regarding the application of the Act and the Regulations. The need for the SSRO's input may arise in circumstances where there is a disagreement between contracting parties, uncertainty as to the application of the scheme or the desire to have an independent expert view on price.

11.2 The Act and Regulations specify the circumstances in which referrals may be made to the SSRO. These range across the regulatory framework but do not cover all aspects of the scheme. The SSRO's first call for input identified the following areas in which it may be helpful to provide for referrals to the SSRO:

- steps 1, 4 and 5 of calculating a contract profit rate;
- whether a contract is a QDC or a QSC; and
- directions that contracts are not QDCs or QSCs (exemptions).

11.3 The SSRO does not propose to proceed with a recommendation at this time for referrals in respect of exemptions. This takes into account the responses submitted by stakeholders to the call for input and the SSRO's assessment of the likelihood of referrals being made. More generally, the SSRO intends to keep the number and scope of exemptions under review, given the potential for these to indicate or affect the functioning of the regime.

11.4 Responses to the call for input were mixed in relation to the contract profit rate steps and the question of whether a contract is a QDC. Some stakeholders supported expanding the grounds for referral or thought that it merited further consideration. A number of industry respondents felt that business risk is increased if the MOD may refer matters to the SSRO without contractor agreement. The SSRO notes this concern but there is no indication of referrals being overused or of a preponderance of referrals from the MOD.

### Contract profit rate

11.5 A contracting party may seek an opinion or a determination from the SSRO regarding the appropriate adjustment under steps 2, 3 or 6 of the contract profit rate calculations. If the SSRO determines the amount of the adjustment it may in consequence determine that the contract price is to be adjusted by a specified amount. The relevant provisions are found in regulation 18 and in section 35 of the Act.

11.6 By contrast, steps 1, 4 and 5 of the contract profit rate calculations are not specified as matters that may be referred to the SSRO. As a consequence, the SSRO has no jurisdiction to make determinations on those steps and may only give an opinion if a joint referral is made by permitted parties. A joint referral requires agreement between the Secretary of State and the primary contractor or sub-contract, depending on whether it is a QDC or QSC.

11.7 Circumstances may arise in which a contracting party disagrees with the application of steps 1, 4 or 5 to the calculation of the contract profit rate, or is unclear as to what the correct application of those steps may be. This may occur where:

- there is disagreement about when a contract is entered into;
- there are multiple baseline profit rates; or
- there is dissatisfaction with the decision as to the incentive adjustment.

11.8 An issue as to the applicable date of entry into contract may arise in cases where work has taken place in advance of execution of a written contract. There are a variety of potential circumstances, such as those described as being at risk and those subject to intention to proceed letters in which the date of entry into contract may be in issue. If the potential dates straddle financial years, then a different baseline profit rate (step 1) or SSRO funding adjustment (step 4) may apply, depending on the choice made.

11.9 If the Secretary of State determines multiple baseline profit rates, in accordance with the SSRO's methodology, then judgment will have to be exercised in selecting the baseline profit rate for a contract. This will be subject to the SSRO's guidance and any issues that arise should be capable of being referred to the SSRO for an opinion or determination.

11.10 The incentive adjustment (step 5) is awarded at the discretion of the Secretary of State in order to give the primary contractor a financial incentive for the performance of some contract provision. It is feasible that the parties may disagree as to how the discretion has been exercised (e.g. the percentage awarded) or how the step has been applied in the calculation (e.g. has the percentage been applied in the right place in the six steps). The SSRO has observed instances in which the adjustment appears not to have been applied in the order required by regulation 11.

### Whether a contract is a QDC or QSC

11.11 In order to be a QDC, a contract must satisfy the requirements of the definition set out in section 14 of the Act and the Regulations, must not fall within one of the exclusions in the Regulations and must not be exempted from the regulatory framework by direction of the Secretary of State. The regime only applies to QSCs that have been assessed and notified as such, as summarised in section 7 of this consultation paper.

11.12 There is considerable scope for issues to arise regarding the requirements for a contract to be a QDC or a QSC. The SSRO has been asked to give views (as distinct from opinions) about such matters from time to time, including whether a contract relevantly resulted from a competitive process and the correct valuation for a contract. Such cases are problematic as the SSRO lacks the information needed to provide a contract-specific response.

11.13 There is no provision for a contracting party to refer to the SSRO a question relevant to whether a contract is, or would be, a QDC. There may be scope for argument about whether such a question could be the subject of a joint referral. However, interested persons may be prevented from obtaining a definitive view from the SSRO in circumstances where a relevant matter is contested or there is otherwise a lack of clarity.

11.14 QSCs are treated differently, as the Act provides that a sub-contractor may appeal to the SSRO if dissatisfied with an assessment that a contract is a QSC. Further, the MOD may issue compliance and penalty notices if there is a failure in the QSC assessment process. However, there is no provision to seek the SSRO's opinion at the time when an assessment is being carried out, which may helpfully avoid disputation or compliance issues.

### Recommendation

11.15 The SSRO proposes to recommend that all steps of the contract profit rate calculation should be specified as grounds of referral to the SSRO, as should questions relevant to whether a contract is a QDC or a QSC.

**Proposed amendment:**

An amendment to section 18 of the Act and to regulations 18(1), 51(1)(a) and 51(2)(a)(i) to provide that any of the contract profit rate steps in Regulation 11 may be referred to the SSRO (including an adjustment agreed on a group basis under regulation 13).

An amendment to sections 14 and 28 of the Act to provide that a contracting party, and in any case the Secretary of State, may refer to the SSRO for an opinion on a question of whether a contract meets the requirements for being a QDC or a QSC.

### Justification

11.16 The SSRO's proposed recommendation would ensure that there is a mechanism of challenge available at the instance of either the MOD or the contractor should issues arise as to the application of steps 1, 4 and 5 of the contract profit rate calculation, or as to whether a contract should be a QDC or a QSC. It would better safeguard against contravention of the Act and the Regulations as there would be an option available to resolve any issues that arise.

### Benefits and impacts

11.17 The proposed changes would ensure that parties may refer issues to the SSRO should the need arise. If the mechanism is used, then the resulting opinions or determinations should be of benefit both in ensuring the subject contract is in accordance with the regime, but also as guidance in respect of other contracts. There is an added benefit in that such referrals may facilitate more efficient contract negotiations.

11.18 The costs of the proposal should only be felt in cases where referrals are made, which will be a matter of choice for the contracting parties. Based on the number and type of referrals to date, there is no indication either that referral mechanisms are being overused, or that the time and cost of dealing with referrals is disproportionate. The change would be expected to have little impact on the costs assessed in the impact assessment conducted on introduction of the regime.

## 12. Compliance and penalty notices

### Background

12.1 The Act provides a scheme of enforcement based on compliance and penalty notices. A compliance notice may be issued if there is a relevant contravention and there are steps that can be taken to remedy the contravention. A penalty notice may be issued if a person fails without reasonable excuse to take the steps required by a compliance notice or if there are no steps that can be taken to remedy the contravention.

12.2 There is a limited set of contraventions that may form the basis of enforcement action. In broad terms the relevant contraventions are concerned with ensuring compliance with the transparency provisions of the Act and ensuring that QSCs are correctly brought within the regime. By contrast, the Act relies primarily on self-regulation for the pricing of QSCs and QDCs.

**Figure 9: Contraventions that may lead to a compliance or penalty notice**

| | |
|---|---|
| **Record-keeping:** | • Failing to keep records.<br>• Failing to permit examination or to provide copies or reasonable further information or explanation. |
| **Reporting:** | • Failing to comply with a reporting requirement under the Regulations.<br>• Providing a contract report that is misleading in a material respect, knowing it is misleading or being reckless as to whether it is misleading. |
| **Duty to notify:** | • Failing to comply with the duty to report relevant events and circumstances that may materially affect the contract and information which may be materially relevant to the contract. |
| **QSC assessment:** | • Failing to make a QSC assessment.<br>• Incorrectly assessing that a sub-contract is not a QSC.<br>• Failing to notify a positive QSC assessment. |

12.3 The duties of record-keeping and notifying material events, circumstances and information are matters of concern primarily to the MOD. The former delivers the open book accounting that the MOD uses for a variety of purposes, including the pricing of contracts. The latter supports contract management by the MOD.

12.4 The other two areas of enforcement action are matters of significant concern to the SSRO in addition to the MOD. The proper assessment of sub-contracts to determine whether they are QSCs is fundamental to ensuring the benefits of the regulatory framework are extended to the right amount of single source defence spending. This is addressed in section 7 above.

12.5 As regards reporting, the SSRO has a duty to keep under review the extent to which persons subject to reporting requirements are complying with them. The SSRO also makes use of the reported data for the purposes of:

- discharging its obligation to keep under review the provision of Part 2 of the Act and the Regulations;
- conducting analysis, either to support the MOD's procurement or the discharge of its own statutory functions.

12.6 The greater transparency provided by standardised reporting is one of the key benefits of the regulatory framework and if the reports are incomplete or inaccurate, then the intended benefits will not be delivered.

12.7 The Secretary of State may issue a compliance notice if there has been a relevant contravention of the Act and if there are steps that can be taken to remedy the contravention. A compliance notice will require specified action to be taken to remedy the contravention and specify a time period within which those steps will be taken.

12.8 If a person fails to comply with a compliance notice without lawful excuse, or if the relevant contravention is such that there are no steps which can be taken to remedy the contravention, then the Secretary of State may issue a penalty notice to the person responsible for the failure to comply or contravention. The Secretary of State must have regard to the SSRO's guidance in determining the penalty.

12.9 The SSRO does not have the powers to compel contractors to meet their reporting obligations as has the MOD. The only course open to the SSRO is to highlight compliance, or lack thereof, by the MOD and single source suppliers in a potential annual report.

12.10 To date the MOD has issued no compliance or penalty notices. The SSRO recognises that the regime needed to go through a period of establishment, during which there was a learning curve for all stakeholders.

12.11 The SSRO understands that the MOD needs to maintain ongoing relationships with its defence contractors and that there may be potential for enforcement action to impact on those relationships or for it to compromise the MOD's procurement. These are considerations that should neither be dismissed nor over-emphasised and the SSRO would be well-placed to consider them objectively.

### Recommendation

12.12 The SSRO proposes to recommend that responsibility for issuing compliance and penalty notices is transferred to the SSRO in respect of reporting and QSC assessments only. Responsibility for issuing notices relating to the duty to keep records and the duty to notify should remain with the MOD, as these primarily affect the Secretary of State's functions.

**Proposed amendment:**

Sections 31 and 32 should be amended to provide that the SSRO may issue compliance and penalty notices in respect of contraventions connected with reporting requirements and QSC assessments. Consequential amendments should be made to sections 33 and 34 of the Act and to Regulations 49(c)(i), 49(d)(i) and 49(e)(i) to reflect the change.

The SSRO should be required to publish and have regard to a statement of policy as to the circumstances in which the powers will be exercised.

A requirement should be imposed for issues raised in respect of penalty notices to be determined by a panel comprised wholly of independent persons.

### Justification

12.13 As a result of its functions and independence, the SSRO will be well-placed to:

- identify contraventions;
- objectively assess whether relevant contraventions are such as to warrant enforcement action; and
- adopt a fair and consistent approach to contraventions.

12.14 This is more likely to result in enforcement action being taken in appropriate cases, incentivising improvements in the completeness and robustness of reporting and supporting appropriate coverage of QSCs.

12.15 The SSRO is the appeals body for determining issues raised in respect of penalty notices. The grounds that may be referred to the SSRO are:

- whether there has been a relevant contravention or a failure to take specified steps;
- whether the person had a reasonable excuse; and
- the amount of the penalty.

12.16 The legislation currently requires that such matters are heard by a committee, comprised of at least one independent person.

12.17 It is necessary to maintain an effective appeals route in the event the SSRO itself is able to issue compliance and penalty notices. This is consistent with the OECD's best practice principles for regulatory policy.[5] In line with the approach taken by other regulators, it is proposed that if the issues listed in paragraph 12.15 are contested in respect of a penalty notice issued by the SSRO, then these should be dealt with by a panel comprised of independent persons.

5 OECD, The Governance of Regulators, http://www.keepeek.com/Digital-Asset-Management/oecd/governance/the-governance-of-regulators_9789264209015-en#.WDg3SLKLRD8#page1, page 80.

### Benefits and impacts

12.18 The proposed changes are expected to provide an improved means of enforcement in respect of reporting and QSC assessments, two important aspects of the regulatory framework. Changing who may issue notices is expected to promote compliance, which supports achieving the benefits of the regime. For example, improvement may be expected in:

- quality and quantity of data received;
- benchmarking and other analysis;
- contracts that strike the right balance between value for money and fair and reasonable prices; and
- QSC assessments.

12.19 There will be costs associated with compliance, but such costs were in contemplation when the Act was introduced. The circumstances in which compliance and penalty notices may be issued, the action that may be required and the potential penalties all remain the same.

# Issues for consultation

## 13. Introduction

13.1 There are two issues on which the SSRO is seeking further representations and evidence before formulating specific recommendations for change. The first is the current exclusion of government to government contracts from the single source regulatory framework. The second concerns the appropriate means of enforcing the price controls contained in the regulatory framework.

13.2 The SSRO has previously called for input from stakeholders in respect of both of these issues. In each case the SSRO is seeking additional evidence to inform its understanding and to enable recommendations to be prepared if appropriate. The SSRO is particularly interested in material relevant to the following:

- the scale of the issue;
- potential ways to resolve the issue;
- impacts and benefits of taking action; and
- possible unintended consequences.

13.3 In order to support the provision of feedback, the SSRO has outlined each issue in some detail below. This sets out the SSRO's current thinking, having considered the views expressed by stakeholders to date.

## 14. Exclusion of government-to-government contracts

14.1 Excluded contracts are dealt with more generally in section 9 of this consultation document, where it is recommended that limitations be placed on two of the existing categories of exclusion:

- contracts made within the framework of an international cooperative defence programme; and
- contracts wholly for the purposes of intelligence activities.

14.2 This section is concerned with the exclusion pursuant to which contracts to which the government of any country other than the United Kingdom is a party may not be QDCs. The SSRO understands the exclusion is intended to deal with situations such as foreign military sales (FMS) with the US, pursuant to which governments manage the sale of some equipment to approved governments. In such cases the other government is effectively an agent, standing between the Secretary of State and the defence contractor that supplies the equipment.

14.3 We understand that the MOD does not record payments to foreign governments in the same way as payments to other suppliers and does not currently publish information about government-to-government contracts in any regular or systematic way. It is understood, however, that such purchases are predominantly, though not exclusively, conducted through FMS[6]. Recent examples of FMS procurement include contracts for the P-8A Maritime Patrol Aircraft and the Apache helicopter upgrade announced in July 2016, which together account for almost £5 billion of spending by the MOD.

14.4 The SSRO considers that, in general, single source defence spending of sufficient value should be subject to the Act. These are the measures developed to permit the correct balance to be struck between value for money for the UK government and a fair and reasonable price for contractors. The SSRO considers there is no reason why both of these requirements should not be complied with in respect of government-to-government contracts.

14.5 It would be contrary to the value for money objective if companies based outside of the UK were able to charge costs that do not satisfy the requirements of being appropriate, attributable to the contract and reasonable in the circumstances. There would be a similar issue if such companies were able to earn profits in excess of those which companies within the regime are permitted. In both cases there would be a concern as to whether there is a level playing field.

14.6 It is unclear why there should be any restrictions on sharing the information required for the operation of the UK regulatory framework. The UK has appropriate mechanisms in place for protecting sensitive information. The Act imposes a criminal offence on any person who discloses reported information other than in limited circumstances. If any additional security is required, that would seem to be a matter that can be considered. Compliance with the transparency provisions of the Act would enable:

- examination of the price to ensure value for money and fair and reasonable prices;
- benchmarking and analysis by the SSRO; and
- project management by the MOD.

14.7 During the parliamentary scrutiny of the Defence Reform Bill concerns were expressed that the transparency provisions associated with a QDC would require foreign suppliers to submit standard reports which could reveal the forecast throughput assumptions of facilities used mainly by a foreign government, and in effect giving insight into that country's defence planning assumptions. Doubts were expressed about the willingness of foreign governments to agree to this. However, the Act already provides means of dealing with such issues:

- The Secretary of State may direct that the contract should not be subject to the supplier reporting requirements (section 25(8) of the Act), while still keeping in place the contract reporting requirements and price control associated with a QDC; and
- Regulation 46 disapplies the transparency requirements of the regulatory framework to the extent that compliance would require contravention of a "relevant restriction".

14.8 If the argument is that the price formula cannot be applied for some reason and that value for money may be demonstrated by some other means, then that is a contention that may also arise under the regulatory framework in respect of other contracts. The SSRO has addressed that issue in section 17 below and suggested both the grounds on which the price formula may be disapplied, but also a mechanism for independent scrutiny of such cases. This would be preferable to automatic exclusion or to exemption on unspecified grounds.

6 Page 723: http://www.dsca.mil/sites/default/files/fiscal_year_series_-_30_september_2015.pdf

14.9 The exclusion of government-to-government contracts has a further adverse consequence in that sub-contracts would not become QSCs. We do not have evidence as to why this should be the case. The reduced level of regulation applied to sub-contracts that are not QSCs is addressed in section 7 of this paper.

14.10 There is a range of options that could address the above issue. For example. it may be that the Act and the Regulations should be amended so as to:

- require greater transparency in respect of government-to-government contracts; or
- remove the exclusion in respect of government-to-government contracts.

14.11 Neither of these approaches would prevent contracts from being exempted by the Secretary of State in appropriate circumstances.

## 15. Enforcing price controls

15.1 Controlling the prices of single source defence contracts is a key aspect of the regulatory framework. To strike the correct balance between good value for money for the government and fair and reasonable prices for contractors, the Act requires that for QDCs and QSCs:

- contract prices are determined according to the formula: Price = (CPR x AC) + AC, where CPR is the contract profit rate and AC is the contractor's Allowable Costs;
- costs are Allowable, satisfying the AAR test; and
- the contract profit rate for each contract is determined by a six step process that starts with the baseline profit rate set annually by the Secretary of State (the six steps).

15.2 The Act relies on three mechanisms to achieve compliance with price control:

- self-regulation by the contracting parties;
- oversight by the SSRO; and
- expert opinions and determinations by the SSRO.

15.3 The primary responsibility for ensuring compliance with price control rests with the contracting parties. They are required to ensure that the price of a QDC or QSC conforms to the formula. If they cannot agree, or if some matter requires clarification, then the Act provides for referral to the SSRO for an opinion or determination.

15.4 The SSRO is charged with keeping under review the provision of Part 2 of the Act and the Regulations. As the application of the price formula is a key feature of the regulatory framework, the SSRO considers the reports it receives on QDCs and QSCs to keep under review whether the price formula is being applied. The SSRO will also take into account other information of which it is aware.

15.5 If the SSRO has any concerns as to whether the price formula has been correctly applied, it makes appropriate enquires, enabling the parties to clarify the situation or take any appropriate action. If action is required, the MOD may either agree an amendment with the contractor, or failing agreement refer the matter to the SSRO for determination.

15.6 The SSRO has made one determination and given two opinions since the scheme commenced in 2014. Overall this is considered by the SSRO to be a low rate of referral. During this period, the SSRO raised a number of queries with the MOD regarding the application of price control. These sorts of queries have not to date resulted in referrals to the SSRO.

15.7 The SSRO accepts that it may be difficult for the MOD to take action in cases where it has already agreed particular terms with the contractor. However, this creates the real possibility that contracting parties may agree a price in circumstances where that is not in compliance with the price formula and the MOD may subsequently pay that price.

15.8 Without limiting the potential approaches to this issue, the Act could be amended to provide an alternative means of enforcement. One option may be to authorise the SSRO to initiate determinations in relation to pricing issues if particular conditions are met. This would affect QDCs and QSCs, rather than proposed contracts.

15.9 Another option may be for the Act to provide the possibility for the parties to make a case to the SSRO for departing from the required price controls due to an inability to apply the price formula and evidence that the price nevertheless represents good value for money for the government and a fair and reasonable price for the contractor. This would need to be accompanied by an appropriate level of transparency, for example as part of the SSRO's annual compliance and review report.

15.10 A concern raised by stakeholders was that the SSRO's independence would be at risk if it identified a potential issue and then proceeded to determine it. In the SSRO's view, there is no reason why there should be any issue of pre-determination simply because the SSRO has initially identified a potential problem. Indeed, it is possible under the legislation as currently framed for an issue originally raised by the SSRO to be referred to it for determination.

15.11 Enhancing compliance with the price formula when agreeing QDCs and QSCs may be expected to support striking the correct balance between value for money and fair and reasonable prices. There may be costs associated with enforcement, but the SSRO has no evidence that these would be disproportionate having regard to the expected benefits.

15.12 The SSRO does not consider that the possibility of intervention by the SSRO should increase uncertainty for parties, nor that the SSRO should be required to become a party to all negotiations. There are a variety of reasons for this:

- the price controls are generally clear and straightforward to apply;
- it would only be in cases where there is genuine doubt as to the legislative requirements that there would be any risk of subsequent intervention;
- if there is genuine doubt as to the correct application of price control, then it would be possible to seek an opinion from the SSRO;
- the SSRO deals with opinion referrals in a maximum of 40 days, but it is also possible to finalise a contract but for the matter that is in doubt and seek a subsequent determination; and
- there would be an opportunity to make a case that there are reasons why the issue should not be considered as part of a determination.

15.13 The status quo is such that parties are within their rights to refer matters to the SSRO for an opinion before they enter into a contract. The SSRO is not considered party to the negotiations in these circumstances and this would remain the case.

# Stakeholder proposals for consultation

## 16. Introduction

16.1 The SSRO has received a number of suggestions from stakeholders for changes to the Act and Regulations. Some of these suggestions relate directly to the SSRO's own recommendations and have been addressed in the relevant sections of this consultation document. The other matters are recorded here for the purposes of enabling public comment.

16.2 Both industry representatives and officials at the MOD have proposed circumstances in which it may be appropriate to depart from the price formula when determining the price of a single source defence contract. This is a matter that goes to the heart of the regime established by the Act and the Regulations and, accordingly, the SSRO has given the matter detailed consideration in the following section.

16.3 The remaining proposals for change fall into three distinct categories:

- changes designed to clarify or otherwise improve the operation of the regime that the SSRO would be inclined to support;
- proposals that the SSRO would not be inclined to support without further evidence; and
- proposals where the perceived problem or solution is unclear and further clarification or evidence is required.

16.4 The SSRO has held a number of direct discussions with stakeholders to better understand their views and the various representations made. There may be some complexities to the operation of the scheme and the SSRO remains open to such further direct engagement with stakeholders as is necessary to ensure that issues are properly addressed.

16.5 Some respondents to the SSRO's calls for input felt that greater experience of using the single source procurement framework would be beneficial before significant changes are contemplated. The SSRO agrees that any existing issues should be overcome and areas of ambiguity clarified, but does not believe the scope of review should be artificially constrained. The SSRO's own recommendations deal with some matters of clarification but go further to the extent that there is a reasonable case for change.

## 17. Disapplication of the price formula

### Background

17.1 A number of respondents to the SSRO's call for input suggested that the Act should in some circumstances permit a price to be set by reference to:

- a supplier's published price list;
- comparable competitive purchases; or
- other market forces.

17.2 A case cited to the SSRO as a relevant example of where this would be appropriate is the purchase of software licences. It has been suggested that the price of such licences may be determined by reference to what consumers in the market are usually willing to pay, as evidenced by the existence of price lists for those services.

17.3 The current regime does not permit such matters, of themselves, to determine the price of an item within a contract or of a contract itself. If something is purchased for the purposes of a QDC or QSC, then under the current scheme it would need to be Allowable, satisfying the AAR test. If the purpose of a QDC or QSC is to purchase the price list item, then the contract price must conform to the price formula.

### Application of the AAR test

17.4 The SSRO has not been shown any evidence to suggest that the AAR test is inappropriate for application in a case where a contractor seeks to rely on some commercially established price. In the absence of such evidence, the SSRO's view is that the AAR test should continue to be applied. The price of something included in the contract must satisfy each element of the test, which requires the parties to be satisfied that it is reasonable to establish the price in a particular way.

### Application of price control

17.5 The SSRO takes a cautious approach to the proposal that contract prices should be fixed by reference to some commercially established price. The current legislative approach in the UK is to the effect that:

- competition is to be preferred, except in a limited set of circumstances permitted under the Defence and Security Public Contract (D&SPC) Regulations 2011; and
- in circumstances where a defence contract is single-sourced, the price should be determined by the price formula under the Act and transparency should apply.

17.6 The proposed alternative means of fixing a price (price lists, comparable competitive purchases and market forces) are suggestive of markets in which competition exists. If there is indeed a competitive market, then the choice to single source should be closely scrutinised.

17.7 Assuming the choice to single source is correctly made, the SSRO supports the approach taken by the Defence Reform Act 2014 to striking a balance between value for money for the government and fair and reasonable prices for contractors. This is on the basis that:

- it is sound to permit only Allowable costs in a contract;
- profits should be controlled and the SSRO's methodology strikes the right balance by assessing a baseline from what industry has achieved when engaged in comparable activities; and
- the transparency requirements are intended to give the government sufficient information to judge what amounts to value for money and a fair price.

17.8 In the circumstances, it is the SSRO's view that the price formula should be applied to single source defence contracts unless there is some good reason why it cannot or should not be applied.

17.9 A scenario in which it may be submitted that the price formula cannot be applied is where the supplier is unwilling to submit to price control. In the SSRO's view, such claims present a significant risk to the regime due to:

- the considerable potential for such claims to be made, as suppliers seek to recover more costs and higher profits;
- difficulty in differentiating a genuinely unyielding position from a supplier's negotiating position, with significant information required about the market; and
- weakening the position of the MOD in negotiations by opening the door to debate as to application of the regime.

17.10 In this regard the SSRO notes that one of the stated policy objectives behind the Act was to ensure widespread coverage of the framework across single source suppliers.[7]

17.11 Assuming that a sound basis could be established for disapplying the price control imposed by the Act, it is by no means clear that value for money and a fair and reasonable price can be established by reference to means such as price lists. For example, the fact that a supplier has a price list does not necessarily mean that it only sells at that price, nor that the price has been constructed based on reasonable costs or a fair profit rate. Fundamental to this problem is obtaining sufficient information to establish that the price will meet the aims of the Act.

17.12 The SSRO understands that in a small number of cases where the price formula has been considered the MOD has sought and secured the Secretary of State's agreement to exempt the subject contract from the single source regime. There is no transparency in relation to such exemptions. In particular:

- the Act does not specify the considerations to be taken into account before an exemption is granted;
- there is no requirement to publish the grant of an exemption or the basis on which it has been determined; and
- exempted contracts have no reporting requirements, preventing scrutiny by the SSRO and reducing the level of transparency within the regime.

7 Ministry of Defence, *Better Defence Acquisition*, Cm 8626, June 2013, paragraph 72.

17.13 The present lack of transparency makes it difficult for the SSRO to assess proposals for change in this area, as the SSRO has not scrutinised the cases referred to by respondents to our call for input. The reasons why such contracts have not been subject to competition are unclear and the SSRO does not know what evidence has been provided to demonstrate that the contract price represents a fair return for the contractor and value for money for the taxpayer.

17.14 The SSRO considers that dis-application of the requirements of the Act should be exceptional but that it may be preferable to impose greater structure and scrutiny on such exemptions. Proposals that prices may be fixed by alternative means such as price lists should be exposed to scrutiny by the SSRO.

### Response to the proposal

17.15 The SSRO considers that disapplication of the pricing formula in a QDC or QSC could be permitted in cases where it can be demonstrated to the SSRO that:

- competition is genuinely unavailable;
- a reasonable justification can be established for departing from the profit formula; and
- the price strikes the correct balance between value for money for government and a fair and reasonable price for the contractor.

17.16 A referral should be required to the SSRO for a determination as to whether the circumstances for disapplication are made out. Where the pricing formula is disapplied, reporting requirements should be modified to reflect the fact that the breakdown of costs and the calculation of the contract profit rate will not be available.

**Possible amendment:**

Section 15 of the Act and Regulation 10 could be amended to indicate that the pricing formula may be disapplied in cases where the SSRO has determined following a referral that: competition is genuinely unavailable; a reasonable justification can be established for departing from the profit formula; and it can be demonstrated that the price strikes the correct balance between value for money for government and a fair and reasonable price for the contractor.

In that event, Regulation 22 should also be amended to indicate which of the reporting requirements will apply to QDCs or QSCs when the pricing formula has been disapplied.

### Justification

17.17 The SSRO understands that the number of cases to which this issue applies is small. It is generally undesirable to exempt from the regime contracts that would otherwise be QDCs or QSCs due to the inability of the MOD and contractor to agree a contract price derived using the pricing formula. The proposed approach is designed to apply an appropriate level of scrutiny to these cases and ensure that disapplication of the pricing formula is only granted in appropriate cases where it can be established that the aims of value for money and fair and reasonable prices will still be met. It would also ensure that an appropriate level of reporting is applied to such contracts.

### Benefits and impacts

17.18 If adopted, the recommendation would result in greater transparency in respect of single source contracts which are currently being exempted from the regime.

17.19 There will be additional costs associated with the proposed referral mechanism. However, if it is an appropriate case for application of an alternative pricing method, the information required for referral should be available for consideration in any event.

## 18. Stakeholder proposals supported by the SSRO

18.1 Some changes have been proposed by stakeholders that are designed to clarify or otherwise improve the operation of the regime. The SSRO would be inclined to support these changes, subject to any further views or evidence that may be submitted as part of this consultation.

### Time limit for determination under section 35(1)(b)

18.2 The Act permits the contracting parties to seek a determination from the SSRO on prescribed grounds. Regulation 52 specifies that the defined pricing structure (DPS) and output metrics are matters that may be referred for such a determination, but the referral must be made no later than six months after the QDC is entered into.

18.3 There may be a problem with this approach if there is a need to change the DPS or the output metrics more than six months after entry into the QDC. This could be required in the event of a substantial contract amendment. In that event, there is potential for the parties to disagree as to the changes and there does not seem to be a good reason why the SSRO should not be called upon to make a determination.

18.4 The DPS and the output metrics are specified in the contract reporting plan, which is required to be submitted within 30 days of the initial reporting date. In the event of a substantial amendment, the MOD may require the information described in a contract reporting plan to be updated in an on-demand contract report.

| **Possible amendment:** |
| --- |
| Regulation 52(2) could be amended to measure the six months from the “time of agreement” of a QDC, as defined in regulation 2, rather than the date of entry into the QDC. |

### Reference to reports

18.5 Regulation 2(2) specifies that a reference to a report under Part 5 of the Regulations includes a reference to a contract pricing statement, a contract reporting plan, a contract costs statement and information provided in an on-demand contract report. This is intended to ensure that provisions applying to Part 5 reports will also include differently described reports. Regulation 22 is an example of where this may be relevant, as it specifies the things that every report under Part 5 must contain.

18.6 There is no similar provision in respect of Part 6 of the Regulations, even though that Part contains the estimated rates agreement pricing statement (i.e. a report that does not have "report" in its name). This results in an inconsistency in the treatment of Part 5 and Part 6, which may be a simple oversight but leaves potential for an argument that the references to Part 6 reports does not include the estimated rates agreement pricing statement.

**Possible amendment:**

Regulation 2 could be amended by adding a new paragraph to specify that reference to a report under Part 6 of the Regulations includes a reference to an estimated rates agreement pricing statement.

### Application of final price adjustment

18.7 The regulatory framework provides for final price adjustment in contracts where:

- the price payable under the contract or a defined component of the contract has been determined by the firm, fixed or volume-driven pricing methods; and
- the total value of that contract or component is of or above the determined amount.

18.8 The final price adjustment is intended to share the pain or gain between the MOD and the contractor in cases where the actual costs differ from the estimated costs and thus the profit achieved by the contractor would be more or less than anticipated. In these circumstances, the trigger in Regulation 16 which depends on the value exceeding the determined amount seems unusual, but this has not been the subject of representations.

18.9 Regulation 17 provides for final price adjustment by reference to the total outturn costs and outturn profit and not by reference to the outturn costs or profit of a defined component of the contract. If a defined component of a contract is determined by firm, fixed or volume-driven pricing and the rest of the contract is priced by a different pricing method, then:

- it would seem inappropriate to take into account costs that were never based on estimates and thus never carried risk that actual costs would deviate from estimated costs; and
- different results will be arrived at depending on whether the final price adjustment is applied to the whole contract or the defined component, with final price adjustment being less likely if the calculation is applied to the whole contract.

18.10 In such cases it is more likely to be consistent with striking the correct balance between good value for money for the government and fair and reasonable prices for contractors if the final price adjustment calculation is applied only to the defined component that is priced by firm, fixed or volume-driven pricing.

**Possible amendment:**

Regulation 17 could be amended to specify that where only a defined component or components of the contract has or have been determined by the firm, fixed or volume-driven pricing methods, the calculation should be applied to that component or components.

### SSRO's power when determining the extent to which a QSC cost is Allowable

18.11 Where the SSRO determines the appropriate amount of a contract profit rate adjustment for a QSC, regulation 65(9)(b) modifies the SSRO's consequential power so that the SSRO may determine that a payment of a specified amount must be made to or by the Secretary of State. The effect of this is to require an adjustment payment to be made directly between the Secretary of State and the sub-contractor, rather than requiring the QSC to be varied, with consequent impact on another qualifying contract or contracts.

18.12 There is no similar provision made in respect of cases where the SSRO determines the extent to which a cost in a QSC is Allowable under section 20(5) of the Act. In such a case the SSRO may determine under section 20(6) that the price payable under the contract is to be adjusted by specified amount. It may be preferable, however, for such cases to be treated in the same way as adjustments to the contract profit rate of a QSC, with an adjustment payment made directly between the MOD and the sub-contractor.

**Possible amendment:**

Regulation 64 could be amended by adding a paragraph to specify that section 20(6) has effect as if instead of determining that the price payable under the contract is to be adjusted by a specified amount, a payment of a specified amount must be made to or by the Secretary of State.

### Cost allocation statement

18.13 The actual and estimated rates claim reports in regulations 34 and 36 do not clearly require a statement of the contractor's cost allocation system, setting out how costs are allocated between direct and indirect costs and how costs are apportioned between direct and indirect costs. This is information that the MOD may obtain via its Questionnaire on the Method and Allocation of Costs (QMAC), but this is not a statutory requirement and lacks a clear deadline.

18.14 The SSRO would support inclusion of the method and allocation of costs in the actual and estimated rates claim reports. This would remove any uncertainty regarding the timing of submission and would also make the information available to the SSRO, supporting its ability to carry out relevant analysis.

**Possible amendment:**

Amend regulations 34 and 36 to include a requirement to set out the contractor's methods of cost allocation, apportionment and recovery.

## 19. Stakeholder proposals not presently supported by the SSRO

19.1 There are some proposals for change put forward by stakeholders that appear to the SSRO to be either unnecessary or potentially contrary to efficient functioning of the regime. In these cases, the SSRO would be inclined to recommend against any change, unless some compelling further submission or evidence is presented.

### Contract Pricing Statement (CPS) requirement where the pricing method is based on actual costs

19.2 A proposal was put forward to the effect that a contract pricing statement may be difficult to complete in cases where the contract price is not based on estimated costs but rather on actual costs ascertained at a later date. It has been suggested that the contract pricing statement might not be required until a later date in such circumstances.

19.3 This proposal ignores the fact that the contract price may still be estimated even if the price will ultimately depend on actual costs. This is, in effect, what happens when a limit is placed on liability. In the SSRO's experience, contractors have been able to submit contract pricing statements in cases where part of the contract is priced on a cost-plus basis. In the circumstances the case for change is not compelling and, as it would result in a significant decrease in transparency, has not been supported.

### Negative incentive adjustment

19.4 It was suggested that step five of the process for determining a contract profit rate might be amended to permit the profit rate to be decreased as a negative financial incentive for the contractor to perform specified provisions of the contract. The basis on which such a provision is considered necessary is unclear, as there does not appear to be anything in the requirements for pricing of contracts that would prevent contractual provisions for damages in relation to delay or contract breach. The SSRO would not support legislative change if the matter may already be addressed contractually.

### Incentive adjustments in QSCs

19.5 A concern was raised that the contracting parties may agree incentive adjustments in QSCs without consent from the Secretary of State. The SSRO notes that it is permissible for the contracting authority and sub-contractor to agree an incentive adjustment under step 5 when the determining the contract profit rate on a QSC. However, the QSC price will then be a cost under the contract to which it is a sub-contract (whether a QSC or QDC) and must satisfy the AAR test. If the MOD considers that payment of an incentive adjustment is not warranted then it may conclude that the QSC price is not wholly Allowable. If this question is disputed, it may be referred to the SSRO for determination. On the basis that there is already a means of dealing with the issue, the SSRO would not support legislative change.

### Clarification of "defence contract"

19.6 A proposal was made to amend the definition of "defence contract" in regulation 32(6)(a) to limit it to extant contracts. It is unclear how this would be beneficial. The term is used in Part 6 of the Regulations to specify reporting requirements. For example, the SME report is required to specify the total revenue received from defence contracts in a relevant financial year. A reference to the defence contracts being extant would not appear to add anything and may cause confusion.

### Restrictions on record-keeping

19.7 Some stakeholders submitted that the requirement to keep records should be limited to such records as would be available in normal accounting and financial data systems. This seems unduly restrictive in circumstances where the purposes for which records must be kept include matters such as performance monitoring and determining whether a contract is a QSC. Taking into account the purposes for which records are kept, the present inclusion of "other records" in the definition of "relevant records" in section 23(2) of the Act seems appropriate.

19.8 A further proposed restriction is that the duty to keep records should reflect each contractor's reporting cycle and the need for internal audit and reconciliation. This seems unnecessary, as the definition of relevant records is already suitably restricted to records:

- that a person may reasonably be expected to keep; and
- that are sufficiently up-to-date and accurate.

19.9 There is thus an objective test of what a contractor is expected to keep, based on reasonableness and sufficiency. This seems adequate and appropriate for regulatory purposes.

## 20. Stakeholder proposals where additional explanation or evidence is required

20.1 There are some proposals put forward by stakeholders where the perceived problem or solution is sufficiently unclear that the SSRO would need further explanation or evidence before making a decision on whether to support the change. Stakeholders have asked the SSRO to consult in respect of some of these proposals and these are described in Figure 10 below. The remaining proposals are described in Figure 11. Respondents to the consultation are invited to provide material if they choose in support of the case for change.

**Figure 10: Proposals on which the SSRO has been asked to consult**

| Stakeholder proposal | Initial comments by the SSRO |
|---|---|
| (1) A contract should be able to have more than one profit rate, with different rates being applied to defined components of the contract. | It is not clear to the SSRO in what circumstances this is considered necessary. If the defined components have different risks it is nevertheless possible to arrive at a single cost risk adjustment. To the extent that there is an issue with pricing amendments this is dealt with separately. |
| (2) Where contracts are amended in a way that affects the price only the amendment should be re-priced. | The SSRO's initial response is set out below. |
| (3) There may be merit in changing the legislation to support multiple baseline profit rates, providing different rates can be applied to different parts of the contract, or blended rates may be used. | The SSRO considers that multiple baseline profit rates are already permitted by the legislation, but remains open to exploring ways in which multiple baseline profit rates may be supported. |

## Re-pricing contract amendments

20.2 The Regulations provide for re-determination of the price of a QDC or a QSC in the event that the contract is amended in a way that would affect the price (Regulation 14). The re-determination is required to be made in accordance with the price formula. As a result of the SSRO's first call for input, some respondents contended that the entire contract price should not be re-determined in the event of a contract amendment.

20.3 Re-determining the price requires calculating the contract profit rate, which begins by taking the baseline profit rate at the time of agreement. The "time of agreement" is a defined term in the Regulations and, in the event of a re-determination, means the time of the re-determination (Regulation 2(1)). Given that the baseline profit rate is determined annually by the Secretary of State, there is the possibility that a re-determined contract profit rate may be different from the rate determined when the contract was entered into, or when the price was last re-determined.

20.4 There is an important qualification to the requirement that the contract price be re-determined in the event of a pricing amendment. If the costs of the amendment are severable from the pre-amendment contract costs, then the price of the amendment may be determined separately and simply added to the pre-amendment contract price.

20.5 The Regulations do not provide guidance as to when costs of an amendment may be severable from pre-amendment costs. It would seem reasonable, however, that if the amendment involves the provision of goods, works or services not priced in the pre-amendment contract, then the costs would be severable. By contrast, if costs already priced in the pre-amendment contract are to be amended, then it may be considered that the costs are not relevantly severable and the whole price needs to be re-determined.

20.6 The SSRO accepts that the obligation to re-price the contract where non-severable pricing amendments are made may result in a changed profit rate that benefits one of the parties in a significant way and correspondingly disadvantages the other party. However, the responses to the SSRO's call for input have not provided evidence of cases where such amendments have been required which the SSRO can use to analyse the need for and prevalence of such amendments and whether re-determination of the whole contract price was appropriate or not. The SSRO notes in this context that the legislative scheme currently provides a variety of means for dealing with difficulties in estimating costs, namely that:

- the fixed and volume-driven pricing methods permit estimated costs to be adjusted by reference to indices and rates;
- the cost-plus and estimate based fee pricing methods use actual costs;
- the target pricing method enables sharing of pain and gain where actual costs differ from estimates;
- estimating risks may be included in the Allowable costs; and
- a cost risk adjustment may be made in appropriate cases to reflect the risk of actual Allowable costs differing from estimates.

20.7 In the circumstances the SSRO has not proposed a recommendation to amend the current provisions regarding re-determination of the contract price. If evidence is provided of non-severable pricing amendments made under the regime, the SSRO will further consider the matter.

**Figure 11: Other proposals requiring additional explanation or evidence**

| Stakeholder proposal | Initial comments by the SSRO |
|---|---|
| (1) The term "contract value" may benefit from clarification for reporting purposes. | The precise nature of the perceived problem has not been specified. |
| (2) In circumstances where the SSRO provides the results of analysis to the Secretary of State under section 36(3)(b) of the Act, it should also provide the results to industry. | The SSRO has transparency as one of its core values and prefers to publish its analysis for access by all. Details need to be considered as to how the proposal would be implemented and whether there may be appropriate exemptions. |
| (3) The definition of "relevant record" should require the keeping of data rather than records. | It is unclear why a distinction is being made between records and data or why the former is considered insufficiently broad. |
| (4) The words "concerning" or "directly concerning" should be used in place of "relating". | The word relating appears nine times in Part 2 of the Act, once in Schedule 4, twice in Schedule 5 and 19 times in the Regulations. It is not clear what the perceived issue is with use of the word on each occasion or what improvement is sought to be made by replacing it as proposed. |
| (5) Section 23(6) of the Act should be amended to remove the SSRO's discretion as to whether to carry out a review of the way in which the MOD has acted when examining records. | It is unclear why this is necessary. There is no instance of the SSRO inappropriately declining to accept a referral. The proposal assumes there would be no circumstances in which it would be inappropriate to deal with a referral. |
| (6) Provision should be made for the contractor to be compensated in the event the SSRO finds in its favour following a review under section 23 of the Act. | Further consideration needs to be given to what costs may be claimed, whether there are alternative means of recovery available and the procedure which is proposed in this instance. |
| (7) The duty to notify in Section 26 of the Act should be amended to: impose a reciprocal duty on the MOD to disclose relevant information to the contractor; delete 26(3)(b), which indicates that a material effect on the contractor's costs has a material effect on the contract; and define what is considered material. | The problems that are sought to be addressed need to be described and consideration given to the implications of making the suggested changes. |
| (8) The word "substantially" should be deleted from regulation 56(2)(b) so that Schedule 5 will apply to information obtained by the Secretary of State by examining records (and thus disclosure may be a criminal offence) if its disclosure would be likely to prejudice the commercial interests of a person, rather than substantially prejudice such interests. | Care needs to be taken before extending the circumstances in which criminal liability may apply. The perceived problem needs further explanation and the implications of the change need to be better understood. |

| Stakeholder proposal | Initial comments by the SSRO |
|---|---|
| (9) Article 5 of Schedule 5 to the Act specifies circumstances in which information to which the Schedule applies may be disclosed without criminal liability. There are 12 categories of permitted disclosure specified in Article 5. Some stakeholders proposed that recipients of disclosed material should be subject to a criminal offence if they further disclose the material. | It is unclear in what circumstances an onward disclosure may be made where it would be appropriate for a criminal offence to apply. The SSRO is concerned that the proposal does not take account of the current interaction between the offence provision in Article 2(1) and the disclosure permitted by Article 5(1). There seems real potential for serious unintended consequences. |
| (10) The benefits should be explored of increasing the percentage adjustment permitted at step five of the contract profit rate calculation. | The SSRO is interested in receiving reasons and evidence in relation to this proposal. |