SSRO

Single Source
Regulations Office

Assuring value, building confidence

Summary of call for input responses

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

30 January 2017

Contents

Summary of responses to SSRO's call for input

1. Introduction

1.1 The SSRO's Consultation on Recommendations sets out its approach to stakeholder engagement for the purposes of formulating recommendations for review of Part 2 of the Defence Reform Act 2014 and the Single Source Contract Regulations 2014. This involved calling for input from interested persons over two eight week periods from May to July 2016 and from September to November 2016 and subsequent dialogue with stakeholders. A summary of the comments received is set out in this document.

2. First call for input

2.1 The first call for input covered most elements of the regulatory framework, but left detailed consideration of transparency to the second call for input. The SSRO expressed some initial views for the purposes of assisting participation by stakeholders, but also invited general input from stakeholders on any matters that they considered relevant.

Contract amendments

2.2 The SSRO called for input from stakeholders regarding the treatment of contract amendments. Stakeholders were not in favour of removing the requirement for mutual agreement. There was a view that the original bargain made by the parties needed to be preserved. There was also a concern expressed about retrospective application of the regulatory provisions of the Act and the Regulations.

2.3 There was general support from stakeholders to clarify the treatment of sunk costs. Some respondents thought that it would need to be made clear what is meant by sunk costs and it was proposed that these should include committed costs. A view was also expressed that dealing with the issue required preserving the profit and pricing methodology that applied prior to amendment. The view was also expressed that there should be no requirement to report sunk costs.

2.4 Respondents to the call for input provided some additional views about contractual amendments. Some respondents suggested that consideration be given to defining when a contractual amendment is material, in the same way as is done in the Public Contract Regulations 2015. A number of respondents stated that the whole contract price should not be required to be re-determined when a contract is amended.

2.5 The SSRO called for input from stakeholders as to whether it should be clarified that material contract amendments trigger the requirement to assess whether a contract is a QSC. Some stakeholders considered that removing the need for mutual consent of the parties would make the legislation apply retrospectively and one stakeholder considered that the legislation would therefore be unconstitutional. Some industry respondents considered that material contract amendments should not trigger the requirement to assess whether a contract is a QSC. One industry respondent suggested that the SSRO should examine explanations as to why existing contracts cannot comply with QSC requirements to determine if there are good reasons or not.

QSC definition

2.6 A number of industry respondents supported improvement and clarification regarding the definition and treatment of QSCs. One respondent suggested that there should be a complete restatement of the statutory provisions as they apply to QSCs to avoid uncertainty and confusion.

2.7 The SSRO sought views on whether the legislation should be amended to make clear that a contract may still satisfy the QSC definition if it relates to a proposed QDC. Two respondents agreed that any ambiguity or inadequacy connected with the timing of entry into a sub-contract should be addressed. One respondent submitted that the timing issue is too difficult to legislate for and will require assessment on a case-by-case basis.

2.8 Some respondents considered that the QSC definition is too broad and should be limited. It was proposed that QSCs should be limited to contracts solely for the provision of goods, works or services directly allocated to the performance of QDCs or QSCs. It was also suggested by some that there is difficulty in reconciling the requirement that 50 per cent by value of the obligations of the contract should be to enable the performance of a QDC or QSC with the requirement that the contract involve the provision of anything for the purposes of a QDC or QSC. One respondent stated that fungible and stock items should not be caught by the framework.

Access to QSC assessments

2.9 The SSRO invited views on whether it should have power to require QSC assessments to be provided. Two respondents considered it is important that the SSRO has access to the information it needs to fulfil its statutory role. Of these, one supported some proportionate access but not a blanket requirement for the SSRO to access every QSC assessment. One respondent supported the disclosure of positive QSC assessments to the SSRO. Several industry respondents stated that the SSRO should not be given the power to require provision of any QSC assessment, for a variety of reasons such as that it undermines independence, is unnecessary and duplicates the MOD's role.

QSC thresholds

2.10 In response to a call for input regarding the level at which the value threshold for a QSC is cur-rently set (£25 million), the MOD indicated that it did not support removal of the threshold but felt there was merit in exploring different thresholds.[1]

2.11 A number of respondents expressed the view that removal of QSC thresholds could disproportionately impact SMEs with greater costs as they would not have the scale to absorb additional reporting requirements in a cost effective manner. Some respondents felt that the QSC threshold should be increased to balance the cost of compliance with the ability to seek efficiencies and savings from larger contracts. It was suggested the threshold could mirror the value definition of an SME, which requires that annual turnover does not exceed 50 million euro and/or an annual balance sheet total not exceeding 43 million euro.

2.12 One respondent submitted that there could be an option to allow the regulatory framework to apply below the current threshold by agreement between the MOD and the contractor, with limited reporting requirements.

1 The MOD specified that its input is made at the level of officials and that views may develop as the consultation progresses.

Exclusions

2.13 Several respondents considered that clarification may be of assistance regarding the application of the exclusions from the QDC and QSC definitions. One respondent cautioned that any further description or amendment should not be too prescriptive.

2.14 In respect of the specific exclusion for government to government contracts, there was a diversity of views. Some respondents stated that FMS should not be permitted to subvert the Act or create competitive advantages. One respondent proposed that all purchases should be subject to the same regulation. There was also a view that including such agreements under the framework may be attractive in principle as it would increase the application of the regulations, but that it would not work in practice. A concern was raised as to unintended consequences of such approach.

2.15 By contrast some respondents submitted that government to government contracts should stay outside of the regime. One respondent stated that FMS are already regulated and another respondent considered that no further definition is required.

The pricing formula

2.16 There was no clear view on whether any different approach would be preferable to the current pricing formula. Some respondents took the view that the cost plus formula is appropriate, while some others thought it was premature to consider alternative approaches at this time. One respondent welcomed suggestions regarding different approaches and one thought that the process needs to be more adaptable.

2.17 A number of individual views were expressed related to the application of price control. One respondent asked for clarification around target cost incentive fee contracts and innovative gain-share methodologies. Some respondents considered that the SSRO should change its methodology for determining the baseline profit rate, for example by changing the comparator groups. One respondent sought greater clarity on when costs are Allowable in a QDC or QSC.

Six steps for determining the contract profit rate

2.18 One respondent considered that the process needed to be more adaptable to ensure a value for money solution. Another respondent stated that there may be merit in allowing greater flexibility in the six steps. The MOD proposed that a negative incentive adjustment might be introduced.

2.19 A respondent submitted that in some circumstances it should be permitted to establish the contract price by reference to price lists, comparable competitive purchases or other market forces. In such cases it was suggested that the usual price control should be dis-applied.

2.20 A number of respondents submitted that the cost risk adjustment needs greater development, clarification or guidance. Some respondents thought there may be merit in pricing according to both activity and risk. One respondent sought clarification in relation to application of the step 4 POCO adjustment.

Blended rates

2.21 The SSRO sought particular input on whether the legislation should be amended to clearly permit blended contract profit rates. Several respondents thought that it should be possible to apply price control to parts of contracts.

2.22 The representations regarding blending were connected to the SSRO's methodology of having multiple baseline profit rates. A number of respondents cautioned that complexity would arise from the combination of six pricing methods, six steps for determining the contract profit rate and multiple baseline profit rates, which would need to be compared carefully with the benefits obtained. One respondent provided qualified support for blended rates but considered that the appropriate rate should be contingent on contract outputs rather than inputs and felt that such rates may be difficult to apply in practice, potentially not recognising risk ownership and end-to-end management. One respondent stated that multiple rates are not supported by the legislation and would add complexity and disproportionate delay. Another respondent supported blending only in respect of zero and infrastructure rates.

Capital servicing

2.23 The SSRO called for input regarding step 6 (capital servicing adjustment), whether it should remain part of the process for determining the contract profit rate and, if so, how it should be applied. The MOD thought that the issue is worth exploring but practicalities need to be addressed. A number of industry respondents considered that step 6 should remain, while some were of the view that greater experience is required before considering eliminating the CSA. Some industry respondents specified that the capital servicing adjustment should remain in its current form.

SSRO funding adjustment

2.24 The SSRO sought views regarding the SSRO funding adjustment, in particular the option of dis-applying step 4 and introducing a levy. Some industry respondents indicated that a levy might be supported but sought greater clarification. One respondent stated that if a levy is introduced it should be based on contractor size and that the operation of dual systems (adjustment and levy) should be avoided.

2.25 A number of respondents did not support a levy and some considered that the MOD should pay for the SSRO. Two respondents stated that a levy-based approach would disadvantage SMEs and smaller companies. One respondent considered that top-slicing profit is simple, predictable and even-handed.

Aims of the Defence Reform Act

2.26 The SSRO sought views as to whether the aims of value for money and fair pricing should be stand-alone aims under Part 2 of the Act. One industry respondent considered the two objectives should be given equal weight and wider application. A number of other industry respondents felt that it is unnecessary for value for money and fair pricing for these to become stand-alone aims and one stated that the aims are appropriate only for the SSRO. One respondent suggested that two duties should be imposed on the MOD: a duty to notify, reciprocal to the one imposed on contractors; and a general duty to respond promptly to issues raised.

SSRO functions

2.27 The SSRO sought general views regarding its functions as the independent regulator. The UK Regulators Network made the point that independence strengthens regulators to make judgments and take action. One industry respondent stated that the current SSRO functions are appropriate. One respondent stated that increased powers are not needed and cautioned that increased power may prejudice the SSRO's impartiality. Some industry respondents thought that greater experience is required before SSRO functions are changed and a few submitted that the review should not promote greater powers for the SSRO.

Access to information

2.28 The SSRO outlined a need for expanded powers to gather information and most respondents commented on the issue. Some respondents indicated support for the SSRO having greater access to information. There were different views expressed by these respondents, as follows:

- One respondent stressed the importance of information powers in enabling regulators to discharge their functions and noted these may be subject to stringent duties regarding disclosure.
- One respondent supported the SSRO's access to information if the information currently provided is not sufficient but did not support a blanket requirement for all QSC assessments to be provided.
- One respondent supported an access to information power limited to referrals only, but thought there could be some scope for provision of contracts and notification of single source defence contracts valued below £5 million, subject to mutual agreement.
- Some respondents indicated support for access to information powers but identified a number of aspects that would need to be addressed.

2.29 Matters that respondents identified would need to be addressed included:

- Security of information, particularly given the public listing of a number of single source contractors and their associated disclosure requirements.
- Clarity on how information will be used and that the powers do not expand beyond the scope of the SSRO's role.
- Avoidance of duplication of work, having regard to the roles of the MOD and the SSRO.
- Costs of compliance, specifically that these should be Allowable Costs.

2.30 Other stakeholders opposed the SSRO having the power to access information. Matters raised in support of such opposition included:

- A view that the SSRO already has sufficient powers to fulfil its statutory role.
- A concern that it would allow the SSRO to request information without effective restraint.
- A concern that requests for information would place a burden on contractors.
- A desire not to undermine the MOD's role or create price uncertainty.

General views on the compliance provisions

2.31 The SSRO invited general views on the compliance provisions in Part 2 of the Act and the Regulations. Some industry respondents supported the current arrangements and stated that there was no need to extend the SSRO's powers. One respondent thought that the contractor should not be identified in a determination by the SSRO. Another respondent thought clarification was required as to how a determination can be made that affects the contractual relationship between prime and sub-contractor.

Grounds for referral

2.32 The SSRO sought views as to whether the grounds on which it may make determinations and give opinions should be extended, specifically to: all steps of the process for determining the baseline profit rate; whether a contract is a QDC; and directions that contracts are not QDCs or QSCs.

2.33 A number of stakeholders were opposed to the proposed extension of referral grounds. Concern was expressed as to the associated business risk to contractors if the MOD could refer a wider range of matters without their agreement. One respondent thought that extended opportunities for referral would duplicate effort and increase costs to the taxpayer.

2.34 By contrast some respondents expressed a degree of support, with views put forward that:

- the SSRO should be able to determine on referral whether a contract is a QSC or QDC (although one respondent thought this was a matter of law and not suitable for referral); and
- there may be some merit in exploring determinations and opinions in relation to the contract profit rate.

Expanding the grounds of compliance and penalty notices

2.35 The SSRO invited views on whether the grounds for compliance and penalty notices should be amended; and whether failures to notify a QDC or to correctly apply pricing control should be grounds for compliance and penalty notices. One respondent identified that referrals may be made to the SSRO in cases where a contractor refuses to remove a non-allowable cost rather than using compliance and penalty notices.

2.36 Most respondents considered that the grounds on which compliance and penalty notices may be issued are adequate and appropriate as they currently stand. The concern was expressed that there would be no appeals route if the SSRO was able to issue compliance and penalty notices.

2.37 One respondent considered that compliance and penalty notices could be issued for failing to notify a QDC or for incorrect pricing control, but only if the MOD could also be fined (e.g. for failure to agree rates within an agreed timescale). Another respondent argued that: the size of penalty amounts should be reduced; the compliance regime should be reduced in relation to reporting; and requirements to identify, assess and notify QSCs should be reduced.

The SSRO's role in compliance

2.38 The SSRO invited views from stakeholders on whether it should have the powers to initiate the giving of opinions and the making of determinations or empowering it to issue compliance and enforcement notices as part of effective enforcement of the regulatory framework.

2.39 One respondent supported the need for regulators to have access to enforcement powers in order to regulate efficiently and effectively. Another respondent thought the SSRO should be able to initiate opinions and determinations but cautioned there were issues to be addressed and that the measure may be premature. It was suggested that the Act and the Regulations could be revised to enable the SSRO to better oversee the exercise of the Secretary of State's compliance and enforcement powers.

2.40 Those stakeholders who opposed the proposal, cited the lack of an appeals and complaints route if the SSRO were to initiate referrals and potential unintended consequence of the SSRO becoming less independent. Some respondents considered that to remove the risk of subsequent intervention the SSRO would have to become a third party to any contractual negotiations and this would not be value for money. One respondent expressed the view that the SSRO should act in an advisory capacity. Similarly, there was also a comment that the SSRO's role is to act as the neutral adjudicator in relation to specific issues referred by either the MOD or the supplier in circumstances where they cannot reach agreement.

2.41 In relation to the SSRO having powers to issue compliance and penalty notices, there was a view that it is the responsibility of the Secretary of State and if the SSRO was to have this power, an additional appeal body would need to be established.

Flexible changes to reporting requirements

2.42 The SSRO invited views on whether a more flexible arrangement should be introduced that permits the SSRO to add to or remove reporting requirements without the need to further amend the regulations.

2.43 Most respondents considered that the reports as they currently stand provide sufficient information and that there is no need for the SSRO to be able to make amendments. One respondent thought the result would be increasing levels of data without additional benefit and another respondent cautioned that this may impose an unlimited additional reporting burden. Some respondents expressed concern about additional costs for contractors.

2.44 One respondent considered that some refreshing and refinement of reporting templates could be undertaken annually, to the benefit of contractors, the MOD and the SSRO. It was suggested that the SSRO should be able to propose revisions to the standard reports as analysis of actual SSRO reporting increases and issues or common queries are identified.

2.45 One respondent considered the current specified structure should be replaced with a different framework. One respondent considered that reporting deadlines should be determined by agreement between the contracting parties. Another respondent considered that the guidance on reports could be clarified and that the macros in report templates should be removed to avoid security issues.

Open book accounting

2.46 The SSRO sought views on whether it should be given open book access, which the MOD already has. One respondent questioned why the SSRO would need such access and noted that the SSRO does not have the same auditing responsibilities as the MOD. The same respondent wanted to avoid duplication of work performed by the MOD and the costs associated with giving the SSRO such access.

Increasing efficiency of the regime

2.47 The SSRO invited views on reforms that may increase the efficiency of the regulatory framework. In response, the following comments were made that:

- the first review should focus on clarifying the existing legislation and reducing the administrative burden associated with implementation;
- corrections or clarifications need to be made so that the legislation achieves its original intentions and reflects practical working arrangements;
- the framework could be made more efficient by increasing the thresholds which bring contracts into the regime; and
- the MOD should be required to support contractors to identify what is sufficient evidence to support costs being Allowable.

2.48 The MOD indicated that it has a series of technical changes that it would like to make.

3. Transparency

3.1 The SSRO's second call for input from stakeholders dealt specifically with transparency. The SSRO identified a number of issues to promote discussion following a detailed examination of the relevant statutory provisions. The SSRO also invited stakeholders to address any other matter related to transparency as they considered appropriate.

General views regarding transparency measures

3.2 The SSRO invited general views regarding the transparency measures and associated safeguards. A number of respondents considered that reporting requirement should be reviewed to assess the costs and benefits. At the same time, some respondents expressed the view that the reports provide the SSRO with sufficient information to carry out its statutory functions.

3.3 Several industry respondents expressed the view that the reporting processes and procedures need to be made to work effectively and efficiently before the scope of reporting is widened. The following proposals for clarification were made:

- contract value needs to be clarified for reporting purposes;
- the term "defence contract" in section 32(6) needs to be limited to extant contracts and clarification given to what is meant by "other defence contracts";
- the definitions of "direct" and "indirect" costs at regulations 29(5) and 32(6) need to be improved and the references to "claimed" or "allowable" are unnecessary; and
- if the SSRO analyses data for the Secretary of State under section 36(3), then the results should also be provided to industry.

3.4 Some industry respondents represented that the scope and timing of requirements for keeping relevant records should be clarified. The following specific proposals were made for change:

- The term "record" should be defined, as it may be better to refer to data from which records can be produced.
- A contractor should not be required to keep more data than would be available in normal accounting and financial data systems.
- There should be flexibility around record keeping requirements to reflect each contractor's reporting cycle and the need for internal audit and reconciliation.
- The words "concerning" or "directly concerning" should be used in place of "relating".
- Section 23(6) of the Act should be amended to remove the SSRO's discretion in cases where a referral is made.
- Provision should be made for the contractor to be compensated in the event the SSRO finds in its favour following a review.

3.5 A number of industry respondents thought that the duty to notify in section 26 of the Act should be amended to impose a duty on the MOD to disclose relevant information to the contractor. One respondent submitted that sub-section 26(3)(a) is unnecessary and should be deleted (it identifies the primary contractor's costs as something that may materially affect a contract). Another respondent represented that the Regulations should define what is considered material for the purposes of the duty.

3.6 Some respondents stated that the criminal offence in Schedule 5 of the Act should continue to apply. It was proposed that information to which Schedule 5 applies should be widened by removing the word "substantially" from Regulation 56(2)(b) (information obtained by the Secretary of State through open book access is covered if its disclosure would be likely to substantially prejudice the commercial interest of any party). A number of respondents also proposed that the permitted grounds of disclosure in paragraph 5 of Schedule 5 should be restricted to make clear that the recipient of disclosed material is subject to the criminal offence in paragraph 2(1).

Contract reports

3.7 The SSRO called for input regarding the content composition and frequency of the standard reports required to be submitted in respect of QDCs and QSCs.

Initial contract reports

3.8 The SSRO asked whether a single initial report should be introduced. Respondents expressed a variety of views regarding the three initial reports. The MOD saw no need to change the requirement, but some industry respondents favoured combining the three reports into one or two reports.

Interim contract reports

3.9 The SSRO asked whether a single interim report should be introduced. There was some support from industry respondents for having a single interim report, provided that:

- the selected option is the less-frequent interim contract reports;
- the requirement for quarterly reports is removed; and
- the level of reporting remains proportionate to the value of the contract.

3.10 Two respondents cautioned that the interim contract report requires use of the DPS whereas the quarterly contract report does not. The industry respondent expressed a desire to be involved in formulating what would be contained in the single interim report.

Quarterly contract reports

3.11 The SSRO sought views on whether the frequency of quarterly contract reports should be changed. A number of industry respondents considered that quarterly contract reports are unnecessary or disproportionate and that the actual use made of these reports by project teams should be examined. By contrast the MOD stated that the quarterly frequency is right.

Final accounting

3.12 The SSRO sought input on whether a final accounting report should be required in cases where actual costs are not known at the time of the contract costs statement and whether this should include a requirement for actual payments. Some industry respondents suggested that it is too early to make an assessment, others made clear that additional reports are not welcome and some suggested alternative approaches such as delaying reports or changing the behaviour of the Cost Assurance and Analysis Service (CAAS). The MOD indicated that the status quo is satisfactory, adding that it is more important to investigate costs incurred in a timely manner rather than concentrate on absolute accuracy.

Contract costs statement

3.13 The SSRO invited views on whether the contract costs statement should provide a description of the facts, assumptions and calculations relevant to each element of the Allowable Costs that represent variations from the original estimates. A number of industry respondents stated that it would not add value to require this information and some stated that the requirement would be onerous, adding reporting costs. Some respondents thought the information is already reported.

TCIF and final price adjustments

3.14 The SSRO proposed that it should have some means of accessing final TCIFs and final price adjustments. Some respondents questioned whether there is merit in giving the SSRO visibility of final price adjustments. Two respondents thought the matter required further consideration.

Contract report dataset

3.15 The SSRO sought general input regarding the dataset generated by the contract reports. Some respondents expressed the view that it is too early to make an assessment of the sufficiency of datasets. A number of respondents reiterated the need for a review of the reports by reference to what use the MOD is making of them, whether the data is relevant and whether project teams understand the data.

Transparency in relation to sub-contracts

3.16 The SSRO sought views on the impacts and benefits of:

- requiring the contract completion report to describe the sub-contracts and state the proportion of contract value that was sub-contracted; and
- adjusting the threshold value or number of sub-contracts about which details are required to be provided.

3.17 Industry respondents were against changing the requirements for describing sub-contracts and questioned the value of doing so. By contrast the MOD indicated support for removing the 20-contract limit on the number of contracts that must be described.

3.18 Two additional proposals were put forward by industry respondents: that some sub-contracts (referred to as “indirect” sub-contracts) should be excluded from the regime; and that there is a difficulty in dealing with the regime where a manufacturing resource planning (MRP) system or enterprise resource planning (ERP) system is operated which should be addressed (referred to as the “line of sight” problem).

Supplier reports

Threshold value

3.19 The SSRO sought general input regarding the appropriateness of the threshold at which supplier reports are required. Most industry respondents represented that the threshold should be raised. By contrast the MOD considered there is insufficient evidence to justify lowering the thresholds. Some industry respondents thought that greater clarity was required in relation to the thresholds and submitted that:

- the costs of reporting are high and are a disincentive;
- the forward looking nature of the reports is a security concern;
- it is not appropriate for the customer to hold the contractor's information on internal budget and planning; and
- the costs of group sites need to be Allowable, so it is not clear what is to be gained by including them in supplier reports.

Exemption from the ongoing contract condition

3.20 The SSRO asked whether there should be greater transparency regarding the exemption of contracts from the ongoing contract condition. The MOD thought there was no need for change at this time. Most industry respondents thought that this was a matter for the MOD. Some industry respondents saw no benefit in greater transparency in this area.

Qualifying business unit (QBU) conditions and threshold

3.21 The SSRO invited views on the application of the QBU conditions and the impact of the £10 million QBU threshold. One respondent considered that there is insufficient evidence to justify change. Some industry respondents thought that the threshold is too low and some submitted that the overhead reports require review and clarification. One industry respondent thought that the definitions of both QBU and the £10 million threshold require clarification.

Supplier reports dataset

3.22 The SSRO sought general views on the effectiveness of the dataset generated from the overhead reports. Some respondents considered that it is too early to make an assessment. By contrast other respondents stated that a review should be conducted of the reports by reference to what use the MOD is making of them, whether the data is relevant and whether project teams understand the data. The following specific issues were raised:

- The SME report requirement should be reviewed to determine whether it provides new information (compared to what must be reported to Cabinet Office) or is value for money.
- The SME report serves no purpose and the indirect cost support from SMEs can't be completed.
- The rates comparison report is flawed in conception should be based on a business unit rather than a whole contract.
- The estimated rates claim report should require only show cost and volume data and not other budget information.

- The QBU estimated and actual cost analysis report templates include material not required by the regulations.
- QBU organisation and associated cost structure is unlikely to mirror that of the company and it is questionable what insights may be provided.
- The thresholds for the SICR report need to be reviewed, as they result in details being required of sites that make a £1 million contribution to regulated contracts.
- Only key contractor sites should be covered.

3.23 One respondent submitted that data should permit benchmarking but need not enable analysis of whether costs are being apportioned correctly.