SSRO

Single Source
Regulations Office

Assuring value, building confidence

SSRO Opinion

Opinion on Allowable Costs arising from work undertaken at risk

1. Introduction

1.1 The Single Source Regulations Office (the SSRO) was jointly referred a request by the MOD and a contractor for an opinion in respect of a proposed Qualifying Defence Contract (QDC). The referral sought the SSRO's opinion on whether work undertaken at risk, ahead of the agreement of the contract through negotiation, may in principle represent *Allowable Costs* under the contract once it is in place. The referral was made under Section 35(3) of the Defence Reform Act 2014 (the Act). A joint referral permits the SSRO to give an opinion on any matter relating to a proposed QDC (section 35(3)(b) of the Act).

1.2 Following receipt of the request for an opinion, the SSRO formally accepted the referral, having conducted due diligence in line with its guidance[1].

1.3 The SSRO appointed a Referrals Committee, a sub-committee of the SSRO Board, comprising two non-executive members of the Board and an independent member who is not a member or employee of the SSRO, to consider the referral. The SSRO has reviewed written submissions from both the MOD and the contractor.

1.4 The SSRO's general obligation under Section 13 of the Act is to aim to ensure that good value for money is obtained in government expenditure on qualifying defence contracts (QDCs) and that persons (other than the Secretary of State) who are parties to QDCs are paid a fair and reasonable price under those contracts.

1 Guidance on the SSRO's referrals procedures for opinions under the Defence Reform Act 2014 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/510493/Referrals_opinions_guidance_February_2016_v2.pdf

2. Opinion overview

2.1 In accordance with the procedure published in the SSRO's referrals guidance, this document provides an anonymised summary of the SSRO's opinion. Recognising the commercial sensitivity for the parties, this summary provides an overview of the key principles which emerge from the opinion, rather than providing details of either the opinion or the parties involved.

2.2 The SSRO was asked for its opinion on:

"If work undertaken at risk, ahead of the agreement of the contract through negotiation, may in principle represent allowable costs under the contract once it is in place?"

Opinion scope and assumptions

2.3 In accepting the referral, the SSRO noted that:

- the MOD and the contractor are not in dispute over the issue; and
- in commencing work prior to agreement of the contract, the contractor accepts there is a risk that costs incurred may be assessed or determined as not AAR should a contract be signed.

2.4 With regard to the scope of the referral, the SSRO has proceeded on the basis that the contractual relationship for payments between the contractor and any sub-contractors in respect of pre-contract works is outside the scope of this referral.

2.5 In answering the referral question, the SSRO has made the following key assumptions:

- there are no contractual obligations between the MOD and the contractor in respect of the work covered by the referral question; and
- the MOD has not requested or instructed the contractor to undertake work prior to a contract being entered into.

The Opinion

2.6 The SSRO is of the opinion, in light of the circumstances of this referral, the limitations on scope and assumptions made at respectively paragraphs 2.4 and 2.5 and considerations set out below, that costs incurred at risk prior to entering into the contract may be *Allowable* once the contract is in place.

2.7 The SSRO's opinion is subject to the pre-contract at risk costs meeting the requirements of the regulatory framework before they are included in the price of the proposed QDC. The SSRO's opinion that pre-contract costs at risk may be *Allowable* is therefore subject to whether such costs are considered by the MOD and the contractor (or by the SSRO by way of determination) on or after entering into the contract, as meeting the AAR test, having regard to the SSRO's *Single Source Cost Standards*.

2.8 The SSRO notes that, in relation to the proposed QDC in this case, the lack of a specification prevents an assessment or determination at this stage of whether particular costs are or will be AAR.

2.9 If a QDC or QSC is subsequently entered into, the MOD and the contractor will need to review the pre-contract costs incurred at risk against contractual obligations in order to, amongst other things, but in particular, decide whether the costs can be classified as necessary to fulfil the requirements of the contract (see paragraph 2.14).

2.10 In forming this opinion, the SSRO has had regard to the following key considerations:

- evidence submitted by the parties;
- relevant legislation; and
- relevant guidance, including the Single Source Cost Standards.

Parties' evidence

2.11 The SSRO notes the parties' views on whether pre-contract at risk costs may be *Allowable* reflect that the AAR test must be satisfied and the parties must have regard to the principles set out in the *Single Source Cost Standards* in order for costs to be *Allowable*.

Relevant legislation

2.12 The relevant legislation for the purposes of this opinion, in addition to the general obligation in section 13 of the Act, includes the following:

i) Section 20(2) of the Act specifies that in determining whether a particular cost is an *Allowable Cost* under a QDC, the Secretary of State (or an authorised person) and the primary contractor must be satisfied that the cost meets the AAR test, which requires that the costs must be:

a. "appropriate;

b. attributable to the contract; and

c. reasonable in the circumstances".[2]

In the SSRO's opinion, there is nothing in section 20(2) which prohibits costs incurred at risk being *Allowable Costs*, provided that the AAR test is met. In particular, this provision does not, on the face of it, prohibit costs from being considered Attributable to a contract, just because they were incurred prior to the date of entering into the QDC or QSC. There is nothing inherent in whether the cost is "attributable to the contract" which excludes costs that are pre-contract and at risk.

ii) Section 15 and regulation 10(1) provide the formula whereby contracts are to be priced (one element of which is *Allowable Costs*) to be determined under and further to section 20, and in accordance with one of the six pricing methods set out in that regulation. Under regulation 10(4) to (11) depending on the pricing method used, an *Allowable Cost* may be as estimated at the time of agreement, or the estimated amount subsequently adjusted according to specified indices or rates, or actual costs as determined during or after the contract completion date. The distinctions made in this regard do not, in the SSRO's opinion, limit the date upon which a cost may be incurred in order for it to be considered an Allowable Cost once the contract is in place. In this regard see paragraph 6.4 of the *Single Source Cost Standards* and paragraph 2.15 below.

2 Defence Reform Act 2014 Section 20(2)

Relevant guidance

2.13 Section 20(1) of the Act provides the power under which the SSRO issues guidance about determining whether costs are *Allowable* under a QDC. Section 20(3) provides that, in deciding whether a particular cost meets the AAR test, the Secretary of State (or an authorised person) and the primary contractor must have regard to the guidance (the *Single Source Cost Standards*).

2.14 The SSRO draws attention to the whole of the *Single Source Cost Standards* insofar as relevant but in particular to the following principles as to whether costs incurred at risk are AAR to a contract when a contract is entered into.

AAR criteria	Cost requirement for QDC
Appropriate	Appropriate: "Whether a cost might be expected to be incurred in the delivery of the qualifying defence contract"
Attributable	Attributable to the Contract: "A cost is Attributable if it is incurred directly or indirectly for the fulfilment of the qualifying defence contract or qualifying sub-contract in question and it is necessary to fulfil the requirements of that contract". In order to assess whether a cost is Attributable, consideration should include: "Whether the cost has a causal relationship with the contract, in the sense of being required for its delivery". "Whether the cost is incurred in fulfilling the requirements of the qualifying defence contract".
Reasonable	Reasonable in the circumstances: "Whether it is congruent with meeting the contract requirements".

2.15 The *Single Source Cost Standards*, at paragraph 6.4, specifically state that:

"This guidance applies to both estimated and actual costs. Those costs that are incurred in advance of a contract becoming a qualifying defence contract or qualifying sub-contract may also be subject to the regime and this guidance[3]."

2.16 Also relevant, by way of analogy, are paragraphs 9.28 and 9.29 of the *Single Source Cost Standards*. These paragraphs provide that bid costs, which by definition have to be incurred pre-contract and at risk, may be *Allowable* if properly evidenced.

2.17 It is relevant to note that the SSRO considered a question in its SSRO Answers[4] publication and the SSRO's May 2016 Newsletter[5], which addressed a related point.

"Where an Intention to Proceed (ITP) falls under the Act and Regulations, how should costs incurred "at risk" be treated once the main contract is signed?"

3 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/555277/Allowable_Costs_guidance_1_July_2016_-_Final_WEB2.pdf paragraph 6.4

4 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/541501/SSRO_Answers_28_July_2016.pdf. Paragraph 4.13

5 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/521524/Newsletter_May_2016_final_for_web.pdf

2.18 The SSRO Answer concluded that "Work undertaken pursuant to an ITP may be genuinely at risk and not strictly subject to the single source regulatory framework at the time when it is carried out" and that "it is possible for costs to still be "attributable" to a main contract even though they were incurred during an ITP".

2.19 It should be noted that SSRO Answers are not binding[6].

Status of the Opinion

2.20 Opinions, unlike determinations, under section 20(5) of the Act and in relation to a particular cost, are not binding. Paragraph 4.4 of the SSRO Guidance on the SSRO's referral procedures for opinions under the Defence Reform Act 2014 provides that:

"the purpose of opinions issued by the SSRO is to inform and advise and, in this regard, they are not legally binding".

2.21 The SSRO would however expect, were it to be called upon to give an opinion or make a determination at a future date, to both take a relevant opinion into account and to be likely to decide in accordance with that opinion, subject to there being any change in circumstances either in relation to a proposed or actual QDC or QSC or arising from the application of the general obligation in section 13 of the Act.

2.22 The parties may refer further questions to the SSRO in this matter for opinion or determination. Such referrals may raise questions as to the Allowability of costs under the contract, including costs incurred pre-contract and at risk.

6 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/557176/SSRO_Answers_30_September_2016.pdf See disclaimer