SSRO

Single Source Regulations Office

Assuring value, building confidence

Recommendations to the Secretary of State

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

June 2017

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Introduction

1. The SSRO's review

1.1 The SSRO is required to keep under review the provision of the regulatory framework for single source defence contracts established by:

- Part 2 of the Defence Reform Act 2014 (the Act); and
- the Single Source Contract Regulations 2014 (the Regulations).

1.2 In reviewing the regulatory framework, the SSRO has taken into account its statutory aims of ensuring that:

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

1.3 The review has been based on extensive consultation, as outlined in more detail below. The SSRO would like to formally acknowledge and express its gratitude for all the contributions made to the review, which have helped to identify and refine the changes needed to improve the operation of the regulatory framework.

1.4 The SSRO has engaged actively with relevant stakeholders since its inception, 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.

1.5 The SSRO began to formally consider the need for changes to the regulatory framework 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.

1.6 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 themes, but with limited focus on transparency; and
- the second call for input (12 September to 4 November 2016) focused specifically on transparency.

1.7 The SSRO shaped its calls for input by reference to the experience gained in delivering its statutory functions and from its extensive 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 has separately published a summary of the responses to its calls for input.

2. Consultation on proposed recommendations

2.1 The SSRO consulted publicly on proposed changes to the regulatory framework from 30 January 2017 to 23 March 2017. In developing the consultation proposals, the SSRO took into account its engagement with a wide variety of stakeholders and prioritised the matters it considered most likely to deliver significant benefits to the regulatory framework.

2.2 A total of 21 responses were received to the consultation, broken down in the manner shown in Figure 1 below.

Figure 1: categories of consultation respondents

Respondent category	Number
Central government	1
Defence contractor with QDCs or QSCs	7
Defence contractor without QDCs or QSCs	4
Trade body	1
Consultants	3
Academic, think tank or similar	1
Other	4
Total:	**21**

2.3 The SSRO engaged with stakeholders throughout its calls for input and the public consultation. This has included a series of meetings and workshops with the MOD and industry representatives for the purposes of the review. The SSRO has also taken into account engagement and consultation in connection with its other functions, including guidance on Allowable Costs, the profit rate methodology, compliance and its studies programme.

2.4 The SSRO has considered all responses when finalising its recommendations and will publish all non-confidential responses in full on its website. The responses have been summarised and addressed in this document and the SSRO has indicated its views as appropriate. We have indicated whether proposals have been modified after considering consultation proposals and we have given reasons for these decisions. Detailed treatment has not been given in this document to responses that are not directly related to proposals to change the regulatory framework.

3. Overview of the recommendations

3.1 The SSRO recommends 14 changes to the regulatory framework, eight proposals initiated by the SSRO and six proposals initiated by stakeholders. All the recommendations are designed to improve the functioning of the framework, having regard to the SSRO's experience of its operation to date and the extensive consultation conducted. The basis for each recommendation is described in detail in sections 7 to 16 of this document together with the SSRO's response to feedback from stakeholders. Figure 2 contains a summary of the proposals by reference to key themes.

Figure 2: summary of recommended changes

	SSRO initiated	Stakeholder initiated
Pricing	• Contracts regulated following amendment (section 6, recommendation 1)	• Amendments within the framework (section 15, recommendation 9) • Final price adjustment (section 16, recommendations 13 and 14)
Coverage	• QSC definition (section 7, recommendation 2) • QSC thresholds (section 8, recommendation 3) • Exclusions (section 9, recommendation 4)	
Transparency	• Supply chain transparency (section 10, recommendation 5) • SSRO's power to access information (section 11, recommendation 6)	• Contract value for reporting (section 16, recommendation 10) • References to Part 6 reports (section 16, recommendation 12)
Referrals	• Grounds for referral (section 12, recommendation 7)	• Time limit for determination referrals (section 16, recommendation 11)
General	• SSRO funding (section 13, recommendation 8)	

3.2 The recommendations involve a mixture of amendments to the Act and Regulations as summarised in Figure 3. 13 of the recommendations propose changes to the Regulations and six recommendations propose changes to the Act.

Figure 3: Recommendations to change the Act, Regulations or both

	Recommendations
Act	R8
Regulations	R3, R4, R5, R9, R10, R11, R12, R13
Act and Regulations	R1, R2, R6, R7, R14

3.3 Four of the recommended changes include proposals for the SSRO to be able to issue statutory guidance. At present, parties who are subject to the regulatory framework are only required to have regard to guidance issued by the SSRO in respect of Allowable Costs, the contract profit rate, reporting requirements and penalties. The SSRO has proposed that this be extended to QSC assessments (recommendation 2(2)), application of exclusions (recommendation 4(3)), application of the QDC and QSC definitions (recommendation 7(3)) and pricing amendments to QDCs and QSCs (recommendation 8(d)). There may be merit, however, in giving the SSRO a general function to issue guidance within its areas of responsibility and requiring parties subject to the regime to have regard to that guidance.

3.4 There are proposals considered as part of the SSRO's review in respect of which it has not recommended changes to the framework due to evidence constraints. The proposals range from major policy changes, such as requests for increased flexibility in the pricing of contracts, to a range of more technical changes to the framework. The SSRO's consideration of these proposals to date is set out in sections 19 to 22 below and we ask that the Secretary of State considers the views expressed as part of his review.

3.5 There are proposals considered as part of the SSRO's review that it does not support and in respect of which it recommends changes are not made to the regulatory framework. The proposals are dealt with in sections 23 and 24 below and we ask the Secretary of State to take the recommendations into account as part of his review.

3.6 In response to the consultation, the trade body, ADS, submitted a list of 93 issues with the regulatory framework. Ten of these items have been expressly withdrawn and 12 of them are in scope of proposals given substantive treatment in this document. The remaining 71 items were expressly identified by ADS as being of lesser priority and capable of being deferred for later consideration. ADS also indicated that many of the issues might be resolved by guidance rather than legislative change. The SSRO deferred consideration of the 71 issues, with agreement from ADS and the MOD. This was on the basis that if the issues were further considered as part of the Secretary of State's review, which is to be completed in December 2017, then the MOD would engage with the SSRO to seek its views on how the issues should be addressed.

4. Impact

4.1 The regulatory framework remains relatively new, although it is maturing rapidly. The SSRO's review methodology involved identifying relevant areas for improvement, considering potential solutions and assessing the impact of changes. In each case the SSRO has considered the evidence available to support any case for change. We have explicitly recognised that in some cases it is premature to recommend changes to the regulatory framework and recommendations have been focused on areas where sufficient evidence is available.

4.2 The SSRO adopted an evidence based approach to its review, looking for material that would indicate a case for change, support the development of solutions and enable impacts to be assessed. The package of recommended changes is considered to strike an appropriate balance between benefits and costs. The changes are designed to improve the functioning of the regulatory framework, with the overall aims of ensuring good value for the government from QDCs and fair and reasonable prices for contractors. The detailed consideration of impacts is set out in sections 7 to 16 below, taking into account the responses to consultation.

5. Review by the Secretary of State

5.1 The SSRO submits the recommendations in this document to the Secretary of State and asks that they be considered as part of Secretary of State's own review which is due to be completed in December 2017. The MOD has indicated that it will engage with the SSRO as part of that review. The SSRO welcomes that opportunity and will continue providing analysis to support the Secretary of State's first periodic review of the regulatory framework.

Recommendations initiated by the SSRO

6. Contract amendments

Introduction

6.1 The regulatory framework relies on contracts becoming QDCs or QSCs. 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. An issue in this context is the treatment of contracts that were not QDCs or QSCs when awarded, but which are amended in a non-competitive way.

QDCs

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[1] 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 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. This situation is not adequately addressed by the aggregation provisions in the Regulations, as there would arguably be only a single contract.

6.4 The application of the QDC definition to contract amendments is dependent on the contracting parties agreeing that the amended contract should become a QDC. This places the application of regulatory controls at the discretion of those who would be regulated and creates a potential weakness in coverage of the regime. There is no obligation to report amended contracts that are kept outside of the regulatory framework and, accordingly, the SSRO does not have a complete picture of the composition of that group of contracts.

1 There is an exception for contracts entered into from 18 December 2014 to 30 March 2015, for which the threshold value is £500 million.

QSCs

6.5 For a sub-contract to become a QSC, it must be positively assessed as meeting the QSC definition and notification must be given to that effect to the sub-contractor and the Secretary of State. Part 2 of the Act and the Regulations specify when the purchaser under the relevant sub-contract is obliged to make a QSC assessment, which is where it is proposed to enter into a contract to provide anything for a QDC or QSC or a proposed QDC or QSC.

6.6 There is no express provision for dealing with amendments to sub-contracts in either the QSC definition or the requirement for QSC assessment. In that absence, the better construction of the relevant provisions is that a QSC assessment is required if an amendment is made that is more than immaterial or minor. This is on the basis that the terms "contract" and "sub-contract" should 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, which will trigger the requirement for assessment.

6.7 The MOD has taken a different approach from the SSRO to the construction of the legislation. The MOD's view is that material contract amendments do not require assessment and it advises 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.

The SSRO's proposal

6.8 The SSRO consulted on a proposal that contract amendments of £5 million or above are treated as if they involve entry into a new contract. This was intended to remove barriers to amended contracts being brought within the regulatory framework by achieving the following:

- Material contract amendments would have to satisfy the QDC definition before becoming a QDC but there would be no requirement for the parties to consent to application of the regulatory framework.
- Clarifying that material amendments to sub-contracts trigger the requirement for a QSC assessment.

6.9 Consistent with the approach of removing barriers to amended contracts being brought within the regulatory framework, the SSRO proposed the following measures to prevent the price formula from applying to the price committed under the contract prior to amendment:

- The Act should be amended to permit the Regulations to provide that the price formula may be applied to only a defined component of a contract.
- The Regulations should 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 amendment.

6.10 These measures were designed to avoid any unfairness resulting from retrospective application of the price formula and remove a recognised ground on which parties might have withheld consent to an amended contract being brought within the regulatory framework.

Stakeholder feedback

6.11 The proposal that contract amendments exceeding a materiality threshold should be treated as if they were new contracts was supported by an academic in the field of defence procurement who found the proposal reasonable and sensible. One industry consultant supported removal of the requirement for agreement between the parties but did not otherwise support the proposals. The remaining respondents who addressed the proposal did not support it, including the MOD and the remaining industry respondents.

Evidence for the proposal

6.12 One industry respondent asserted there was no evidence of a problem, but did not address the matters detailed in the consultation document. It is understood that the submission was directed to the SSRO's proposed treatment of material contract amendments, as the respondent agreed the treatment of committed price was a barrier to contracts becoming QDCs that needed to be addressed.

6.13 There is evidence that the requirement for the contracting parties to agree to an amended contract becoming a QDC is resulting in contracts being kept outside the regulatory framework. The SSRO is aware of contracts that have been amended but not brought within the regime. The responses to the SSRO's consultation reinforce the concern that contracting parties may not wish to consent to amended contracts being regulated.

6.14 In relation to sub-contracts, there was no suggestion that the SSRO had incorrectly identified the different construction adopted by the MOD. If the legislation were not clarified, or were clarified in favour of the MOD's preferred construction, this would have the consequence that sub-contracts may be materially amended without the need to assess whether the amended contracts would be QSCs.

6.15 The SSRO accepts that while there is evidence of barriers to amended contracts becoming QDCs and QSCs, it does not have complete evidence regarding the scope of the problem. The MOD is likely to hold the information necessary to assess the scope of the problem and the SSRO recommends that it makes such an assessment and reports to the Secretary of State for the purposes of the review under Section 39(3) of the Act to be completed in December 2017. The assessment should identify the following:

- the number and value of contracts that have not become QDCs for lack of agreement required under Section 14(4)(d) or 14(5)(d) of the Act;
- the number and value of sub-contracts that have been materially amended with resulting values of £25 million or more, but which have not been subject to QSC assessment; and
- the number, value and expected completion dates of extant single source defence contracts entered into before 18 December 2014 that remain outside the regulatory framework.

Applicability of the price formula

6.16 The MOD asserted that it is not always the case that QDC status will be better than the extant position. It was understood that the MOD meant it may not be better for the government in terms of value for money to bring an amended contract within the regulatory framework. It was stated that this would be a particular issue where the contract is substantially complete and has limited cost and schedule going forward, but specific examples were not provided.

6.17 The SSRO's proposal is designed to deal with material amendments to contracts. It has proposed that only the amendment should be priced and any committed price should not be subject to regulation. If the MOD considers the regulatory framework would not provide an appropriate basis on which to price a material amendment, that raises a broader issue regarding the appropriateness of the price formula and this is addressed in sections 17 to 21 below.

Materiality

6.18 The industry body, ADS, asserted that materiality is dealt with sufficiently in contract and case law and two of its members expressly supported this position. The SSRO accepts there is provision in European law for determining when a contract may be modified without triggering a new procurement procedure. However, these provisions are not imported into the Defence Reform Act and will not assist to determine whether an amendment to an existing contract should be brought within the single source regulatory framework, where the amendment is the result of a single source procedure.

6.19 Two contractors with QDCs thought that £5 million may not be material in the context of single source defence contracts. It is certainly the case that the original contract value may be significantly higher than £5 million, but the SSRO's proposal is that committed price should not be affected when a pre-existing contract is brought within the regime; it is the price associated with the amendment to which the regulatory framework would apply. In this regard, £5 million is the materiality threshold currently set by the Defence Reform Act for new single source contracts.

Retrospective effect and destabilising the contract

6.20 Four defence contractors raised a concern that the proposed amendment would have a retrospective effect on agreed contracts. This is a possibility that the SSRO expressly sought to avoid by making provision for the price formula not to apply to the price that has already been committed.

6.21 Eight industry respondents submitted that it would be inequitable if an amended contract were required to be brought within the regulatory framework. This was put in a variety of ways, but the underlying premise was that there would be an agreed profile of investment, risk and reward that should not be destabilised. One defence contractor asserted that there may be contractual terms governing the treatment of amendments and that these may be inconsistent with application of the price formula.

6.22 The SSRO's proposal is designed to avoid such impacts by applying the regulatory framework to material amendments and keeping any committed price outside of the regime. There may be scope to further refine the definitions of when price is committed and what constitutes a material amendment, but the SSRO remains of the view that appropriate definition will avoid destabilising the contract.

Expediency, cost and efficiency

6.23 Three contractors asserted that the costs of negotiations would be such that the proposal could not be justified. This appears connected with the proposal that if the materiality threshold is exceeded then a new contract will be taken to have been entered into on the amended terms. However, it is the SSRO's intention to capture the costs associated with the amendment in the regime and to exclude committed costs. On this basis the negotiation costs will be the costs of negotiating the amendment, which would need to be done in any event.

A disappearing issue?

6.24 Two contractors submitted that the issue identified by the SSRO will disappear over time, as contracts that pre-dated the regime expire. There is some force in this argument, but the SSRO does not think it provides a reason to not recommend the proposed change. First, there will continue to be legacy contracts in existence for a significant period and thus potential for amendments that should be brought within the regime. Secondly, there will be ongoing potential for contracts to be awarded competitively and then amended on a single source basis.

Committed costs

6.25 All but two of the respondents addressing this issue supported the SSRO's proposal to exclude committed price when applying the pricing formula to a contract that becomes a QDC following amendment. The two respondents opposing the proposal were industry consultants and the concerns raised do not change the SSRO's approach for the following reasons:

- One consultant submitted that treatment of committed price should be resolved between the MOD and the supplier. This would not address the underlying barrier to amended contracts being brought within the regulatory framework.
- One consultant stated that the proposal would undo previously agreed prices, but no explanation was provided and, in fact, the proposal is designed to have the opposite effect.

6.26 Several respondents were concerned that the proposal should include greater clarity regarding what is meant by committed price. It was the view of some respondents that only the price covered by the amendment should be subject to the regulatory framework. The SSRO generally supports this approach.

6.27 The SSRO believes that the pricing formula should be applied in the same way to contracts brought within the regime on amendment as it is applied to pricing amendments to contracts already within the regime. In other words, the pricing formula should be applied to the costs attributable to the amendment in a manner consistent with the proposals in section 15 below.

6.28 One industry respondent submitted that the usual reporting requirements should be limited to the new scope, with limited reporting on the original scope. The SSRO supports the intent behind this submission, although prefers to avoid introducing the concept of scope. The reporting requirements should apply to the costs, payments, deliverables etc. attributable to the amendment. There should be limited reporting in relation to the part of the contract that is not attributable to the amendment.

Conclusions and recommendations

6.29 After considering the responses to consultation, the SSRO continues to believe that the following barriers exist to the regulatory framework covering amended contracts:

- The requirements in Sections 14(4)(d) and 14(5)(d) for the contracting parties to agree to an amended contract becoming a QDC.
- The purported construction of the Act pursuant to which materially amended sub-contracts are not subject to QSC assessments.

6.30 The SSRO considers these barriers should be removed, but as a preliminary step recommends that the MOD:

- investigates the extent to which contracts have been or may be prevented from becoming QDCs or QSCs as a result of these barriers; and
- reports to the Secretary of State for the purposes of the review under Section 39(3) of the Act to be completed in December 2017.

6.31 The investigation should identify the following:

- the number and value of contracts that have not become QDCs for lack of agreement required under Section 14(4)(d) or 14(5)(d) of the Act;
- the number and value of sub-contracts that have been materially amended with resulting values of £25million or more, but which have not been subject to QSC assessment; and
- the number, value and expected completion dates of extant single source defence contracts entered into before 18 December 2014 that remain outside the regulatory framework.

6.32 The SSRO continues to believe that committed price should not be regulated when a contract becomes a QDC or QSC following amendment.

Recommended changes

Recommendation 1:

(1) A new section 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.

(2) A new Regulation should be added to specify that where a contract becomes a QDC or QSC by reason of an amendment, the price payable under the amended contract must be determined in accordance with the formula but excluding any committed price.

(3) The MOD should investigate the extent to which contracts have been prevented, or may be prevented, from becoming QDCs or QSCs and report to the Secretary of State (see paragraphs 6.29 and 6.30 above).

(4) The intended treatment of amended sub-contracts should be clarified.

7. QSC definition

Introduction

7.1 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.

7.2 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 sub-contract involves the provision of anything "for the purposes of a QDC"; and a sub-contract cannot be a QSC if it was entered into prior to the QDC being signed. The argument is that if a QDC technically did not exist at the time the sub-contract was entered into, the sub-contract could not be for the purposes of a QDC and could not therefore be deemed to be a QSC.

7.3 The SSRO considers that this interpretation of the legislation is incorrect. The fact that a sub-contract 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.

Summary of the SSRO's proposal

7.4 The SSRO proposed that the definition of QSC in Section 28 of the Act is amended by supplementing the existing requirements in Sections 28(3) or (4) that the contract provides anything for the purposes of a QDC or a QSC to make it clear that a contract may equally be a QSC if it provides anything for the purposes of a proposed QDC or QSC.

Stakeholder feedback

7.5 Five respondents supported the SSRO's proposal, including the MOD and two contractors with QDCs. Ten respondents did not support the proposal, including a number of defence contractors, both with and without QDCs. The SSRO has considered the substantive matters raised by respondents in the paragraphs below.

The correct approach to the QSC definition

7.6 One defence contractor submitted that it is correct and logical to prevent a sub-contract from becoming a QSC if it is signed in advance of the QDC or QSC to which it relates. The SSRO believes this approach would permit avoidance of the regulatory framework and it is to prevent such a construction that it has proposed the definition be amended.

Sufficiency of existing anti-avoidance measures

7.7 Some industry respondents recognised the potential for avoidance but submitted that Sections 29(3) and 29(4) of the Act provided adequate anti-avoidance measures. The SSRO has considered those provisions, but does not believe they provide a sufficient answer for the following reasons:

- Section 29 establishes when a contract should be assessed to determine whether it is a QSC and these requirements are implemented in Regulation 61.
- An assessment is required in circumstances where a person proposes to enter into a QDC or QSC and also proposes to enter into a sub-contract that involves the provision of anything for the purposes of the proposed QDC or QSC.
- The assessment is carried out by reference to the QSC definition in Section 28 of the Act and this arguably leaves open the contention (which the SSRO says is incorrect) that the definition does not apply.

Knowledge

7.8 The MOD supported the SSRO's proposal but only in relation to situations when a sub-contract is signed in the knowledge that it is intended to be part of a proposed QDC. The SSRO accepts that there needs to be a relevant connection between the sub-contract and the proposed QDC. However, Section 29(3) of the Act and Regulation 61(4) already provide for such a connection, relevantly requiring a QSC assessment if:

- A person (E) proposes to enter into a QDC or a QSC.
- E also proposes to enter into a sub-contract with another person (F).
- The proposed sub-contract involves the provision by F of anything for the purposes of the proposed contract.

7.9 On this basis, the assessment will only be carried out where both the proposed QDC or QSC and the proposed sub-contract are within the contemplation or knowledge of E. The SSRO considers that this establishes the right connection and achieves the outcome sought by the MOD. There is no need to explicitly include a requirement for knowledge, as this is already the effect of the trigger for conducting an assessment. All that remains is to be clear that the QSC definition may be satisfied where the QDC or QSC is proposed.

7.10 One contractor submitted that the legislation should allow for cases in which a sub-contract is placed in advance of the QDC or QSC, without any intention to avoid the regulatory framework, but subsequently becomes part of the supply chain of a QDC or QSC. The SSRO considers that the circumstances in which a sub-contract is required to be assessed are properly set out in Regulation 61. If those circumstances are not met when it is proposed to enter into the sub-contract, then an assessment will not be required. The obligation to make an assessment is not reactivated at a later stage and, on this basis, it is difficult to see that anything further is required to deal with the situation where a sub-contract is later brought within the supply chain. If bringing the sub-contract within the supply chain involves a material non-competitive amendment to the contract, then this raises a different issue which the SSRO has addressed in the above section on amendments (section 6).

Circumstances where the QDC does not come into existence

7.11 Three contractors raised a concern regarding what would happen if the sub-contract is assessed as being a QSC, but the proposed QDC or QSC is not then signed. The SSRO has not encountered any actual cases where this has occurred, nor were any examples submitted in response to our consultation. Assuming the scenario may occur, there is a mechanism in Regulation 63 by which Part 2 of the Act and the Regulations may cease to apply to a QSC. The mechanism can be applied where the sub-contract ceases to meet the requirement that at least 50 per cent by value of the obligations under the contract is required to enable the performance of a QDCs or QSCs. This provides a relevant control, as it allows the loss of the primary QDC or QSC to be taken into account and for Part 2 of the Act and the Regulations to cease to apply, after following the specified procedure.

PFI and PPP contracts

7.12 One contractor raised a specific concern regarding the applicability of the price formula to private finance initiatives and public-private partnerships. This issue does not arise from the SSRO's proposal, but is a wider issue for the regulatory framework and is addressed in section 21 below on alternative means of pricing QDCs and QSCs.

Guidance

7.13 Three respondents submitted that guidance would be helpful to assist the parties to determine when a potential sub-contract becomes a single source contract and potentially a QSC. Another two respondents thought that some clarity would be required as to what constitutes a proposed QDC. It was suggested in this context that a contract might be proposed as early as when the parties discuss the possibility of contracting, or as late as when signature is imminent.

7.14 The SSRO considers that the application of the legislative requirements for assessing whether sub-contracts are QSCs is an area in which guidance should be given. This is consistent with the SSRO's recommendation in respect of expanding the grounds for referral. The issuing of guidance by the SSRO is also addressed on a more general basis in section 3.2 of these recommendations.

Conclusions and recommendations

7.15 Having considered the consultation responses, the SSRO recommends that the QSC definition is amended to clarify that a sub-contract may still be a QSC if it is entered into before the primary contract to which it relates. In addition, the SSRO recommends that it be empowered to issue guidance in relation to QSC assessments.

Recommended changes

Recommendation 2:

(1) The QSC definition should be amended to clarify that a sub-contract may still be a QSC if it is entered into before the primary contract to which it relates, specifically by:

(a) amending Section 28(3)(a) of the Act to include reference to a proposed QDC to which the primary contractor will be a party; and

(b) amending Section 28(4)(a) of the Act to include reference to a proposed contract in the definition of Contract A.

(2) Regulation 61 should be amended to require a person carrying out a QSC assessment to have regard to guidance issued by the SSRO.

8. QSC thresholds

Introduction

8.1 A sub-contract becomes a QSC if it meets the requirements summarised in paragraph 7.1 above. The threshold value for a sub-contract to become a QSC is £25 million, which is five times higher than the £5 million QDC threshold. The SSRO was concerned that this presented a barrier to sub-contracts becoming QSCs and consulted on a proposal to amend Regulation 58(1) to lower the threshold.

8.2 The SSRO believes the regulatory framework is more likely to achieve value for money for government and fair and reasonable prices for contractors if single-source sub-contracts of significant value become QSCs. If a sub-contract is a QSC:

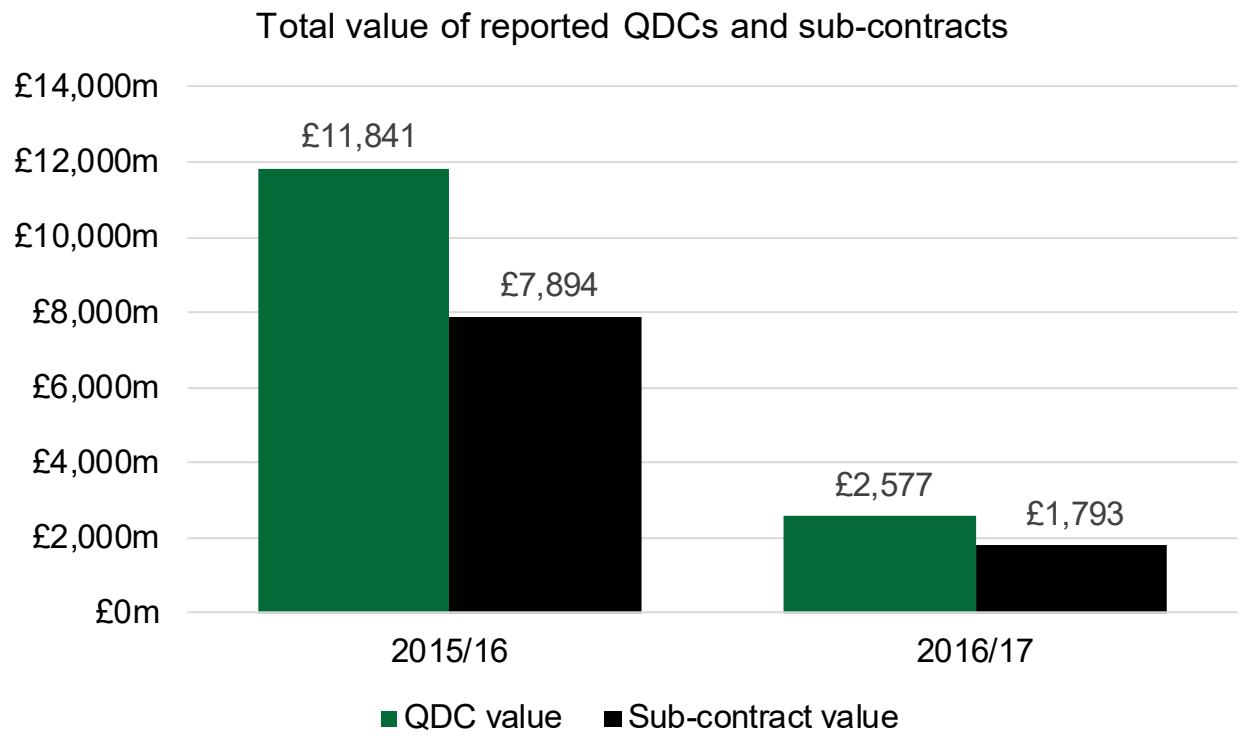
- The price must conform to the price formula, providing enhanced scrutiny of costs and profit.
- Contract reports must be submitted providing enhanced transparency over the supply chain.

8.3 If a sub-contract is not a QSC its price must still be an Allowable Cost within the QDC or QSC to which it relates, meaning it must be appropriate, attributable to the contract and reasonable in the circumstances (the AAR test), but this does not expose costs and profit in the same way as the profit formula and very limited transparency is required. There have also been instances reported of prime contractors experiencing difficulties in obtaining the information required from sub-contractors to apply the AAR test and complete reports.

8.4 The £5 million QDC threshold was determined to capture the overwhelming value of single source spending from a proportionate number of contracts of material value. There is a point of difference between QDCs and QSCs, because as little as 50 per cent of the value of a QSC may be for the purposes of enabling the performance of QDCs or QSCs (Regulation 58(3) – (5)). However, it is not otherwise clear what the justification is for differentiating between the thresholds for QDCs and QSCs.

8.5 Figure 4 shows the value of QDCs and reported sub-contracts in 2015/16 and 2016/17. Due to the limitations of reported information, it is not clear how much of this spending was itself awarded under single-source contracts. The figures may also be overstated due to cases where a sub-contract is signed for delivery of more than one contract. The figures nevertheless show significant value in the QDC supply chain.

Figure 4: Total value of reported QDCs and sub-contracts in 2015/16 and in 2016/17



Source: DefCARS database as of 30 April 2017[2]

The SSRO's proposal

8.6 The SSRO consulted on a proposal to amend Regulation 58(1) to reduce the current threshold for QSCs to £10 million to bring it closer to alignment with that which applies for QDCs. The proposed threshold allowed for the fact that up to 50 per cent of the value of a QSC may be for purposes other than enabling the performance of a QDC or another QSC.

Stakeholder feedback

Sufficiency of evidence

8.7 The MOD was not averse in principle to lowering the QSC threshold, but felt there was not enough data to support changing the legislation. The MOD suggested that the SSRO's proposals to increase the transparency of sub-contracts may provide a stronger dataset. Industry respondents submitted that it is too early to form a view on the effectiveness of the current regime and that the sample of relevant contracts is too small.

2 As of 31 March 2017, the SSRO was notified of 97 contracts that became QDCs/QSCs. Contractors have one month after the date the contract becomes a QDC (the initial reporting date) to submit reports, and as of 30 April 2017 the SSRO had received initial contract reports for 88 contracts that became QDCs/QSCs by 31 March 2017, which the following analysis is based on.

8.8 The SSRO does not accept the argument that there is insufficient data. There is an anomalous differential between the QDC and QSC thresholds and data is available that can be used to assess the impact of bringing these closer into alignment. Figure 5 shows two years of reported data in respect of QDCs, QSCs and their sub-contracts. The data is not complete, as not all sub-contracts are reported, but it provides a sufficient basis on which to assess the effect of changing the threshold on the number and value of sub-contracts in scope.

Figure 5: 2015/16 and 2016/17 sub-contract analysis and SME participation[3]

Analysis of 2015/16 and 2016/17 data			
Sub-contract value	**Number of sub-contracts**	**Total reported value (£ million)**	**Number of SME sub-contracts**
£25m +	48[4]	2,862	1
£20m - £25m	14	309	0
£15m - £20m	9	152	1
£10m - £15m	20	245	2
£5m - £10m	66	458	10
£1m - £5m	143	344	20

Proportionality

8.9 Several industry stakeholders raised proportionality considerations arguing that any additional costs of administration must be outweighed by the benefits of capturing additional single source contracts in the regulatory framework. Some of these respondents considered the SSRO had not provided evidence to demonstrate proportionality.

8.10 The SSRO considers that lowering the QSC threshold to £10 million will not result in a disproportionate administrative burden for contractors for the following reasons:

- It was considered when introducing the regulatory framework that a £5 million QDC threshold was proportionate, having regard to the proposed pricing and reporting requirements. There is no basis for concluding that the administrative requirements applied to a contract valued at £10 million or more would be disproportionate.

3 Please see footnote above.
4 13 of these sub-contracts became QSCs.

- Lowering the threshold would not result in excessive numbers of contracts becoming QSCs. Figure 5 shows that for 2015/16 and 2016/17, lowering the threshold would have brought 43 more sub-contracts within scope, with a total value of £706 million and an average contract value of more than £16 million. Not all contracts brought within scope will become QSCs, as they will still need to meet the other requirements summarised at paragraph 7.1 above. Based on the contracts reported in 2015/16 and 2016/17, less than 30 per cent of all the contracts valued at £25 million or above became QSCs.[5]

8.11 At the same time, the level of the recommended threshold means that the regulatory framework will focus upon a more significant proportion of the value chain. The change would capture around 80 per cent of the overall reported sub-contracted value chain, subject to sub-contracts meeting QSC requirements.[6]

Market impact and security of supply

8.12 Some respondents were concerned that a lower threshold would impact on the market for single source defence contracting, with the following specific concerns being raised:

- Some contractors will prefer to exit the market to avoid the requirements of the regulatory framework.
- This will be a particular issue in respect of companies for whom defence is only a small or marginal part of their business and US suppliers.
- If contractors exit the market, that will disrupt supply chains and jeopardise security of supply of critical components.

8.13 These representations raise serious matters for consideration and caution should be exercised before making changes that would jeopardise national security. However, the respondents did not provide evidence in support of the claimed impacts and, for the following reasons, the concerns raised do not appear to be justified by evidence available to the SSRO:

- The £5 million QDC threshold has not caused contractors to leave the market or disrupted security of supply.
- There is already provision in standard MOD contract clauses (DEFCONs) to impose reporting obligations on sub-contractors and there is no evidence that these requirements have caused contractors to leave the market or disrupted security of supply.
- Analysis of the companies with sub-contracts valued from £10 to 25 million shows that these are predominantly larger companies. Many of the companies are owned or controlled by the major defence companies or large companies from other sectors.

5 It varied from year to year. In 2015/16 10 per cent of sub-contracts in the band above £25 million became QSCs, whereas in 2016/17 this percentage was significantly higher due to nature of contracts and represented almost 60 per cent.

6 The exact proportion is likely to vary year on year. Based on the 2015/16 data lowering the threshold to £10 million would have captured 89 per cent of the reported value chain, whereas the data in 2016/17 suggests it would be 71 per cent. However, we note that only proportion of these would become QSCs to which further reporting and price control obligations would apply.

- The lower threshold is not expected to impact on SMEs, for the reasons given below.
- The costs of compliance may be recoverable as Allowable Costs, provided they satisfy the AAR test.

8.14 There is no doubt that contractors unfamiliar with the regulatory framework will be awarded QDCs or QSCs from time to time. However, the SSRO's experience is that new entrants can be assisted to understand and meet their regulatory requirements. This is something to which the SSRO has devoted, and will continue to devote, resources.

Small and medium-sized enterprises (SMEs)

8.15 Some respondents argued that a change would have a negative impact on SMEs. One defence contractor raised the following specific concerns:

- The costs of compliance will be a significant barrier to SMEs entering the defence market and they will not be prepared to incur the additional costs of operating under the regulatory framework, such as staff training and reporting.
- SMEs would have to maintain a higher non-recoverable overhead base in periods when they don't have defence contracts or where they are seeking to grow in other market sectors.
- Lowering the threshold would contradict the government's policy of encouraging SMEs into the defence supply chain and that. The MOD said that lowering the threshold is likely to pull in a larger number of sub-contractors, many of which will not be familiar with SSCRs.

8.16 The available data does not support a conclusion that lowering the QSC threshold to £10 million will impact on SMEs and their presence in the value chain. Analysis of the information reported on QDCs, QSCs and sub-contracts in 2015/2016 and in 2016/17 shows that:

- SMEs represented less than 5 per cent of the total number of contracts placed at or above £10 million.
- Three additional SME contracts would have been in scope if a threshold of £10 million had been in place in 2015/16 and 2016/17. Two of these SMEs were wholly-owned subsidiaries of well-established, large companies.
- The average SME contract value was just above £5 million. This figure is well below the proposed threshold of £10 million and is likely to be overstated, given that the reporting only captures contracts valued at £1 million or more.
- It is unlikely that all SME contracts in scope of the lower threshold would become QSCs (based on a 30 per cent conversion rate over the two years).

8.17 It is unclear why the concern regarding SME involvement is a particular issue in relation to QSCs. SMEs may equally be interested in being awarded QDCs, to which a significantly lower threshold of £5 million applies. The MOD does not have a policy of limiting the size of contracts awarded to SMEs and the data available to us supports this view. In 2015/16 and 2016/17[7], SMEs were awarded 7 per cent of the total numbers of QDCs and represented 11 per cent of reported sub-contracts.[8]

8.18 To date, no SMEs have raised concerns as to the impact of lowering the threshold, but the SSRO will continue monitoring the operation of the regime and engaging with SMEs. The recommendations aimed at improving transparency of the QDC/QSC value chain set out in section 10 below will provide an enhanced basis on which the SSRO can monitor impact and take appropriate action.

Alternative proposals

8.19 Some respondents identified an anomaly arising from the 50 per cent contribution requirement in Regulation 58(3) – (5). They identified that the interaction of this requirement with the £25 million QSC threshold was that:

- A sub-contract with a value of £24 million may not be a QSC, even if it is wholly dedicated to enabling the performance of QDCs and QSCs, because its value is below the threshold.
- A sub-contract with a value of £25 million may be a QSC, even though only 50 per cent of its value (£12.5 million) is to enable the performance of QDCs and QSCs.

8.20 These respondents suggested that a significantly higher threshold of £50 million should apply if only part of the value of a sub-contract is enabling performance of QDCs and QSCs.

8.21 The SSRO accepts there is a potential anomaly in the way that the 50 per cent contribution requirement operates in conjunction with the threshold. However, it is unclear that this results in any unfairness in practice and no evidence has been provided to this effect.

8.22 The reports do not currently require contractors to indicate if contract contributes to the performance of more than one contract nor to specify the amount attributable to the specific QDC. We consider it important that the SSRO has more visibility in this area to be able to monitor the application of the requirement and have made a recommendation to this effect. If this proposal is implemented, it will place the SSRO in a better position to review the way in which the two requirements interact.

7 Based on data from the DefCARS database as of 30 April 2017.

8 In terms of the percentage of the value chain these represent it is 4 per cent for the sub-contracted value chain and 0.4 per cent for the QDC value chain. The split per individual years indicates that while the overall proportion of both value and numbers is consistent between the years in relation to the SMEs presence in QDCs, the data varies in relation to sub-contracts. The proportion of the number of individual sub-contracts awarded to SMEs was 6.7 per cent in 2015/16 and 15.2 per cent in 2016/17. These represented 3.1 and 5.9 per cent in value terms for the respective years.

8.23 A further suggestion was made that the QSC threshold should be based on a proportion of the overall contract value, or a combined approach of a proportion of the overall contract value and an absolute sub-contract value. The latter approach would require defining both the minimum percentage of the QDCs value as well as the threshold of the sub-contract itself. The SSRO accepts there are alternative ways to identifying QSCs. However, it is not clear to us what the rationale of the proposal is, how this approach is superior to the existing one, what the exact proposal on the threshold is or the evidence in its support.

8.24 Finally, some stakeholders suggested that the QSC threshold should be raised and one contractor proposed increasing it to that of the sterling equivalent of the turnover threshold in the EU definition of an SME (€50 million). No justification was provided for this proposal and the SSRO does not support it, as there does not seem to be any reason to link the threshold to company turnover.

Conclusions and recommendation

8.25 Having analysed the consultation responses, the SSRO considers it appropriate to reduce the QSC threshold to £10 million in order to:

- bring the QSC threshold into closer alignment with the QDC threshold;
- extend the regime to a larger proportion of the value chain of QDCs; and
- ensure that contracts of significant value are subject to an appropriate level of scrutiny and control.

8.26 The recommendation is considered to strike the right balance between the costs and benefits of improved transparency and increased reporting.

Recommended changes

Recommendation 3:

Regulation 58(1) should be amended by replacing £25 million with £10 million.

9. Exclusions

Introduction

9.1 The Act excludes prescribed categories of contracts from being QDCs or QSCs.[9] 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 Since the Regulations came into force in December 2014, the SSRO has received queries regarding the application of these exclusions. 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. Many respondents to the SSRO's call for input in 2016 also called for greater clarification as to when a contract might be subject to these exclusions.

The SSRO's proposal

9.3 The SSRO consulted on proposals that:

- The international cooperative defence programme exclusion is restricted to contracts made wholly within the relevant cooperative framework.
- Contracts wholly for the purposes of intelligence activities are only excluded where the operational purpose for which the contract is required may be discerned if the contract became a QSC or QDC.

9.4 In this context, the SSRO referenced other proposed amendments to enable price regulation to be applied to a defined component of a contract. If accepted, those changes had potential to enable parts of contracts to be excluded.

9.5 The SSRO addressed another exclusion in the consultation document, relating to government to government contracts. Without making specific proposals to change the regulatory framework, the SSRO sought further representations and evidence to inform its understanding and support recommendations if appropriate. To encourage input, the SSRO:

- expressed concerns as to how value for money could be secured if companies based outside the UK were able to charge costs that are not Allowable under the regulatory framework, or earn profits exceeding what is permitted under the framework;

9 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'.

- challenged assumptions that information sharing restrictions or concerns about application of the price formula should present barriers to government to government contracts being QDCs or QSCs;
- noted that if the exclusion were removed the Secretary of State could still exempt contracts if necessary; and
- identified a lack of transparency in respect of government to government contracts and that this may be improved to inform review of how these contracts are treated.

Stakeholder feedback

9.6 The SSRO received 15 responses to its proposals to change the exclusions in respect of international cooperative defence programmes and intelligence activities. The MOD supported narrowing the scope of the exclusions, but suggested:

- ensuring that parts of contracts within international cooperative defence programmes are excluded but other parts are not; and
- making the intelligence activities exclusion dependent on whether the provision of information in contract reports under the regulatory framework would cause a risk to national security.

9.7 Four other respondents, including CIPFA, two defence companies and an academic, supported or gave qualified support for the SSRO's proposals. Some industry respondents wanted greater clarity in the exclusions and supported change subject to further work on the detail and the views of the MOD. Five defence contractors and two industry consultants opposed change on the basis that it may endanger national security or collaboration with foreign governments. The SSRO has considered the substantive matters raised by respondents in the paragraphs below.

International cooperative defence programmes

9.8 The MOD considered the exclusion should not be restricted to contracts made wholly within an international cooperative defence programme, as there may be instances where a small part of the value of a contract is outside an international cooperative defence programme and it would be impractical to then require the entire contract to be treated as a QDC. The MOD supported a revised exclusion pursuant to which:

- part of a contract made within the framework of an international cooperative defence programme is excluded, with the remainder being subject to the regulatory framework; and
- the parties may agree to the whole contract becoming a QDC even though some element of it may be within the framework of an international cooperative defence programme.

9.9 The SSRO agrees with this approach. The proposal to only exclude the parts of contracts within international programmes is in line with its consultation proposal. The proposal that the parties may agree to the whole contract being brought within the regulatory framework even though part is within an international programme allows suitable flexibility in cases where application of regulatory control would not jeopardise UK involvement in the programme.

9.10 One defence contractor did not support changing the exclusion, but stated that if an amendment were made, there should be a minimum value of a contract outside of the international cooperative defence programme before it is subject to the Regulations and treated as a QDC. £5 million was proposed as the minimum value, in line with the QDC threshold. The SSRO accepts that it would be consistent with the approach to the QDC threshold to only apply the regulatory framework to components of contracts if they are valued at £5 million or more.

9.11 Some industry respondents expressed concern that the proposed change could compromise the UK government's ability to participate in these programmes. The SSRO would not wish to jeopardise UK involvement in international cooperative defence programmes, but has not been provided with any evidence that narrowing the exclusion would have that effect. The MOD's view is that the exclusion may be narrowed without placing at risk UK involvement in such programmes.

9.12 Three industry respondents agreed that the international cooperative defence programme exclusion was unclear and gave the following examples where greater clarification and guidance is required:

- contracts where only part of the output relates to an international programme;
- contracts where a significant proportion is procured on a bilateral arrangement and the remainder under a Memorandum of Understanding (MOU); and
- contracts involving quantities procured as part of an international workshare as opposed to follow-on purchases solely for the UK.

9.13 These respondents suggested that any change to the exclusion should cover all the likely scenarios and provide: a comprehensive solution; clarity on the boundaries of the exclusion; and safeguards to prevent its misuse. The SSRO agrees that these are all important considerations that need to be taken into account, but believes the modifications outlined above appropriately address these concerns.

9.14 One defence contractor called for the inclusion in the Regulations or in guidance of a definition of what constitutes an international cooperative defence programme. The SSRO accepts that guidance on the application of the exclusion would promote consistency. It would support an amendment to the Regulations to require regard to be had to guidance issued by the SSRO on this subject. The SSRO would prepare such guidance in consultation with stakeholders.

9.15 Some industry respondents recognised that safeguards must be developed to ensure the exemption is used only in appropriate circumstances. The SSRO agrees there is a need for safeguards and proposes that to further its duty to keep the provision of the regulatory framework under review, the MOD should provide it with information regarding the number and value of contracts to which the exclusion is applied. This would allow the SSRO to monitor use of the exclusion and assess whether it is overused.

Intelligence activities and national security

9.16 As set out above, national security was the key issue for most respondents in relation to the SSRO's proposal to amend the intelligence activities exclusion. Some respondents felt that linking the exclusion to operational purpose would not be workable or easily understood. The MOD proposed an alternative approach in which contracts are excluded if:

- disclosure of the nature or timing of the procurement would cause a risk to national security; and
- there is information required in reports under Part 5 of the Regulations that would disclose the nature or timing of the procurement.

9.17 The SSRO accepts that any amendment must safeguard national security concerns and this informed its consultation proposal. Having considered the consultation responses, the SSRO considers a reformulation of the exclusion should be preferred that:

- makes national security the central concern;
- avoids the need to define intelligence activities; and
- removes the need for the contract to be "wholly for" intelligence activities.

9.18 This would accord with the views expressed by some respondents that the MOD's judgment should be preferred concerning what exclusion is required to protect national security.

9.19 A concern was raised by two defence contractors that the SSRO is subject to the Freedom of Information Act 2000 and disclosure may affect national security. These respondents acknowledged the existence of relevant exemptions in relation to national security, but thought that even the application of such exemptions may give information an unwelcome profile and potentially harm national security or international relations. The SSRO accepts that national security and international relations must be protected, but questions the logic of this specific concern, given that the MOD is equally subject to FOI requests and must apply exemptions as appropriate.

9.20 Some industry respondents recognised that safeguards must be developed to ensure the exemption is used only in appropriate circumstances. The SSRO agrees there is a need for safeguards and proposes that to further its duty to keep the provision of the regulatory framework under review, the MOD should provide it with information regarding the number and value of contracts to which the exclusion is applied. This would allow the SSRO to monitor use of the exclusion and assess whether it is overused.

Government to Government contracts

9.21 The SSRO received 12 responses regarding government to government contracts. One respondent, CIPFA supported inclusion of government to government contracts in the regime. All other respondents, consisting of the MOD and industry respondents, did not support inclusion of these contracts.

9.22 The MOD submitted that it obtains value for money on government to government contracts through the superior leverage or negotiating power of the foreign government with its own domestic suppliers. Some respondents questioned the need for the change on the basis that government to government contracts are already subject to the other government's regulation of single source defence contracts.

9.23 The SSRO accepts that it may be possible to demonstrate value for money is being obtained by the MOD through government to government contracts. However, other regulatory frameworks are not the same as the UK's and there remain concerns around a level playing field for UK based and non-UK defence companies supplying to the MOD. The additional transparency from bringing these contracts within the UK regulatory framework would help to ensure fairness.

9.24 The MOD and industry respondents questioned the practicability of trying to bring government to government contracts within the regulatory framework. The MOD stated that it does not have the means to enforce the Act on foreign governments. Some respondents thought that other governments would not instruct their suppliers to adhere to the regulatory framework.

9.25 The SSRO acknowledges there would be challenges in applying the requirements of the Act to contracts with other governments. It believes that greater transparency would assist exploration of how they may be addressed.

9.26 One contractor raised a concern that removing the exclusion for government to government contracts would have the unintended consequence of capturing government to government sales by the MOD. By definition, however, QDCs are contracts pursuant to which the Secretary of State procures goods, works or services for defence purposes, so contracts for sale are not covered.

9.27 The MOD acknowledged that the lack of transparency around government to government contracts is an issue and suggested that there may be merit in providing the SSRO with greater transparency over when these contracts are let, and the reasons why a government purchase was preferred. The MOD proposed that this could be provided by agreement, rather than through changing the Regulations.

9.28 The SSRO welcomes the MOD's proposal to provide greater transparency around government to government contracts. To keep the provision of the regulatory framework under review and assess its effectiveness, the SRRO would benefit from having access to the following:

- Details of each contract awarded, including a brief description of the goods, works or services that will be provided, the date of entry into the contract, the expected contract completion date and the contract price.
- A brief statement of the reasons for choosing a government to government contract rather than a direct contract with the defence contractor and the basis on which this is considered to represent value for money.

Conclusions and recommendations

9.29 Having considered the consultation responses, the SSRO recommends that the exclusions in respect of contracts made within the framework of international cooperative defence programmes and contracts wholly for the purposes of intelligence activities are amended. The SSRO will work with the MOD and industry to publish guidance on application of the international cooperative defence programme exclusion.

9.30 The SSRO does not make a recommendation to include government to government contracts within the regime. Instead it proposes to keep the issue of government to government contracts under review and make use of the additional information provided by the MOD for this purpose.

Recommended changes

Recommendation 4:

(1) Regulations 7(b) and 58(2)(a) should be amended to exclude such component of a contract as is made within the framework of an international cooperative defence programme, unless the parties agree that part of the contract may be a QDC or QSC. It should be specified that the remaining parts of the contract may be a QDC or QSC if they meet the requirements of the relevant definition.

(2) Regulations 7(c)(iii) and 58(2)(b)(iii) should be deleted and a new exclusion added to Regulations 7 and 58(2) to exclude contracts if: (a) there is information required in reports under Part 5 of the Regulations that would disclose the nature or timing of the procurement; and (b) disclosure of the nature or timing of the procurement would cause a risk to national security.

(3) Provision should be added to Regulations 7 and 58, requiring guidance issued by the SSRO in respect of international cooperative defence programmes to be considered.

(4) The MOD should provide the SSRO with transparency in relation to the international cooperative defence programme, national security, and government to government exclusions, as proposed in paragraphs 9.15, 9.20 and 9.28.

10. Transparency of the supply chain

Introduction

10.1 The supply chain for QDCs represents a significant component of single source spending, as demonstrated in Figure 4 above. The regulatory framework recognises this significance by controlling the prices of QSCs and requiring transparency over those contracts. An enforcement regime is established for ensuring that assessments are correctly carried out as to whether sub-contracts are QSCs and the outcomes notified. In addition, details of sub-contracts are required to be reported in the contract reports for QDCs and QSCs, including the outcomes of QSC assessments. The SSRO uses this information for keeping under review the provision of the regulatory framework.

10.2 As part of its review, the SSRO identified the following issues impacting the transparency of the supply chain for QDCs:

- a lack of any deadline for carrying out QSC assessments;
- incomplete reporting of QSC assessments due to issues of timing;
- a lack of clarity as to the reasons for negative QSC assessments; and
- limited information about sub-contracts.

10.3 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. The absence of a deadline for conducting a QSC assessment has the following impacts:

- The application of regulatory controls to contracts that should be QSCs may be delayed or frustrated entirely.
- Enforcement action by the MOD for failure by a contractor to make a QSC assessment may be frustrated, as the point at which failure has occurred cannot be fixed.
- QSC assessments may be conducted after the initial contract reports are submitted, with the potential for considerable time to elapse before the next standard report in which the outcome may be made known.

10.4 The contractor carrying out a 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.

10.5 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 there is no requirement to provide reasons why the contract was not considered to be a QSC. This does not support compliance, as the MOD would be required to interrogate every assessment in order to understand the reasons. From the SSRO's perspective it hampers the review of the regulatory framework, as the actual grounds preventing contracts becoming QSCs are not made known.

10.6 The reports submitted for QDCs and QSCs are required to include basic details about sub-contracts, including the outcome of the QSC assessment for each sub-contract. This provides a limited and partial set of information, as details need only be reported in respect of:

- the sub-contracts valued at £1 million or more (the £1 million threshold); or
- if there are more than 20 such sub-contracts, each of the 20 which have or are expected to have the highest value (the 20-contract limit).

10.7 The restrictions on transparency outlined above impede understanding of how the regulatory controls are being applied to sub-contracts. It is difficult, for example, to assess the correct placement of the QSC threshold or the value in the QDC supply chain with details of only a limited set of sub-contracts. As described, the limited details reported also impact on compliance monitoring.

The SSRO's proposal

10.8 The SSRO consulted on amendments to the regulatory framework to require the following:

- Completion of QSC assessments within 30 days of the time of agreement of the sub-contract.
- Notification of QSC assessments to the Secretary of State and the SSRO within 30 days of assessment if they are not included in the Contract Notification Report.
- Provision of reasons for a negative QSC assessment when reporting or notifying the outcome of the assessment.
- Removal of the 20-contract limit on reporting details of sub-contracts valued at £1 million or more.

Stakeholder feedback

10.9 Fourteen respondents commented on the proposals, with support varying depending on the proposal in question. The different issues raised are addressed below by reference to each proposal.

10.10 One respondent supported all the proposals, finding them reasonable and sensible. Another respondent, Transparency International, did not directly address the proposals but supported measures to increase transparency and oversight of single source spending.

10.11 One defence contractor responded without providing specific comments, but expressing the general view that it is too soon for the SSRO to recommend changes to QSC assessments. The SSRO accepts the general point that evidence is required before recommending change, but believes there is a sufficient foundation for change for the reasons outlined in the consultation and further considered below.

Deadline for QSC assessments

10.12 The majority of respondents, including the MOD and some industry respondents, supported imposition of a deadline requiring QSC assessments within 30 days of sub-contract award.

10.13 The MOD considered that the requirement should not result in significant additional costs for contractors. By contrast, one defence contractor argued that costs would increase because meeting a deadline would require additional resources and submitted there was insufficient justification for such an increased burden. The SSRO agrees with the MOD's view in this regard. Contractors are already required to produce and keep a record of QSC assessments and we would expect that resources are being allocated to meet this requirement. It is not expected that the requirement to do the assessments within a reasonable timeframe would lead to any additional burden.

10.14 Some industry respondents identified a need to ensure that the changes are adopted from the date the regulatory framework is amended, rather than retrospectively. The SSRO supports this view, which is line with its original intent.

10.15 Some industry respondents sought further clarification on the start date for the 30 days. The SSRO proposed that the start date should be defined in a similar way to the term "time of agreement", which is used in the Regulations. This will generally be the date of entry into contract, but would allow for the possibility that the contract was required to be assessed following a material amendment.

Notification of QSC assessments

10.16 Industry respondents and the MOD did not support the proposal that QSC assessments should be notified to the Secretary of State and the SSRO if not reported as part of the Contract Notification Report. The MOD felt that it would set upon another ad hoc reporting mechanism and preferred that the assessment be notified in the next standard report. Some industry respondents did not believe there is any merit in notifying unreported QSC assessments at all.

10.17 The SSRO believes the proposal for notification of QSC assessments needs to be evaluated alongside the introduction of the 30-day deadline. If there is no effective notification mechanism, then it may remain unclear whether the requirement to carry out a QSC assessment has been completed and the benefit of having a deadline will be lost.

10.18 The SSRO understands the MOD's desire to avoid any additional reporting requirement, but is concerned that the timeframes for the standard reports may be too long. If the primary contract is valued at £50 million or more, then the QSC assessment would be reported in quarterly contract reports. However, for primary contracts below £50 million, there is no requirement for quarterly contract reports and the alternative interim contract reports may be as infrequent as once every five years. Reporting a QSC assessment up to five years after it has been carried out does not provide sufficient transparency as to whether the regulatory framework is operating as intended.

10.19 An obligation to notify the outcome of QSC assessments that were not reported in the Contract Notification Report is a proportionate means of improving transparency to both the MOD and the SSRO. In 2015/16 and 2016/17, approximately one in five sub-contracts reported in the Contract Notification Report had not been subject to QSC assessment. Imposition of a deadline may reduce this number, leaving a relatively small percentage of cases in which it is necessary to make a notification outside of the standard reporting requirements.

10.20 The requirement to notify provides a means of scrutinising QSC assessments that take place after the initial stages of the primary contract. This will support an effective deadline for those assessments, with the aim of:

- avoiding delay in sub-contracts being assessed; and
- ensuring that price controls and transparency are applied as intended.

Reasons for negative QSC assessments

10.21 Industry respondents did not support a requirement to provide reasons for negative QSC assessments. A variety of arguments were put forward against the proposal, which may be summarised as follows:

- The outcome of the vast majority of assessments will be self-evident, as the contract value will be below the QSC threshold and, associated with this, QSC assessments should only be required where the value of the sub-contract is near the QSC threshold.
- The information is of little value, as a sub-contractor would not want to challenge a negative assessment and the MOD may access the records if it chooses, and consequently the additional cost is not justified.

10.22 The MOD was supportive of the requirement that reasons should be given for negative assessments but submitted there would have to be a suitable materiality threshold to avoid every assessment being reported.

10.23 The SSRO accepts that the outcome of a QSC assessment may be predicted if the value of the sub-contract is below the QSC threshold. It does not, however, agree that this is a basis for not requiring assessments or for concluding that reasons should not be provided for negative assessments in appropriate cases. There may be multiple reasons why a sub-contract would not be assessed as being a QSC, which include:

- The contract resulted from a competitive process.
- The contract value was below the QSC threshold.
- The contract is in a category excluded by the Regulations.
- Less than 50 per cent of the value of the contract obligations are to enable a QDC or QSC.

10.24 It is precisely for the purpose of understanding which reasons have resulted in a sub-contract not becoming a QSC that the SSRO has recommended reasons be given for negative QSC assessments.

10.25 There is force in the MOD's representation that the requirement to provide reasons should be connected to a materiality threshold. Having regard to the fact that QSC assessments of sub-contracts below the QSC threshold will necessarily be negative, it may be logical to only require reasons to be given for a negative assessment if the value of the sub-contract is at or above the threshold.

10.26 The introduction of a materiality threshold would however result in very limited transparency in respect of sub-contracts below the QSC threshold. It would mean that no information is provided as to whether those sub-contracts were the result of a competitive process. The question of whether contracts in the supply chain are competed or not is potentially critical information concerning the operation of the regulatory framework. Accordingly, the SSRO recommends that the question of whether a sub-contract was the result of a competitive process should be one of the standard details required to be provided about sub-contracts valued at £1 million or more. The provision of this information may easily be facilitated within the SSRO's DefCARS database.

10.27 The SSRO set out in its consultation proposal the grounds for requiring reasons for negative QSC assessments. In summary, it is considered proportionate to require reasons to be provided because:

- The reported reasons will give the MOD visibility of negative assessments and a first-line basis for a compliance programme around whether QSC assessments are being correctly carried out. The MOD may then choose to exercise its open book rights to scrutinise individual QSC assessments in appropriate cases.
- The reasons for negative assessments will allow analysis of whether the requirements for whether sub-contracts should become QSCs are operating effectively, including the competitive dynamic across the value chain and the interaction between the various requirements.
- The SSRO is able to facilitate the submission of the required information through its DefCARS database, for example by providing pre-defined categories that contractors may select when reporting on sub-contracts.

Removing the 20-contract limit

10.28 There were mixed views regarding the proposal to remove the 20-contract limit on the number of sub-contracts required to be described in QDC and QSC reports. The MOD and some industry respondents were concerned that reporting requirements should remain proportionate and thought that if the 20-contract limit were removed, then the related £1 million threshold should be increased. By contrast, one respondent thought the change could easily be implemented as part of the standardised contract reports.

10.29 The SSRO accepts the need for proportionality, but believes the impact of removing the 20-contract limit needs to be carefully considered against the available evidence. The data reported for 2015/16 and 2016/17 shows[10]:

- 88 QDCs and QSCs;
- of which 7 QDCs reported the maximum 20 sub-contracts valued at £1 million or more;
- the values of the 7 QDCs ranged from around £0.5 billion to £8.5 billion, with an average of £2.2 billion;

10 As of 31 March 2017, the SSRO was notified of 97 contracts that became QDCs/QSCs. Contractors have one month after the date the contract becomes a QDC (the initial reporting date) to submit reports, and as of 30 April 2017 the SSRO had received initial contract reports for 88 contracts that became QDCs/QSCs by 31 March 2017, which the following analysis is based on.

- the values of the sub-contracts associated with these 7 QDCs ranged from around £1 million to £190 million, with an average of £21 million; and
- the 7 QDCs are shared between 2 prime contractors.

10.30 Having regard to this data, it is clear that the overwhelming majority of QDCs and QSCs would be unaffected by removal of the 20-contract limit and, accordingly, there is no justification for simultaneously increasing the £1 million threshold in respect of those contracts. It is also clear from Figure 5 above, that if the £1 million threshold were increased, there would be a loss of transparency over the supply chain. That loss may be substantial, depending on where the new threshold is placed, and would be a backwards step.

10.31 The reported data shows that a small number of very high value contracts would be affected by removal of the 20-contract limit. As a result of the existing limit, the SSRO does not have a clear picture regarding the number of sub-contracts valued at £1 million or more for each affected QDC. However, the SSRO does not believe the reporting requirement would be excessive, for the following reasons:

- The details required for each sub-contract are minimal, consisting of the name of the company, whether it has an SME status, a brief description of the goods, works or services provided, and the price payable under the contract.
- The requirement will apply to a small number of major defence contractors with the highest value QDCs and QSCs and these may be expected to have the systems required to make the information available.
- No evidence was provided by respondents to demonstrate a significant impact.

10.32 The assessment of proportionality should take into account the use that may be made of the data, in addition to any impact from increasing reporting requirements. From the SSRO's perspective, the reported data on sub-contracts valued at £1 million or more has been critical to keeping under review the provision of the regulatory framework in respect of QSCs, particularly in relation to QSC thresholds, QSC assessments and the extent to which it is important for regulatory controls to apply to sub-contracts. The SSRO has used such data for its statistical bulletins. Overall this sort of analysis is important given that the framework depends for its operation on contracts becoming QDCs and QSCs. It is having regard to the value of the data that the SSRO has sought to remove the 20-contract limit, so that a complete picture is provided of sub-contracts above the £1 million limit.

Conclusions and recommendation

10.33 Having considered the consultation responses and made appropriate modifications, the SSRO recommends the regulatory framework is amended to provide greater transparency over the supply chain to ensure that:

- QSC assessments are timely and appropriately reported; and
- details are provided of more sub-contracts and that the details provided identify whether the contract was the result of a competitive process.

10.34 The recommended changes are expected to:

- promote correct coverage of QSCs by the regime;
- improve visibility over a larger number of sub-contracts that form part of a QDC value chain;
- provide more insight into sub-contracting value chain, including its diversity; and
- support effective review by the SSRO and enforcement action by the MOD.

Recommended changes

Recommendation 5:

(1) Regulation 61 should be amended to add the requirements that:

(a) A QSC assessment must be completed within 30 days of the date the sub-contract was entered into or from the date of amendment that triggered the QSC assessment.

(b) The outcome of a QSC assessment must be reported to the Secretary of State and the SSRO within 30 days. If none of the standard reports that include outcomes of QSC assessments are due in this timeframe, then a separate notification should be provided.

(2) 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)”.

(b) Add a requirement to specify the reasons for any negative QSC assessment if the value of the sub-contract assessed is at or above the threshold specified in Regulation 58(1).

(c) Add a requirement to specify for each sub-contract valued at £1 million or more whether it was the result of a competitive process.

(d) Add a requirement to specify for each sub-contract valued at £5 million or more whether it combines obligations for the purpose of enabling performance of contracts other than QDCs and QSCs.

11. Access to information

Introduction

11.1 The SSRO has a range of statutory functions on which the operation of the regulatory framework depends. It gives guidance, delivers expert opinions and determinations, assesses the rates used in price regulation, conducts analysis for the Secretary of State, monitors compliance with reporting requirements and keeps the provision of the regulatory framework under review. In discharging its functions the SSRO aims to ensure good value for money for government and fair and reasonable prices for contractors and carries out analysis and studies in support of this.

11.2 The SSRO relies for the discharge of its functions on a database of information 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.

11.3 Unlike other regulators, the SSRO has no power to require information in addition to that provided in the standard reports. Instead, it is limited to requesting information from the MOD and contractors on a voluntary basis.

11.4 Since inception, the SSRO has experienced circumstances where the reported information has not been sufficient and it has requested supplementary material. There have been occasions, some of which were detailed in the consultation document,[11] on which the SSRO has requested information that has either not been provided or an incomplete response has been received. The following are examples of where the SSRO may need to obtain additional information:

- 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; and
- 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.

11 See section 10 of the Review of the Single Source Regulatory Framework - Consultation, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/586659/Review_of_the_Single_Source_Regulatory_Framework_-_Consultation_on_recommendations_26_Jan_2017.pdf

11.5 As part of its review, the SSRO considered ways in which the standard reports may be modified to better support discharge of its functions. However, it is unlikely that the SSRO may meet its future information requirements by further specifying the contents of the standard reports due to the potential for unforeseen questions to arise that require additional information.

The SSRO's proposal

11.6 The SSRO consulted on a proposal to amend the Act to give it the power to require contractors to provide the SSRO with information reasonably necessary for carrying out its statutory functions. This was proposed as the most appropriate and effective means of supporting the SSRO to deliver its functions and bring it into closer alignment with other UK regulators.[12]

11.7 To ensure that notices are complied with, the SSRO proposed that it should be empowered to impose compliance and penalty notices in cases where the recipient of a notice:

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

11.8 Recognising that stakeholders may be concerned about the way in which this power may be exercised and the burden it may impose, the SSRO proposed that the Act should require it to publish a policy statement on how it will exercise the power and use the information obtained. To promote accountability, the SSRO proposed that it should be required to publish an overview of its use of information powers in its Annual Report and Accounts.

Stakeholder feedback

11.9 The majority of respondents to the consultation commented on this proposal. Most non-industry stakeholders indicated full support for the SSRO having greater access to information and attention is drawn to the following:

- The Taxpayers' Alliance expressed concern that discharge of the SSRO's functions may be impeded by a lack of information. It welcomed the proposal for an annual account of how the power has been exercised to enable a judgment as to whether it has been used proportionately.
- Transparency International referred to the 2015 Government Defence Anti-Corruption Index (GI) which found that although the UK scored high overall, the lack of transparency and oversight of single source procurement was amongst the UK defence sector's highest corruption risks. It considered that it would be preferable for the SSRO to determine and specify what information need to be included in the reports it receives and where information is not reported by contractors, the SSRO should have the powers to require it.

12 See Figure 8 of the Review of the Single Source Regulatory Framework - Consultation.

- CIPFA emphasised that in order to exercise effective scrutiny and oversight of the procurement process for single source contracts, the SSRO should be given powers to access information. It noted that regulators have the powers to request information so that they can make an assessment about value for money. It was of the view that giving the SSRO the same powers would strengthen transparency and accountability and provide more rigour to the regulatory system for single source contracts.
- The UKRN considered that information powers would bring the SSRO in line with other economic regulators and emphasised the importance of such powers given the information asymmetries and challenges associated with understanding value in cases where there are single buyers and sellers. It further added that access to accurate and up to date information is essential for regulators to discharge their functions effectively and efficiently, supporting risk-based regulatory decisions underpinned by evidence. It is also important to ensure greater transparency and accountability in regulated sectors.

11.10 By contrast, the MOD and industry respondents did not support the proposal for information powers. The MOD was concerned that the SSRO should not be given unrestricted power to compel industry to provide information. Industry respondents had a similar concern, but also expressed the following further objections:

- The SSRO has sufficient access to information so the rationale for additional powers is unclear.
- The MOD already has open book access to information.
- The power to require information would impact the SSRO's independence and undermine the discharge of its referral functions.

11.11 Each of these representations is addressed in greater detail below.

Concern about unrestricted power

11.12 The MOD and industry respondents raised a concern that the SSRO should not be given unrestricted power to obtain information from industry. The SSRO accepts that any power to access information must be proportionate, but believes the proposed power is appropriately constrained. The consultation proposal contained the following checks and balances:

- The SSRO may only require information for the performance of its statutory functions, limiting the power to the provision of the regulatory framework.
- The SSRO must be satisfied that issuing an information request would be reasonable. In line with other regulators, this would prevent use of the powers if there is no clear need and justification.
- The SSRO would be required to state a policy on the exercise of the powers. It is expected that this would involve: stating the purpose of each request and how it relates to the SSRO's functions; issuing information requests in draft form; and providing recipients an opportunity to make representations.
- Recipients would have the right to challenge information requests by appealing to an independent panel.

- The SSRO would be required to publish an annual account of its use of the powers, exposing that use to public scrutiny.

11.13 It was unclear from the representations received on what basis it was considered the proposed constraints on the power would be inadequate. From workshops held with the MOD and ADS, there was a concern that the SSRO may make unreasonable requests for information, either because it requests too much information or because it is trying to comply with a requirement unreasonably imposed on it by the Secretary of State. An example was given of the SSRO requesting decades of data. However, the SSRO would be required to act reasonably and an appeal would be available if it did not.

11.14 The SSRO has continued to engage with stakeholders on its recommendations post-consultation and has received indications of support from the MOD for a power to access information in the manner proposed.

The SSRO's role and sufficiency of available information

11.15 Some industry respondents considered the SSRO has sufficient access to information to discharge its functions. One respondent asserted that there is no desire by either industry or the MOD to expand the Regulations or the role of the SSRO. These respondents did not comment on the circumstances identified in the consultation document where additional information would be required. The representations appeared to focus on a preferred role for the SSRO, rather than addressing the specific powers given to the SSRO under the regulatory framework and how these may reasonably be discharged. Assertions that the SSRO is not a regulator equally avoided this issue.

11.16 Irrespective of whether industry stakeholders accept the SSRO as a regulator,[13] it is given clear statutory functions that are critical to the regulatory framework delivering good value for money for government and fair and reasonable prices for contractors. The difficulties the SSRO has experienced in accessing information to date have principally related to the following functions:

- the SSRO's duty to monitor the extent to which contractors are meeting their reporting obligations under Section 36(2) of the Act.
- arrangements made with the Secretary of State to provide analysis pursuant to Section 37 of the Act;
- the SSRO's duty under Section 39(1) of the Act to keep the provision of Part 2 of the Act and the Regulations under review; and
- the SSRO's function of issuing statutory guidance, particularly its duty to issue statutory guidance on Allowable Costs under Section 20(1) of the Act.

11.17 It is reasonable for the SSRO to require evidence to inform the discharge of these functions. The SSRO's power to request (but not require) such evidence is clear from paragraph 4 of Schedule 14 to the Act.

13 The Explanatory Notes to the Act state in paragraph 46 that: "The SSRO will act as the regulator for the new framework".

11.18 At the same time that industry has opposed the SSRO having powers to access information, there has been a lack of support to requests for information from the SSRO. In the last 12 months, the SSRO has sought information from industry to support its studies, but this engagement has resulted in limited support. In one study, a small number of defence contractors participated and more information from industry would have provided a more complete picture. Given that it was not forthcoming, the SSRO relied on publicly available information to complete its study, which fact was subsequently criticised by some defence contractors.

Alternatives proposed to information powers

11.19 Some respondents submitted the following alternative means for the SSRO to access the information it needs:

- The standard reports may be amended to provide any additional information, avoiding the need for ad hoc requests.
- The SSRO may obtain the information it needs from the MOD, which can obtain data through its open book rights of access.
- The SSRO should build and improve relationships with industry to a level at which industry will voluntarily share any needed information.

11.20 The SSRO agrees the standard reports should be made as fit for purpose as possible. Following its review, the SSRO has recommended changes to the standard reports, for example to provide additional transparency over the supply chain (see paragraph 10.33 and following above).

11.21 However, the SSRO has also recognised the inflexible nature of standardised reports and does not believe it is practicable to identify all potential information requirements in advance. Circumstances will arise in which additional information is required in order to understand how the regulatory framework is operating or what changes should be made to ensure the government obtains good value for money from QDCs and contractors are paid fair and reasonable prices.

11.22 The SSRO accepts that it may request information from the MOD. However, for the following reasons, it is neither practical nor appropriate to expect the SSRO's information requirements to be met in every case by the MOD:

- The MOD may not hold the information and its open book rights are limited to specific purposes.
- It would be inefficient for the SSRO's requests to be relayed through the MOD when the SSRO could access the information directly.
- Responsibility for complying with an information request should remain with the holder of the information rather than the MOD as an intermediary.
- The SSRO's access to information would continue to be dependent on cooperation from the parties to regulated contracts, albeit the MOD rather than industry.

11.23 Where possible, the SSRO will continue obtaining information on an informal and cooperative basis. However, this is not a sufficient solution for two reasons. First, it has demonstrably failed to deliver the information the SSRO needs, which has led to the proposal for information powers. Secondly, it has the underlying flaw that parties who are subject to regulation may influence the extent to which the SSRO is able to discharge its functions in support of the regulatory framework.

Enforcement of information notices and right of appeal

11.24 Two defence contractors raised explicit concerns regarding the proposal that the SSRO should be able to enforce compliance with information requests, arguing that:

- It would be inappropriate and excessive for the SSRO to be able to enforce by imposing the significant penalties provided under the regulatory framework.
- The independence and impartiality required for the SSRO's arbitral role would be compromised.
- There would be insufficient recourse in cases where the SSRO has not acted reasonably.

11.25 These concerns were reflected in the submissions of other industry respondents, although not necessarily stated explicitly.

11.26 If the power to make information requests were not backed up by appropriate sanctions, there would be no material change from the existing arrangements pursuant to which information is sought on a voluntary basis. The potential for the SSRO to impose financial penalties will encourage compliance and is not considered excessive for the following reasons:

- Notices requiring information will only be issued when cooperation has failed and it is reasonable and proportionate to require the information in support of the SSRO's statutory functions.
- Penalties are the last resort and would be preceded by a compliance notice.
- A penalty notice may be appealed.
- The SSRO would be required to publish a statement of policy on the use of these powers, which would set out the circumstances in which enforcement is appropriate. This would involve an appropriate process of escalation and require consideration of matters such as seriousness, conduct and proportionality.

11.27 It is unclear in what way respondents considered the SSRO's independence would be undermined by having information powers. The SSRO believes to the contrary that its independence would be enhanced, as it will be able to decide how its functions should be exercised and obtain the information it needs.

11.28 The suggestion that the SSRO would be unable to deal impartially with referrals if it had information powers was also not supported. The SSRO complies with the requirements of natural justice when dealing with referrals and would continue to do so if it has information powers. The committees dealing with referrals include independent members. All committee members are required to declare relevant interests and would not be chosen to deal with a referral if there were any conflict.

11.29 It is reasonable for the public body that issues an information notice to also be empowered to enforce compliance, given that it is best placed to understand the information required and whether it has been provided. Both powers are exercisable by other organisations, such as the regulators in the telecommunications, post, electricity, gas, water, air traffic services, healthcare services or financial services (including payment systems) sectors.

11.30 The SSRO agrees that contractors should have a right to appeal to an independent body that could confirm or set aside the decision and give the SSRO such other directions as it considers appropriate. In line with the position outlined in the paragraphs above, we consider it reasonable that such a right should also include the assessment of whether the information request was within the SSRO's statutory powers and proportionate. The SSRO proposed that an independent panel could be established to hear appeals and we remain of the view that this would provide an appropriate solution.[14]

Detailed comments on implementation

11.31 Some respondents made specific comments on details of the proposal they considered would need to be addressed or resolved. There were suggestions that:

- Security of information needs to be ensured and confidentiality agreements may be required rather than relying on the provision of Schedule 5 of the Act.
- Requests should only apply to significant and long-term contracts.
- Notices should not be issued to the ultimate parent company, as it is unlikely to be party to a QDC or QSC.
- Contractors should be able to agree a timescale for compliance.

11.32 The SSRO takes the handling of commercially sensitive material seriously. However, it does not support a requirement for confidentiality agreements as a pre-condition for two reasons. The criminal offence for disclosure of information to which Schedule 5 to the Act applies was considered sufficient protection for reported information and there is no reason to treat information provided pursuant to ad hoc requests differently. In addition, achieving a confidentiality agreement would depend on cooperation, which has not proved a successful way for the SSRO to obtain information.

11.33 The SSRO does not support introducing further limitations on the proposed information powers by reference to the nature of the requests that can be made, the contractors to whom notices may be issued or requiring timeframes to be agreed. The proposal already limits the requests that may be made in the manner outlined in paragraph 11.12 above and these constraints are considered to be sufficient.

14 There are alternative models that could be adopted. In 2014, the Enforcement Decision Panel (EDP) was established to take decisions in some enforcement cases on behalf of the Ofgem and, in April 2016, its jurisdiction was extended to the CAA. The EDP's decisions are independent from the investigating team and the authorities cannot change or overrule EDP decisions.

Costs of compliance

11.34 Some industry respondents were concerned that requests for information would place a disproportionate burden on contractors. The SSRO accepts there will be costs associated with complying with information requests, but these are not expected to be excessive for the following reasons:

- The SSRO already makes information requests on an informal basis.
- The required information is likely to be contained in existing records held by contractors.
- An information notice would only be issued following an initial cooperative process as specified by the SSRO in the required statement of policy.
- A reasonable time would be allowed for information to be provided.
- It would be expressly required that information notices are reasonably required in support of the SSRO's functions.

11.35 It is possible that the costs of complying with an information request may be claimed as Allowable Costs under a QDC or QSC. Whether those costs may be claimed on individual contracts will depend on whether they satisfy the AAR test.

Conclusions and recommendation

11.36 Having considered the consultation responses, the SSRO recommends that the regulatory framework is amended to empower the SSRO to require defence contractors to provide it with information. This power should have the features and be subject to the constraints set out below.

Recommended changes

Recommendation 6:

(1) A new section should be inserted in the Act to empower the SSRO to issue requests for information or to empower Regulations to be made to that effect. The following matters should be provided:

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

(b) 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.

(c) The information, explanation or documents must be provided or produced before the end of such reasonable period as may be specified in the notice.

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

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

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

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

(2) A new section should be inserted in the Act to empower the SSRO to issue compliance and penalty notices in circumstances in which there was a failure to comply with a notice issued under the new section.

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

(4) A requirement should be imposed for issues raised in respect of compliance and penalty notices to be determined by an independent panel established by the SSRO.

12. Grounds for referral

Introduction

12.1 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.

12.2 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 considers that there two additional areas where it would be helpful to have the option for referral to the SSRO. These are outlined below.

Steps 1, 4 and 5 of the contract profit rate

12.3 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 and the relevant provisions for this are found in Regulation 18 and in Section 35 of the Act. By contrast, Steps 1, 4 and 5 are not specified as matters that may be referred to the SSRO. The SSRO may not, therefore, 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-contractor, depending on whether it is a QDC or QSC.

12.4 Circumstances may arise in which a contracting party may disagree 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. Whilst the option is available to make a joint referral to the SSRO, there may not be agreement between parties to do so, particularly where:

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

12.5 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 or where the contractual terms and conditions are still under review. There are circumstances, some of which the SSRO has already encountered, such as contracts described as being 'at risk' or subject to 'intention to proceed' (ITP) letters in which the date of entry into contract may be in issue. If views on the date of entry into a contract straddle financial years, then a different baseline profit rate (Step 1) or SSRO funding adjustment (Step 4) may apply, depending on the choice made.

12.6 The incentive adjustment (Step 5) is awarded to give primary and sub-contractors a financial incentive for the performance of some contract provision. Parties may well disagree as to how the discretion has been exercised, such as the percentage awarded, or how the step has been applied in the calculation, for example whether the percentage has been applied in the right place in the six-step process. The SSRO has encountered 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

12.7 The regime only applies to contracts that satisfy the requirements to be QDCs or QSCs and, in the case of QSCs, that have been assessed and notified as such. There is considerable scope for queries to arise regarding the requirements for a contract to be a QDC or a QSC and it is essential to the operation of the regulatory framework that the definitions are correctly and consistently applied.

12.8 The SSRO has been asked to give views (as distinct from opinions) about whether the conditions for a contract to be a QDC or QSC have been met. Questions raised have included whether a contract resulted from a competitive process and the correct valuation for a contract. In such cases, however, the SSRO lacks the information and regulatory powers needed to provide a contract-specific response.

12.9 The SSRO has been asked to give an opinion about whether a proposed amended contract would be a QDC, which raised jurisdictional questions.[15] There is no clear provision for a contracting party to refer a question to the SSRO on whether a contract is, or would be, a QDC or QSC. A joint referral may be made for an opinion on any question relating to an actual or proposed QDC or QSC. If, however, the question sought to be referred is whether the contract is an actual or proposed QDC or QSC then issues may arise as to whether that can be the subject of a referral.

12.10 In the case of QSCs, a sub-contractor may appeal to the SSRO if dissatisfied with an assessment that a contract is a QSC. There is no provision to seek the SSRO's opinion at the time when an assessment is being carried out, which could helpfully avoid disputation or future compliance issues.

The SSRO's proposal

12.11 The SSRO consulted on proposed amendments to the regulatory framework to permit a contracting party or the Secretary of State to refer to the SSRO:

- for an opinion on, or determination of, the appropriate rate or adjustment at any of the contract profit rate steps in Regulation 11; and
- for an opinion on a question of whether a contract meets the requirements for being a QDC or a QSC.

Stakeholder feedback

12.12 Fourteen respondents to the consultation addressed the proposals, of which six supported the changes, including the MOD, three contractors with QDCs currently in the regime, a consultancy body and a not-for-profit body. One of these contractors did, however, question whether opinions in relation to QSC assessments would add any real benefit, but the SSRO believes they would for reasons given above.

15 A summary of the opinion is available at: https://www.gov.uk/government/publications/ssro-publishes-formal-opinion-on-qualifying-contracts.

12.13 Seven respondents, including the industry body, ADS, five of its members and a consultancy body considered there was not a clear problem to be solved. These respondents thought that it would be appropriate, however, to identify the best means of providing guidance to contracting parties on the application of Steps 1 to 6 when determining a contract profit rate and whether a contract is a QDC or QSC.

12.14 Regarding the case for change, the SSRO has explained that it is seeking to ensure referrals can be made in circumstances where contracting parties have sought to raise such questions with it, both formally and informally. In making a recommendation, the SSRO is addressing a gap in the legislation and seeking to ensure contracting parties may refer important questions for opinion or determination which may otherwise go unanswered.

12.15 The SSRO is already empowered to issue guidance on the application of the profit rate steps and has issued such guidance since 26 March 2015. There has nevertheless been a referral for determination of the appropriate adjustment at Step 2 in circumstances where the parties could not agree the correct application of the guidance. The SSRO accepts that guidance may limit the need for referral, but believes parties should still be free to refer questions in appropriate cases.

12.16 The submission that the SSRO should issue guidance around application of the QDC and QSC definitions is welcome. The SSRO would support an amendment to the regulatory framework to explicitly empower it to issue such guidance and to require relevant persons to have regard to it. Provision should still be made, however, for matters the subject of the guidance to be referred to the SSRO.

12.17 One contractor with a QDC in the regime thought that the proposed changes would strongly encourage referrals prior to contract agreement, with the consequence that the SSRO becomes a party to contract negotiation. These contentions are not supported by operation of the referrals process to date. The various existing grounds of referral have resulted in just four referrals since 2014. The fact that the SSRO has given opinions and made determinations on matters relevant to the pricing of contracts has not resulted in it being involved in negotiating contracts. Instead, parties are able to make use of published opinions and determinations to provide additional guidance.

Conclusions and recommendations

12.18 Having considered the feedback received, the SSRO recommends that changes be made to the regulatory framework to ensure referrals may be made to the SSRO in respect of all the profit rate steps and whether a contract or proposed contract meets the requirements for being a QDC or QSC. Changes should also be made to ensure the SSRO may give guidance on application of the requirements for a contract or proposed contract to be a QDC or QSC.

Recommended changes

Recommendation 7:

(1) Section 18 of the Act and Regulations 18(1), 51(1)(a) and 51(2) (a)(i) should be amended to provide for an opinion on, or determination of, the appropriate rate or adjustment at any of the contract profit rate steps (including an adjustment agreed on a group basis under regulation 13).

(2) Sections 14 and 28 of the Act should be amended to provide for a contracting party or the Secretary of State to refer to the SSRO for an opinion on a question of whether a contract meets the requirements for being a QDC or a QSC. Section 35 should be amended to make clear that a joint referral may include the question of whether a contract is a QDC or QSC. The Regulations should appropriately support these changes.

(3) The Act and the Regulations should be amended to expressly provide for the SSRO to issue guidance regarding application of the QSC and QDC definitions and the carrying out of QSC assessments. Provision should be made requiring relevant persons to have regard to the SSRO's guidance.

13. SSRO funding adjustment

Introduction

13.1 Both the defence industry and the MOD are subject to the regulatory oversight exercised by the SSRO across the single source regime as its independent regulator. The SSRO is funded by the MOD through Grant In Aid, although half the cost of this is, from 2017/18, recovered from industry through the funding adjustment by a reduction in the price payable on qualifying defence contracts.

13.2 There is a potential conflict of interest in the MOD exercising oversight as sponsor body for the SSRO whilst being subject to the regime and mechanisms are in place to mitigate this risk. The framework document between the MOD and the SSRO clarifies roles and responsibilities. The sponsor team that manages the day to day relationship with the SSRO (the Single Source Advisory Team - SSAT) is located outside of DE&S, the bespoke trading entity which undertakes the majority of defence procurement.

13.3 As regards funding, the SSRO Board considers the resources necessary to undertake its functions and deliver its corporate plan and requests grant in aid funding from the MOD. The Department ensures there is a robust scrutiny of costs through an assessment of SSRO's needs as set out in the annual publication of a three-year corporate plan, approval of the Grant In Aid and appropriate and routine monitoring.

13.4 The SSRO considers that 100 per cent recovery of costs from industry through the existing mechanism or a levy would provide a more sustainable funding mechanism in line with other regulators who recover costs from industry. This would also positively impact on the SSRO's independence.

The current legislative requirement

13.5 As a non-departmental public body SSRO receives its funding through Grant In Aid provided by its sponsor department, the MOD. Industry is expected to contribute to the costs of the SSRO and this is achieved through the funding adjustment which sees the prices paid by the MOD on relevant contracts reduced by a percentage amount fixed for each year. In this way, each contractor contributes to the cost of the regime in proportion to the value of the contracts they hold that are within the regime.

13.6 The extent of the amount recovered by the SSRO funding adjustment is not explicit in the Act. The explanatory notes to the Act set an expectation that up to half of the SSRO's funding requirements are to be recovered through the funding adjustment. The MOD has indicated, in line with the explanatory notes, that the SSRO should seek to recover 50 per cent of its actual running costs using the following methodology:

- determining the average actual running costs of the SSRO over the last three years;
- deducting the average of any SSRO costs over the last three years incurred in relation to specific tasks and analyses requested by the Secretary of State;
- dividing this by the average of the last three years' total value of qualifying defence contracts, to derive a percentage; and

- dividing this by two, to represent a 50/50 split of these costs between the MOD and suppliers with qualifying contracts.

13.7 The Secretary of State will each year determine and then publish the actual SSRO funding adjustment after considering a recommendation from the SSRO. The rate set for 2017/18 is 0.025 per cent, which will recover over the life of any contracts awarded half of the SSRO's planned £5.77 million Grant In Aid for 2017/18. A higher proportion of costs could be recovered through this mechanism without legislative change by amending the methodology.

Perceptions of independence

13.8 The provision of funding directly by the MOD to the SSRO, irrespective of the recovery through the funding adjustment of a proportion of those costs provides for a measure of influence over resourcing that may give rise to adverse perceptions over the SSRO's independence. Tensions are inevitable where a sponsor department and provider of funds to a regulator are also subject to the regulatory regime for which that regulator is responsible. The greater the extent of funding recovered from regulated bodies the greater the degree to which any perceived impact on independence can be mitigated.

13.9 The MOD have advised that amounts recovered through the funding adjustment may be reinvested in defence procurement rather than used to offset Grant In Aid funding provided to the SSRO. Whilst the amounts involved are not likely to be material to the MOD central or procurement budgets, such action may impact the perceptions of independence intended from cost recovery.

Approaches to regulatory funding

13.10 OECD guidelines on the governance of regulators state that it is necessary for there to be clarity about regulators' sources and levels of funding 'to protect their independence and objectivity'. They further note that 'funding sources should be appropriate for the particular circumstances of regulators' and that 'to promote efficiency and equity, it should be made clear who pays for the regulator's operations, how much and why'.

13.11 The Cabinet Office's Regulatory Futures Review, published January 2017,[16] noted considerable variation between regulators in the extent to which they recover costs through charging the regulated for regulatory services. Full cost recovery has not always been possible or beneficial with the status quo often a product of history rather than logic.

13.12 Some regulators were reported as moving towards full cost recovery and this was considered a necessary condition for a move towards greater government regulated self-assurance: the direction of travel set out in the review. This would also help to increase accountability if accompanied by the need to consult on fees and charges and assist in ensuring that regulation is not gold plated. The review stated that, to support this, there should be a presumption of full cost recovery for regulatory services.

13.13 The SSRO's regulatory model could accommodate full cost recovery and this would positively impact its actual and perceived independence.

16 https://www.gov.uk/government/publications/regulatory-futures-review.

The SSRO's proposal

13.14 During the Call for Input the SSRO sought views from stakeholders on the funding adjustment, in particular the disapplication of Step 4 and the introduction of a levy. It did not include a proposal for change in its public consultation document but referred to the need to ensure SSRO independence, backed by financial autonomy.

Stakeholder feedback

13.15 A number of respondents did not support a levy and considered the existing scheme straightforward and proportionate given the amounts involved. Some considered that the MOD alone should pay for the SSRO. This would be inconsistent with the wider government approach to regulatory funding and not in line with OECD principles. Two respondents stated that a levy-based approach would disadvantage SMEs and smaller companies.

Impact on SMEs and smaller companies

13.16 The existing mechanism is proportionate, straightforward and predictable for contractors with their contribution to SSRO funding tied to the life of the contract. The level of costs recovered at (currently) 0.025 per cent are not considered to be at a level where they would cause disruption to SMEs or smaller companies. For a contract with £10 million of Allowable Costs the amount recovered would be £2,500. At 100 percent recovery of SSRO costs, this would rise to £5,000. This compares to an unadjusted baseline profit amount of £746,000 on a contract with Allowable Costs of £10 million.

13.17 However, a proportion of the SSRO's work benefits all contractors, such as reviewing the Regulations, issuing guidance, assessing profit rates and analysing data. Accordingly, there is a proportion of the SSRO's costs that relate to the wider industry (that is, all single source suppliers) and a mechanism linked only to the value QDCs may not achieve an equitable distribution of costs amongst all suppliers, particularly if the calculation and application of the funding adjustment is skewed by a small number of high value contracts.

Introducing a levy

13.18 Removing the SSRO funding adjustment and replacing it with an annual levy on contractors with single source contracts would address this. Such an approach would be in line with the funding of other economic regulators. Based on a rolling average of past numbers and annual values of qualifying defence contracts, it would result in an annual payment rather than a reduction in the contract profit rate and price payable.

13.19 In order to ensure a degree of proportionality but not disadvantage SMEs, a levy would be determined in bands based on the value of the contracts held by the contractor. The scale of the levy in each band would be determined at intervals in line with the corporate plan and could be adjusted to account for past under or over-recovery of costs based on actual contract numbers and values to which the levy had been applied. This approach would provide for greater clarity and certainty for both contractors and the MOD, and would see recovered funds received annually rather than over the life of contracts.

13.20 The administrative burden of determining, consulting on and collecting a levy would, if implemented, fall to the SSRO. Any costs would be contained. In line with the approach across government for other regulators that are NDPBs, the amount of any final levy and consideration of an annual budget and a three-year corporate plan would remain subject to ministerial oversight arrangements.

13.21 As the SSRO funding adjustment is Step 4 of the six-step process set by Section 17(2) of the Act, that step would need to be removed or dis-applied in order to implement a new approach. There is facility in the Regulations to do this. However, the Act does not provide for the Regulations to introduce a levy and some amendment of the legislation would be required to achieve this.

Conclusions and recommendations

13.22 The SSRO recommends a move to full cost recovery from industry through the introduction of a levy. Any levy amount would be assessed in bands, consulted upon and the charge for each band each determined based on an assessment of the extent to which a fixed proportion of costs should be recovered from all relevant contractors.

Recommended changes

Recommendation 8:

(1) Section 17 of the Act should be amended to remove Step 4 of the calculation of the contract profit rate.

(2) Section 19 of the Act should be amended to remove the requirement for the funding adjustment to be assessed and determined.

(3) A new section should be inserted in the Act to enable the SSRO to determine the amount of funding to be recovered following consultation and, subject to final determination by the Secretary of State, require the recovery of such amounts from relevant regime participants by means of a levy.

Recommendations initiated by stakeholders and supported by the SSRO

14. Introduction

14.1 The SSRO consulted on changes to the regulatory framework that were proposed by stakeholders in responses to the SSRO's call for input. In relation to each proposed change, the SSRO indicated on a preliminary basis whether it supported the change, or whether there was insufficient information to reach an initial view. After considering the consultation responses, the SSRO recommends changes to the regulatory framework in respect of the stakeholder proposals outlined below.

15. Pricing amendments

Introduction

15.1 The Regulations provide for re-determination of the price of a QDC or a QSC if the contract is amended in a way that would affect the price (Regulation 14). By default, the whole price of the QDC or QSC is amended if there is an amendment that affects the price, but if the costs of the amendment are severable from the pre-amendment contract costs, then the price of the amendment may be determined and the previously agreed price adjusted to reflect the increase or decrease attributable to the amendment (Regulation 14(2)).

15.2 The price formula is applied to determine the price of the amended contract or the amendment: price = (CPR x AC) + AC, where CPR is the contract profit rate and AC is the Allowable Costs. Calculating the contract profit rate 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 re-determining the price under Regulation 14, means the time of the re-determination (Regulation 2(1)).

15.3 Given that the baseline profit rate is determined annually by the Secretary of State, there is the possibility that a contract profit rate at the time of amendment may be different from the rate determined when the contract was entered into, or when the price was last re-determined. If the costs of an amendment are not severable from the pre-amendment costs, then the amendment may result in the entire contract being re-priced at a different contract profit rate. The Regulations do not provide guidance as to when costs of an amendment may be severable from pre-amendment costs.

Summary of the proposal

15.4 In response to the SSRO's call for input, some stakeholders contended that the entire contract price of a QDC or QSC should not be re-determined in the event of a contract amendment. The SSRO outlined the issue in its consultation document and sought evidence before formulating a specific proposal for change.

Stakeholder feedback

15.5 Eleven respondents to the SSRO's consultation supported a change that would limit the circumstances in which the whole contract must be re-priced on amendment. This included the MOD, the trade body, ADS, a consultancy, an academic and seven contractors. One defence contractor opposed any change. The substantive matters raised in the responses are addressed in detail below.

Evidence for change

15.6 The proposal was opposed by a contractor with a QDC on the basis that there is insufficient evidence time should be allowed for there to be more QDCs and QSCs and more experience with the application of the framework. The SSRO takes seriously the need for evidence to support recommendations for change. Recognising its limited powers to access information, the SSRO specifically asked for evidence from stakeholders as part of its consultation.

15.7 The consultation responses have not provided the SSRO with examples of actual contracts where pricing an amendment under Regulation 14 has presented a problem. The MOD and ADS both asserted that there is a problem and the following general cases were identified in discussions during the consultation period:

- contracts where the scope is reduced on amendment, where direct costs may be reduced but indirect costs increased; and
- contracts with agreed overhead rates that have not been reviewed by CAAS and amendments are subsequently agreed to include revised rates once CAAS has completed its review.

15.8 The SSRO is informed that in both cases issues have arisen as to whether the costs of the amendment are severable. These assertions from key stakeholders provide some evidence of a problem and the SSRO has considered the case for change in further detail below.

Pricing the amendment not the whole contract

15.9 Five industry respondents argued that pricing amendments should be limited to pricing the amendment itself and should not require pricing the whole contract. As the SSRO understands it, this submission involves dissatisfaction with the current default position in cases where the costs of the amendment are not severable from the costs prior to the amendment.

15.10 The SSRO can see that the requirement to re-price the whole contract on amendment may in some circumstances create a disincentive to amendments being agreed. The following potential issues may arise:

- If the baseline profit rate has changed and the whole contract is re-priced, one of the parties may feel the impact is too great.
- Re-pricing the whole contract may be disproportionate in some cases, for example if there is a relatively minor non-severable amendment.
- Questions of fairness may arise if the whole contract is required to be re-priced, for example by impacting on existing performance or commitments.

15.11 Taking these matters into account, the SSRO can see merit in a proposal to change the regulatory framework so that when an amendment affects the contract price, it is generally the amendment that is priced and the previously determined price increased or decreased accordingly. In other words, the default position would no longer be that the whole contract would be re-priced. It may still be the case that an amendment requires the whole price to be re-determined, but that should depend on the extent of the amendment.

Severability and guidance

15.12 Some respondents called for greater definition regarding when costs are severable. This included the MOD and some industry respondents. As set out in paragraph 15.7, examples have been given of contract amendments for which it may be difficult to determine whether costs are severable.

15.13 The concept of severability is apparently intended to differentiate amendments that may be priced separately from those of sufficiently wide-ranging impact that the whole contract should be re-priced. There is an argument, however, that the severability test masks a more fundamental underlying task, which is to identify and price the costs attributable to the amendment. If it is an additional construct that gives rise to difficulties in application, there may be merit in dispensing with it, rather than devoting resource to defining how it should be applied in different circumstances.

15.14 As an alternative to the existing arrangements, it would be preferable to identify the costs attributable to the amendment and price the amendment accordingly. This would sit comfortably with a default position where the requirement is to price the amendment and then increase or decrease the previously determined price accordingly.

15.15 The costs attributable to an amendment will depend on the terms of the amendment in question and the parties should generally be able to determine these. In some cases, the amendment may be so wide-ranging that it impacts on all the previously determined costs and in such cases the whole contract would have to be repriced.

15.16 The SSRO accepts there is a need for guidance on identifying the costs of an amendment and how these should be priced. This guidance should focus on identifying the costs attributable to an amendment. The SSRO can see merit in the parties having flexibility to agree what is attributable when agreeing the amendment. This would be supported by not seeking to define what is attributable in the Act or the Regulations, but rather enabling guidance to be given that the parties must have regard to. This guidance should be given by the SSRO. It would allow for a variety of scenarios to be considered and for guidance to be adapted as necessary.

15.17 There may be cases in which the contracting parties are unable to agree on the pricing of the amendment. There is facility in the regulatory framework for such questions to be jointly referred to the SSRO. This leaves the possibility of disputed cases in which one party believes a referral should be made and the other does not. If there is to be greater scope for the parties to identify the costs attributable to the amendment, then this should be accompanied by facility for either of the parties to make a referral to the SSRO.

Describing how contract changes should be priced in differing circumstances

15.18 One industry respondent submitted that Regulation 14 should be replaced with a different regulation that states how contract changes should be priced in a range of differing circumstances. The SSRO accepts the need for more guidance and an approach that focuses on pricing the amendment, but does not support a complete departure from Regulation 14. There are elements of Regulation 14 that should be retained, particularly the approach in Regulation 14(2) of identifying the increase or decrease in price attributable to the amendment and then adjusting the previously determined price. Rather than stating in the Act or Regulations how different cases should be dealt with, the SSRO prefers the approach recommended above involving statutory guidance from the SSRO and an avenue for the parties to make referrals to the SSRO. This will support flexibility in the regime to deal with the variety of scenarios that may emerge.

The applicable profit rate

15.19 There seemed to be general acceptance during the consultation that amendments should be priced by reference to the baseline profit rate at the time of amendment, rather than at the time of agreement. It was submitted, however, that there may be some instances in which it would be appropriate for the reverse to apply. The circumstances in which this would be considered appropriate were not explored in detail.

15.20 The SSRO considers that the applicable baseline profit rate should not present a barrier to amendments being agreed. However, the significance of any barrier should be removed by the proposal that it is the amendment which should be priced, rather than requiring the whole contract to be re-priced unless the amendment is severable. In those circumstances, the SSRO recommends retaining the current requirement that the amendment should be priced on the basis of the profit rate at the time of agreement. This has the combined benefits of simplicity and general acceptance.

Conclusions and recommendation

15.21 Having considered the consultation responses, the SSRO recommends that changes be made to the regulatory framework to amend the approach to pricing amendments prescribed in Regulation 14.

Recommended changes

Recommendation 9:

Regulation 14 should be amended as follows:

(a) The requirement in Regulation 14(4) to re-determine the whole contract price should be deleted.

(b) The term severable should be deleted.

(c) The general requirement should be that if an amendment affects the contract price, the costs attributable to the amendment should be priced and the contract price should be the sum of the price payable before the amendment and the increase or decrease from pricing the amendment. This is a modified form of Regulation 14(2).

(d) It should be specified that the parties must have regard to guidance issued by the SSRO when pricing an amendment.

(e) It should be specified that either party may refer to the SSRO for an opinion or a determination as to the pricing of an amendment.

16. Other proposals

16.1 The SSRO recommends six other changes to the legislation that were originally proposed by industry or the MOD. These items were identified from responses to the SSRO's calls for input and included in the public consultation.

16.2 Five industry respondents directed attention to the list of 93 issues prepared by the trade body, ADS, which is referred to in paragraph 3.6 above. Where that list includes a proposed change in respect of an item included in the SSRO's consultation document, reference is made to the relevant content below.

Contract value

Background

16.3 Contract value is used under the regulatory framework to determine whether a contract is a QDC or QSC. As set out in section 8 above, a contract may only be a QDC if its value is £5 million or more and a sub-contract must have a value of £25 million or more to be a QSC.

16.4 The value of a contract is to be determined by the contracting authority in accordance with Regulation 5. For this purpose, the contracting authority is the party to the contract which is, or would be, liable to pay the contract price. In determining contract value, the contracting authority must, where appropriate, take account of any option contained in the contract and the likelihood that it will be exercised.

16.5 Contract value is also used for reporting purposes under Part 5 of the Regulations. For example, the contractor is required to:

- report the contract value in the contract reporting plan (Regulation 24(2)(a));
- list payments exceeding £100,000 or one percent of the contract value (whichever is the greater) in the contract notification report, interim contract reports and the contract completion report (Regulations 25(2)(g), 27(4)(j) and 28(2)(l)); and
- describe actual or intended sub-contracts, including the total proportion of the contract value which it expects to sub-contract, in the contract notification report, quarterly contract reports and interim contract reports (Regulations 25(2)(k), 26(6)(j) and 27(5)(d)).

16.6 The regulatory framework uses the term contract price in addition to contract value. It requires the prices of QDCs and QSCs to conform to the formula: price = (CPR x AC) + AC, where CPR is the contract profit rate and AC is the Allowable Costs. The price is required to be included in contract reports, for example the contract pricing statement.

16.7 When the MOD determines the value of a contract under Regulation 5, it estimates the likely spend under the contract. In making its estimate, the MOD will consider contract options and the likelihood they will be exercised, along with other information known to the MOD. The information taken into account may include plans the MOD has not shared, and does not wish to share, with the contractor. By contrast, the MOD considers that the price or value included in contract reports should be the value of deliverables committed to by the authority. This may include options, depending on the contractor's understanding of the likelihood they will be exercised.

16.8 The MOD's approach to value and price (i.e. treating value for threshold purposes differently from value or price for reporting purposes) is not fully supported by the Regulations as currently drafted. Attention is drawn to the following:

- There is no separate definition in the Regulations of the value required for reporting purposes as opposed to that used for threshold purposes. In each case the contract value should be calculated in accordance with Regulation 5. Accordingly, it is the value calculated by the MOD as contracting authority that should be used throughout.
- In prescribing the price formula, Regulation 10 does not make clear whether contract options should be taken into account. This gives rise to a situation in which the value determined in accordance with Regulation 5 may be different from the price determined in accordance with Regulation 10.

16.9 The SSRO reviews submitted contract reports and has had associated correspondence and discussions with contractors, ADS and the MOD. These have disclosed contracts in respect of which:

- There are options but the decision on whether they will be exercised will be taken later under the contract.
- The contracting authority has not disclosed the value determined under Regulation 5 to the contractor, which is unsure what value to report.
- The reported value is different from the value notified separately by the MOD to the SSRO.
- The reported value is below the QDC threshold.
- The reported value or price has included or excluded options on an inconsistent basis.

16.10 The SSRO may give guidance on both reporting and Allowable Costs. It is considering what additional guidance it can give on both value and price within the constraints established by the regulatory framework.

Consultation

16.11 The SSRO consulted on a stakeholder proposal to clarify the term "contract value" for reporting purposes. At the time of preparing the consultation there was a lack of clarity regarding the perceived problem and solution and the SSRO sought further explanation or evidence.

Consultation responses

16.12 The SSRO received seven consultation responses addressing this issue:

- Six industry respondents considered there was a need for further and better definition. ADS submitted that there should be a definition of "contract value" in Regulation 2(1) as distinct from "contract price" or "value of the contract". It proposed further that there should be a different definition of "value of the contract" or just "value" used for reporting purposes in accordance with Regulations 24(2)(a), 26(5), 27(2), 31(2)(a) and (b) and 50(5). Four contractors supported the ADS submission. Another contractor stated that there needed to be a definition of "contract value" as distinct from "contract price" as both terms are used, creating ambiguity and potential dispute.
- One contractor opposed the change on the basis that the regulatory framework needs to operate for a longer period before there can be sufficient evidence of the need for change. It is possible that this contractor has not experienced the issue that other contractors and the SSRO has identified, but it does not mean there is insufficient evidence of the issue.

16.13 ADS stated in its response that this is an issue of lesser priority and further discussions may be deferred until later. The SSRO has no objection to continuing discussions on matters of detail, but believes there is a substantial issue to be addressed.

16.14 ADS submitted that it may be possible to deal with the issue in guidance. The SSRO agrees there is scope to strengthen guidance on reporting and Allowable Costs. This will not, however, remove the existing ambiguity that is caused by use of the term value in both Regulation 5 and Regulations prescribing reporting requirements.

Conclusions and recommendation

16.15 If the MOD intends to continue to treat value for threshold purposes differently from value or price for reporting purposes, then some amendment to the Regulations seems necessary to reflect this policy. Consideration should be given to whether each use of the term value for reporting purposes is correct, or whether a different term should be used. To the extent that the term value is used for reporting purposes, it should be clear what it is intended to mean on each occasion. There may be a need to require the contracting authority to notify the contractor of its reporting obligations consequent on the valuation under Regulation 5.

Recommended changes

Recommendation 10:

The Regulations should be amended to reflect the MOD's preferred approach to value for threshold purposes compared with value or price for reporting purposes. To achieve this:

(a) Regulation 5 should include a requirement that the contracting authority notify the contractor of the reporting requirements arising from the assessed value.

(b) The Regulations clarify whether the term "value" when used refers to the value determined in accordance with Regulation 5, or the committed price, which may itself need to be defined.

(c) Regulation 24(2)(a), which requires the contractor to report the contract value, should be deleted.

Time limit for a determination under Section 35(1)(b)

16.16 The Act permits specified persons to refer to the SSRO for determination of the defined pricing structure (DPS) and output metrics that must be used in contract reports. Regulation 52(2) specifies that the referral must be made no later than six months after the QDC is entered into. The same time limit will apply in respect of QSCs.

16.17 There is a potential issue with the time limit for referral to the SSRO. If a contract is amended more than six months after it was entered into, in a way that requires the DPS or output metrics to be changed, then the existing time limit would prevent a referral to the SSRO to determine what the DPS or output metrics should be.

16.18 On the basis that it may be appropriate for there to be a referral in cases where the contract is amended, the SSRO indicated support for amending Regulation 52(2) to measure the time limit from the time of agreement as defined in Regulation 2. That definition specifies that the time of agreement for a QDC is the date the contract was entered into or, if the contract becomes a QDC by amendment, the date of amendment. If the contract price is re-determined due to an amendment that affects the price, then the time of agreement may be the date of the re-determination.

16.19 Seven respondents to the consultation directly addressed this proposal:

- Five respondents, including the MOD, three contractors with QDCs and a consultant, supported the change.
- One respondent did not support the change and queried what is meant by "time of agreement". This term is defined in Regulation 2, but ultimately the precise language used to define the starting point for the time limit is a matter of detail that may be addressed when drafting the change. The key is to allow the time limit to run from the time of an amendment that requires change to the DPS or output metrics.

- One respondent opposed the change on the basis that the regulatory framework needs to operate for a longer period before there can be sufficient evidence of the need for change. The SSRO accepts the general point, but believes the regulatory framework has operated for a sufficient period to understand that there may be amendments that require change to the DPS and output metrics.

16.20 Five industry respondents directed attention to ADS, as referred to in paragraph 3.6 above. However, that list does not include a proposed change to Regulation 52(2).

16.21 Having considered the consultation responses, the SSRO continues to believe a change is required to make the time limit operate in Regulation 52(2) operate effectively. It has, however, modified the proposal to leave greater flexibility for how the change is made.

Recommended change

Recommendation 11:

Amend the Regulations to enable the time limit in Regulation 52(2) to run either from the time of entry into contract or an amendment that requires a change to one of the prescribed matters on which a referral may be made to the SSRO for determination (currently the DPS and output metrics to be used in contract reports).

Reference to reports under Part 6 of the Regulations

16.22 Regulation 2(2) specifies that a reference to a report under Part 5 of the Regulations includes a reference to 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.

16.23 There is no similar provision in Regulation 2 regarding what a reference to a report under Part 6 of the Regulations should be taken to include. This leaves a difference between the treatment of Parts 5 and Part 6. There does not seem to be a good reason for the difference as Part 6 includes the estimate rates agreement pricing statement (ERAPS) (i.e. a report that does not have “report” in its name) and Regulation 33 specifies what every report under Part 6 must contain.

16.24 On the basis that there seemed to be an inconsistency between the treatment of Parts 5 and 6, the SSRO indicated support for amending Regulation 2 to specify that reference to a report under Part 6 of the Regulations includes a reference to an ERAPS. Seven respondents to the consultation directly addressed this proposal:

- Five respondents, including the MOD, three contractors with QDCs and a consultant, supported the change. The MOD qualified that there would need to be detailed consideration of the change, which seems reasonable.

- One respondent did not support the change, considering that the ERAPS is submitted annually with supporting information and that the proposed change did not achieve anything material. The change is not proposed due to evidence of non-compliance, but rather to avoid confusion about how the ERAPS is treated and remove an inconsistency between the treatment of Parts 5 and 6. These are both considered to be reasonable objectives.
- One respondent opposed the change on the basis that the regulatory framework needs to operate for a longer period before there can be sufficient evidence of the need for change. The SSRO accepts the general point, but notes that the issue was identified by a stakeholder and appears sufficiently clearly from the legislation to warrant a correction.

16.25 Having considered the consultation responses, the SSRO continues to believe a change is required to ensure there is no confusion regarding treatment of the ERAPS and to remove inconsistency between treatment of Parts 5 and 6.

Recommended change

Recommendation 12:

Amend Regulation 2 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

16.26 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.

16.27 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 consequently the profit achieved by the contractor differs from that anticipated.

The consultation proposal

16.28 Regulation 17 provides for final price adjustment by reference to the total outturn cost and outturn profit and not by reference to the outturn costs or profit of a defined component of a contract. The SSRO indicated support for an amendment such that where only a defined component of a contract is determined by firm, fixed or volume-driven pricing, then the final price adjustment is applied only to that component. This was on the basis that:

- It would be inappropriate to include costs in the calculation that were not based on estimates and carried no risk that actual costs would deviate from estimated costs.
- If such costs are included, then the calculation is less likely to result in a final price adjustment, effectively understating or overstating the impact of cost variation on the outturn profit.

- It is likely to be more 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 is applied only to the defined component that is priced by firm, fixed or volume-driven pricing.

16.29 Six respondents to the consultation directly addressed this proposal:

- Five respondents supported the proposal, including the MOD, three contractors with QDCs and a consultant. The MOD considered the change was necessary to ensure the correct final price adjustment is applied and one contractor stated that it would produce a more equitable position.
- One contractor opposed the change on the basis that the regulatory framework needs to operate for a longer period before there can be sufficient evidence of the need for change. The SSRO accepts the general point, but notes that the issue was identified by a stakeholder and appears sufficiently clearly from the legislation to warrant a correction.

16.30 Having considered the consultation responses, the SSRO continues to support a change in accordance with the consultation proposal.

Recommended change

Recommendation 13:

Amend Regulation 17 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.

Other proposals in relation to the final price adjustment

16.31 The response by ADS to the consultation included the following additional proposals in relation to the final price adjustment:

a. A proposal that a "purpose" should be stated in Section 21(1) of the Act to limit the scope of final price adjustments.

b. A proposal to amend Section 21(4) to exclude parts of a contract from final price adjustment, for example gain-sharing and market prices.

c. A proposal to amend Regulation 16 to clarify the parties who may conduct a final price adjustment in relation to a QSC and make appropriate provision for payment consequent upon an adjustment.

d) A proposal to preface Regulation 17(1) with the words "Unless a direction is given under Section 21(5)".

16.32 The proposal at 16.31(c) was identified by ADS and the MOD as a priority item and was discussed at a workshop between ADS, the MOD and the SSRO on 17 March 2017. The SSRO considers there is an issue to be addressed due to the following:

- Section 21 of the Act provides a regulation-making power for final price adjustments to be made by the Secretary of State under a QDC. Section 30 of the Act provides for the regulatory framework to apply to QSCs and to sub-contractors as they apply to QDCs and to primary contractors. Together these suggest there is a power to make regulations for final price adjustments to be made by the Secretary of State under a QSC, but the position is not clear.
- Regulation 65(8) specifies that in Regulation 16(1) "Secretary of State" should be replaced with "contracting authority", which suggests that the final price adjustment is to be carried out between the contracting authority and the sub-contractor. This is arguably outside of the regulation-making power in Section 21 and produces an inconsistency as Regulations 16(5) to (7) continue to refer to the Secretary of State for the purposes of final price adjustment of QSCs and not the contracting authority.
- There is room to question what should happen consequent upon final price adjustment to a QSC, including: (a) whether payment should be made directly between the Secretary of State and the sub-contractor; and (b) whether there should be consequent adjustment to the QDC or QSC to which the QSC is subject, for example to ensure profit is paid in line with the adjusted costs.

16.33 The SSRO considers there is a need for amendment to the regulatory framework to clarify that there may be final price adjustment in relation to a QSC, who may carry out such an adjustment and what should happen consequent on an adjustment to the QSC.

Recommended change

Recommendation 14:

Amend Section 21 of the Act and Regulation 16 to clarify that there may be final price adjustment in relation to a QSC and to specify who may carry out such an adjustment and what should happen consequent on an adjustment to the QSC.

Proposals raised by stakeholders requiring further consideration

17. Introduction

17.1 The SSRO received several proposals from stakeholders in respect of which further evidence and analysis is required before it would reasonably be in a position to recommend that the Secretary of State changes the regulatory framework. Each of the proposals is addressed in sections 18 to 22 below, along with the SSRO's specific comments and recommendations for further consideration.

17.2 Four of the stakeholder proposals are designed to provide greater flexibility when pricing QDCs or QSCs. These proposals target in various ways the existing scheme of price regulation, which requires that:

- The price payable under a QDC or QSC must be determined in accordance with the price formula: price = (CPR x AC) + AC, where AC is the Allowable Costs and CPR the contract profit rate.
- The CPR is determined for each QDC or QSC through a six-step process beginning with the baseline profit rate determined annually by the Secretary of State.
- The Allowable Costs are determined in accordance with one of the six regulated pricing methods and must pass the test of being appropriate, attributable to the contract and reasonable in the circumstances (the AAR test).

17.3 The four proposed changes may be summarised as follows:

(1) to permit contract profit rates to be determined for defined components of a QDC or QSC that are priced according to different regulated pricing methods;

(2) to expand the range of the cost risk adjustment, which is Step 2 of the six-step process for determining a CPR and currently provides for an adjustment of up to ± 25 per cent to the baseline profit rate;

(3) to increase the limit of the incentive adjustment, which is Step 5 of the six-step process for determining a CPR and currently provides for the addition of up to two percentage points to the profit rate; and

(4) to permit disapplication of the price formula and pricing by alternative means (such as the application of an external benchmark) in some cases.

17.4 The application of price controls is one of the key ways in which the regulatory framework seeks to deliver value for money for government and fair and reasonable prices for contractors. Caution should be exercised before introducing greater flexibility, as it has the potential to weaken the ability of the framework to achieve its objectives, even though it is intended to have the opposite effect.

17.5 The current framework provides the following means by which risk may be transferred:

- The regulated pricing methods apportion the financial consequences of risks that occur between the MOD and the contractor.
- The Step 2 cost risk adjustment allows an adjustment in the CPR to reflect the financial risk taken by the contractor.
- The Step 5 incentive adjustment allows for additional profit to be paid for delivery of non-financial performance at the contractor's risk.

17.6 If the Secretary of State is minded to progress proposals in respect of pricing, the SSRO recommends that the benefits and impacts of each proposal are not considered in isolation, but by reference to each other, any other proposed changes, and the existing framework. There is a need to give due consideration to ways in which risk and incentivisation are reflected across the entire contract pricing framework and the potential for unintended consequences. It is also important to have adequate safeguards to ensure any measures are appropriately applied. The SSRO is progressing a risk study that is intended to support consideration of such matters.

18. Segmented contract profit rates

Background

18.1 Several respondents to the SSRO's call for input thought that it should be possible to apply price control to parts of contracts. The SSRO has recommended a limited change in this regard by proposing that the price formula should not apply to committed price when a contract becomes a QDC or QSC on amendment (see section 6 above). However, the MOD asked the SSRO to consider the merits of changing the legislation to support the application of multiple profit rates within a contract, or alternatively the use of blended rates.

18.2 The current requirements for pricing a QDC or QSC are summarised in paragraph 17.2 above. The contracting parties may use different regulated pricing methods for defined components of a contract (Regulation 10(3)). This means that Allowable Costs may be determined differently across components of a contract, depending on whether the pricing method uses actual or estimated costs. However, no similar provision is made for different profit rates to be determined for defined components of a contract and the SSRO considers the correct construction of the Act is that there must be a single profit rate for a contract.

18.3 The six-step process allows an adjustment to the baseline profit rate at Step 2 (the cost risk adjustment) to reflect the risk of difference between the contractor's estimated and actual Allowable Costs. The regulated pricing methods may produce different risk profiles in respect of the Allowable Costs and this difference will be starkest between methods that use estimated costs and those based on actual costs. The SSRO's guidance is that consideration should be given to the pricing method when determining the cost risk adjustment.

18.4 Where there are multiple contract pricing mechanisms within a contract, the single contract profit rate will have to strike a balance between the risk profiles for each defined component of the contract. This may result in a contract profit rate which is relatively low given the risks assumed on some components of the contract and relatively high on others.

Consultation and feedback

18.5 The SSRO did not develop a proposal to change the regulatory framework to facilitate multiple baseline profit rates in a contract. However, in light of the call for input, it invited respondents to the consultation to provide material in support of the following changes:

- Enabling a contract to have more than one profit rate, with different rates being applied to defined components of the contract.
- Changing the legislation to support multiple baseline profit rates, provided different rates can be applied to different parts of the contract, or blended rates may be used.

General Feedback

18.6 One formal response was submitted on this matter, in which the MOD requested that the SSRO consider a process that would allow for the application of different profit rates within the same overall contract. The SSRO received further informal feedback on this proposal at a workshop with the MOD and ADS.

Issues with a single contract profit rate

18.7 The MOD asserted that there are many contracts with components using different pricing methods relating to different types of work, for example combining research and development with construction. This is supported by what the SSRO can discern, with a sample taken on 18 April 2017 disclosing that one third of qualifying contracts (25 of 75) reported multiple pricing methods. It may be that the different components of contract would attract different contract profit rates if priced separately. However, the SSRO was not provided with contracts to examine or other evidence to establish that the contract profit rate may not reflect the correct balance of risk between the different components over the life of contract.

18.8 The MOD posed a scenario in which there may be difficulties if a single contract profit is applied to defined components of a contract. The example involved the following assumptions:

- There is a contract with one component priced on a cost-plus basis and another component priced according to a method that uses estimated costs, such as the fixed price method.
- The contract profit rate that delivers the appropriate overall profit based on the expected balance of costs, but is comparatively high for the cost-plus component and comparatively low for the fixed price component if each were considered separately, taking into account the different risks of each.
- There is an increase in the scope of the cost-plus component or to the fixed price component, which attracts the contract profit rate and is respectively either too high or too low.

18.9 The concern in such scenarios is that there may be a failure to achieve either good value for money for the government or a fair and reasonable return for the contractor, depending on whether there is an over or under-payment of profit by reference to the price formula. The SSRO accepts the theoretical problem, but has difficulty concluding there is a case for legislative change for two reasons:

- First, the regulatory framework provides for pricing amendments and the SSRO has made recommendations to facilitate this. If accepted, then the costs attributable to any amendment made to change the scope of a component of the contract would be priced and the applicable contract profit rate should reflect the correct balance of risk. It is not clear to what extent the scenario posed by the MOD may result without an amendment being made. This will depend on details of contracts which the SSRO does not have.

- Secondly, the SSRO was not provided with contracts and other evidence that would enable it to conclude that there are instances in which the scenario posed by the MOD has resulted in a failure to achieve either good value for money for government or a fair and reasonable return for the contractor. In this regard, any over or under-payment of profit must be weighed against any additional costs associated with negotiating prices. Assuming that there are such failures, the SSRO does not have evidence of the prevalence and magnitude of the problem.

18.10 The MOD suggested that restricting contracts to a single contract profit rate may incentivise the breaking up of contracts into smaller components, creating new integration risks. The SSRO accepts that the regulatory framework should not create incentives to contract in an inappropriate way. However, it seems that such a distortion would only result if either an appropriate initial contract profit rate could not be agreed, or if a change in scope would lead to an over or under-payment of profit. These are the scenarios discussed above.

Reporting requirements

18.11 ADS raised a concern that multiple contract profit rates may increase the reporting burden, in particular due to the requirement to split costs by the DPS. The MOD thought that the contractor should report the price elements for each component of the contract and did not consider this would be onerous. According to the MOD, separately priced parts would be large in value and a price would have to be built up and agreed for each of the defined parts.

18.12 The SSRO would only support a move to multiple contract profit rates if there is no diminution in reporting requirements. It would expect the price elements to be reported for each defined component of the contract. The SSRO agrees with the MOD that reporting requirements in relation to multiple contract profit rates would not be materially greater than those where multiple pricing methods are applied and refers to the following matters in support:

- The requirement to split costs by the DPS should not be affected by a proposal to permit multiple profit rates in a contract. As outlined above, it is already permissible to have defined components in a contract to which different pricing methods apply and thus different bases for determining costs.
- Multiple contract pricing methods already require segmented Allowable Costs data to be reported and the related profits monitored.
- The calculation of contract profit rates appropriate to each contact component will be required to price the contract, irrespective of whether a single rate or multiple rates are ultimately arrived at.
- The SSRO's DefCARS database has been, and will continue to be, developed to facilitate efficient reporting.

Other potential issues

18.13 We expect contract segmentation to be defined only by differences in pricing mechanism and for separate contract profit rates to apply to those same components. If segmentation were permitted on some other basis, such as contract profit rate alone, it is likely to introduce a significant new reporting burden and may have other unintended consequences.

Conclusions and recommendations

18.14 The SSRO can see potential for the objectives of good value for money for government and fair and reasonable prices for contractors to be enhanced by amending the regulatory framework to permit contract profit rates to be determined for defined components of a contract. The amendment would need to permit the six steps to be calculated differently across defined components of a single contract priced according to a contract pricing method associated to that component.

18.15 Before being satisfied that a change should be made, the SSRO recommends that the MOD examines the following:

- The extent to which changes to the pricing of amendments may address any problem scenario and avoid the need for multiple profit rates in a contract.
- The scope of any failure to achieve value for money or fair and reasonable prices that results under the regulatory framework as currently drafted and whether this is significant when quantified.
- Any marginal costs associated with the proposed change and whether these are outweighed by the identified benefits.

18.16 The SSRO would be pleased to work with the MOD on such matters before completion of the Secretary of State's review in December 2017.

18.17 The SSRO's support for introducing the facility for multiple contract profit rates would depend on there being no diminution in the level of data reported. The introduction of multiple contract profit rates will require the SSRO to alter its reporting requirements to collect the six steps and the profit rates for each of each defined component in the Contract Pricing Statement. For each component, the annual profile of total costs and an annual profile (or if not possible the total amount) of profits would be required. These would be needed in Contract Notification Reports, Quarterly Contract Reports, Interim Contract Reports and Contract Completion Reports.

18.18 If changes are made to enable multiple contract profit rates, the SSRO's statutory guidance on the application of the six-step process to accommodate different contract profit rates within a single contract may also need to be amended. For example, the POCO adjustment calculation assumes a single contract profit rate and would need to be revised to address cases of multiple contract profit rates.

19. Cost risk adjustment (CRA)

Background

19.1 Stakeholders have proposed that the existing range of the cost risk adjustment of plus or minus 25 per cent should be changed. The proposal was raised by the MOD, ADS and five defence contractors on the basis that the limits of the current CRA are too restrictive to correctly reward the diversity of risk profiles across regulated single source contracts.

19.2 As set out in paragraph 17.2 above, the pricing formula applied by the regulatory framework is based on Allowable Costs and a contract profit rate. The cost risk adjustment is applied at Step 2 of the six-step process for determining the contract profit rate of a QDC or QSC. It is important to recognise, however, that the formula operates as a whole, within a wider construct that provides more than one opportunity for risk to be allocated and rewarded.

19.3 The stated purpose of the cost risk adjustment is to adjust the baseline profit rate to reflect the risk of the primary contractor's actual Allowable Costs differing from the estimated Allowable Costs. The regulatory framework does not prescribe a relationship between the risk and the amount of the adjustment. However, the SSRO considers risk should be positively related to reward, with higher risk resulting in higher profit and, conversely, lower risk driving lower profits.

19.4 The risk characteristics of a particular contract may be related to the nature of the activity, the effectiveness of risk management, the ability to accurately characterise the expected costs of those activities and the commercial aspects to the contractual arrangement, such as the pricing mechanism and terms and conditions. These factors will influence the extent to which cost risk is allocated between the MOD and its contractors and hence the cost risk adjustment.

19.5 The returns of the benchmark companies and bonds which inform the baseline profit rate and capital servicing rates will include a market determined risk premium conforming to the activity types and credit risk which generate those returns. Therefore, the rates implicitly reward contractors for a level of cost risk, in the absence of any further adjustment. The cost risk adjustment and capital servicing adjustment then offer the opportunity to adjust the contract profit rate to reflect any perceived requirement to increase or decrease that embedded risk premium.

19.6 The allocation of cost risk will be determined in part through the choice and design of contract pricing method. The cost risk may be mitigated by pain or gain sharing, which is a feature of the target pricing method and may also be applied to the fixed, firm and volume-driven pricing methods through final price adjustment. A pricing method that bases Allowable Costs on estimates passes cost risk to contractors, whereas one that relies on actuals, such as cost-plus, allocates cost risk to the MOD, because the Allowable Costs paid to the contractor are those actually incurred. Due to the impact the pricing method has on cost risk, the cost risk adjustment should be contingent on the pricing mechanism. Furthermore, if the pricing method relies on estimated Allowable Costs, the recognised extent of cost risk will be related to the quality of modelling and forecasting.

19.7 Contractual terms and conditions may impact on the exposure to risk associated with variations of Allowable Costs, for example, through the allocation of the financial impact of contract scope change. It is also relevant to consider the effectiveness of risk management and, in particular, who are the beneficiaries of any mitigation.

19.8 The Step 5 incentive adjustment has a role to play in the provision of return for risk in that it offers a potential reward for contractors who take risk in relation to the delivery of performance improvements. Although Step 5 is not explicitly linked to cost risk, an underlying relationship may exist between performance risk and cost risk.

19.9 The statutory guidance issued by the SSRO on application of the cost risk adjustment recognises the complexities associated with judging the risk that actual costs will be different from estimated costs. The SSRO recommends a full negative adjustment where contractors bear no risk with respect to their Allowable Costs, but otherwise sets out a list of factors that contractors and the MOD must have regard to when agreeing the cost risk adjustment.

19.10 The reason for setting the range of the cost risk adjustment at plus or minus 25 per cent of the baseline profit rate is unclear. The Yellow Book allowed for an adjustment to the profit paid on contracts of up to plus or minus 10 per cent, except in the case of 'non-risk' contracts, such as cost-plus, for which the adjustment was minus 25 per cent. The adjustment was determined based on linking risk to types of work, using a matrix of risk and reward.

Consultation and feedback

19.11 The proposal to change the range of the cost risk adjustment did not form part of the SSRO's call for input and was not specifically addressed in the consultation. However, the consultation document explained that the SSRO remained open to any additional recommendations for change that respondents considered should be made to improve the regulatory framework. The proposal was:

- discussed in a workshop with the MOD and ADS during the consultation period; and
- formally supported by seven respondents to the consultation, consisting of the MOD, ADS and five defence contractors.

19.12 Reponses from industry stakeholders focused on increasing the upper limit of the cost risk adjustment. The MOD expressed a desire to increase both the upper and lower limits. Two principal arguments were presented for change: first, that a more flexible negotiating space is needed with respect to profit and risk transfer; and secondly, that there is a misalignment between risk and reward attributable to the profit rate methodology that needs to be addressed.

The argument that ± 25 per cent is too restrictive

19.13 Both industry stakeholders and the MOD suggested that limits placed on the cost risk adjustment were too restrictive given the diversity of risk profiles across regulated single source contracts. The MOD considered that this resulted in it being unable to correctly align risk and reward and specifically that:

- There are contracts where the MOD would like contractors to accept more risk, but cannot achieve this because it cannot pay a sufficiently high profit.
- There are contracts where the MOD cannot pay sufficiently low profit to reflect the absence of risk carried by the contractor.

19.14 One respondent proposed that a positive adjustment of at least 75 per cent should replace the existing upper limit and the lower limit remain unchanged at minus 25 per cent. No evidence was provided in the support of these suggested levels and none of the other respondents suggested what an appropriate range might be.

19.15 The SSRO accepts that the representations of stakeholders provide some evidence as to the inadequacy of a 25 per cent CRA. However, no supporting evidence was provided regarding the risks the subject of negotiation between the MOD and contractors or the improved contract outcomes that may have resulted from having more scope to reward risk.

19.16 The price formula, of which the CRA forms a part, allows cost risk to be rewarded in a variety of ways as summarised in paragraph 17.2 above. It is one of the primary means by which the regulatory framework seeks to deliver good value for money for government and fair and reasonable prices for contractors and without clear evidence the SSRO has the following observations about increasing the range of the CRA:

- Creating greater opportunities for risk trading may only deliver materially better outcomes in terms of value for money if the resulting new transactions are of mutual benefit to both the MOD and industry.
- Significant expansion of the CRA will impact on other aspects of the price formula, for example diminishing the role of the baseline profit and capital servicing rates as determinants of contract profit rates.
- A relatively tightly bounded CRA limits the discretion available to contracting officers. This may prevent opportunities for risk trading, but also limits the scope for material failures in contract pricing.

19.17 The SSRO believes more evidence is needed to establish an adequate foundation for legislative change. The SSRO is undertaking a risk study to examine:

- how risk has been addressed in QDCs and QSCs to date, through the pricing method, Allowable Costs and the CRA;
- the application of the CRA in the pricing of contracts; and
- the role of a commercial partner who acts as a risk counter-party to the MOD.

19.18 The outputs of the risk study will be relevant to any consideration of the appropriate means of pricing risk into contracts, the range of the CRA and how contracts should be located within that range. The SSRO aims to complete its risk study in Autumn 2017, and we intend to provide it in time to inform the Secretary of State's review of the regulatory framework. The success of the study will depend on cooperation from industry and the MOD, including responses to the SSRO's requests for information.

The contention that the baseline profit rate misaligns risk and reward

19.19 One contractor considered that the current regime needed to better align the profits and risks assumed by contractors when entering into single source contracts. Another contractor more explicitly contended that the cost risk adjustment should be increased to provide 'substantive differentiation' between single source defence contractors and the companies that determine the baseline profit rate. No evidence was provided in support of the representations, but if such evidence is forthcoming, the SSRO will consider it in the context of its assessment of the appropriate baseline profit and capital servicing rates.

Conclusions and recommendations

19.20 The SSRO is not making a positive recommendation to change the boundaries of the CRA at this time. However, the SSRO will publish the results of its risk study in Autumn 2017 and recommends that this be considered as part of the review of the regulatory framework. The SSRO would be pleased to work with the MOD on any proposals for change that may result from consideration of appropriate evidence.

19.21 If a case can be made for a greater CRA range, then this would provide greater discretion to contracting officers and should be accompanied by greater controls. At a minimum, there should be greater transparency, but the circumstances in which the increased range is available may also need to be limited. The current requirement in Regulation 23(2)(d) for the contractor to "describe the calculation that was made under regulation 11 to determine the contract profit rate, including all adjustments that were made under steps 1 to 6" would need to be supplemented. Regulation 23 should additionally require evidence to be given demonstrating the cost of the CRA to the MOD is commensurate with the financial value of the risk it expects to retain or transfer and a description of any relevant facts and assumptions.

20. Incentive adjustment

Background

20.1 The SSRO consulted on whether changes should be made to the incentive adjustment, after this was suggested in response to its call for input. The regulatory framework currently makes the following arrangements in respect of the incentive adjustment:

- The adjustment is made at Step 5 in the six-step process for determining the contract profit rate of a QDC or QSC.
- It allows the contract profit rate to be increased by up to two percentage points to give the contractor an incentive to perform specified provisions of the contract.
- The Secretary of State has discretion whether to allow an incentive adjustment and, if so, to specify the amount of the adjustment and the performance that will trigger payment. It is understood that the discretion has been delegated to contracting officers.
- The Secretary of State is required to have regard to guidance issued by the SSRO when exercising the discretion.

20.2 The SSRO has issued statutory guidance on the incentive adjustment, having regard to its aims of ensuring good value for money for government and fair and reasonable prices for contractors. The guidance is principles-based and relies on the MOD and contractors appropriately assessing various factors. These include identifying the appropriate baseline level of performance given the Allowable Costs, performance targets and the value of the incentive on offer sufficient to motivate the contractor to action. The guidance sets some broad boundaries on the application of the incentive adjustment, but does not define how it should relate to performance targets, nor does it describe how those targets should be set.

Consultation and feedback

20.3 The SSRO identified in its consultation document that a proposal had been received from stakeholders that the benefits should be explored of increasing the percentage adjustment permitted at Step 5 of the contract profit rate calculation. The SSRO stated that it is interested in receiving reasons and evidence in relation to this proposal.

20.4 The proposal was discussed at a workshop held with the MOD and ADS during the consultation period. Six respondents to the consultation addressed the proposal. The MOD, ADS and three defence contractors supported increasing the amount available under the incentive adjustment. One contractor did not express a view on whether the amount available should be increased, but suggested it should be reviewed.

20.5 The MOD explained that it may prefer to pay an incentive adjustment rather than to contract for the specified performance to be delivered. This is on the basis that:

- It may be more expensive to price the specified performance, due to the risk for the contractor in delivery.
- If the specified performance is required under the contract, then it becomes a matter for contract management and enforcement.
- The MOD asserted that an adjustment of up to two percentage points is insufficient for the incentive to be worthwhile to contractors.

20.6 The representations of stakeholders as to the insufficiency of the existing incentive adjustment were not accompanied by supporting evidence. The SSRO was not provided with contract-specific information as to the nature of performance being incentivised, its value or the cost of delivery.

20.7 The SSRO's own information regarding the incentive adjustment is limited to the descriptions given in the contract reports on QDCs and QSCs. These show that 17 of 88 contracts had an incentive adjustment, with an average of 0.41 percentage points, and 9 of those contracts had the maximum adjustment of two percentage points.[17] The SSRO only holds basic information on the structure of incentive payments, and it is unclear how the contract performance has been valued in relation to the quantum of the incentive adjustment. The reported information does not permit the SSRO to judge whether larger incentive adjustments would have been desirable, or would be of value in the future.

20.8 The price formula, of which the incentive adjustment forms a part, is one of the primary means by which the regulatory framework seeks to deliver good value for money for government and fair and reasonable prices for contractors. The SSRO is concerned at the potential impact of increasing the incentive adjustment, considering the following matters:

- Significant expansion of the incentive adjustment will impact on other aspects of the price formula, for example diminishing the role of the baseline profit and capital servicing rates as determinants of contract profit rates.
- There may be pressure to pay larger incentives in cases where the justification is weak. For example, the incentives may be paid for performance that was available and could have been delivered in any event. Alternatively, the use of an incentive adjustment could encourage a contractor to inefficiently incur additional Allowable Costs.
- A relatively tightly bounded incentive adjustment limits the discretion available to contracting officers. This may prevent opportunities to offer incentives, but also limits the scope for material failures in contract pricing.

20.9 The SSRO believes more evidence is needed to establish an adequate foundation for legislative change. The risk study that the SSRO is undertaking (referred to in paragraph 19.17 above) will include examination of the incentive adjustment, as it offers a potential reward for contractors taking risk in relation to the delivery of performance improvements. It will consider whether there is any underlying relationship between performance risk and cost risk.

17 Based on data from the DefCARS database as of 30 April 2017. In one case the reported adjustment was greater than two percentage points.

20.10 The outputs of the risk study will be relevant to consideration of increasing the scope to incentivise contractors to deliver performance enhancements at their own risk and how this relates to other modes of incentivisation such as the contract pricing method. The SSRO aims to complete its risk study in Autumn 2017, which should be in sufficient time to inform the Secretary of State's review of the regulatory framework. The success of the study will depend on cooperation from industry and the MOD, including responses to the SSRO's requests for information.

Conclusions and recommendations

20.11 The SSRO is not able to make a positive recommendation to increase the limit of the incentive adjustment at this time. However, the SSRO will publish the results of its risk study in Autumn 2017 and recommends that this be considered as part of the review of the regulatory framework. The SSRO would be pleased to work with the MOD on any proposals for change that may result from consideration of appropriate evidence.

20.12 If a case can be made for increasing the limit of the incentive adjustment, then this would provide greater discretion to contracting officers and should, at a minimum, be accompanied by greater transparency. The current requirement in Regulation 23(2)(d) for the contractor to "describe the calculation that was made under regulation 11 to determine the contract profit rate, including all adjustments that were made under steps 1 to 6" would need to be supplemented. Regulation 23 should additionally require evidence to be given demonstrating the cost of the incentive adjustment to the MOD is commensurate with the value of the additional performance it expects in return and a description of any relevant facts and assumptions.

21. An alternative means of pricing QDCs and QSCs

Introduction

21.1 The Act and the Regulations regulate the prices of QDCs and QSCs in the manner described in paragraph 17.2 above. These measures provide a means of assuring that the government achieves good value for money and contractors are paid a fair and reasonable price.

21.2 Some respondents to the SSRO's call for input suggested there may be circumstances in which the regulatory framework should permit the price formula to be disapplied and the price of a QDC or QSC to be determined by alternative means, such as:

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

21.3 Alternative pricing may be achieved under the current framework by the Secretary of State exempting a proposed QDC or QSC. The SSRO has been informed that a small number of such exemptions have been granted in circumstances where it was considered impracticable to apply the price formula. The SSRO does not have a clear picture of such cases as:

- Exemptions are at the discretion of the Secretary of State.
- There is no obligation to report exemptions to the SSRO.
- The effect of an exemption is to take the contract outside of the regulatory framework.

21.4 If there are single source defence contracts that are being exempted to enable an alternative means of pricing, then it may be reasonable to consider:

- defining the circumstances in which an alternative means of pricing is permitted;
- specifying the means of ensuring value for money and fair and reasonable prices; and
- subjecting such contracts to greater transparency.

21.5 If there is merit in the approach, the regulatory framework would need to be amended to permit an alternative means of pricing and specify its requirements.

Summary of the proposal

21.6 The SSRO took a cautious approach to the proposal that contract prices may be fixed by reference to some commercially established price, on the basis 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.
- If a defence contract is single-sourced, the Defence Reform Act 2014 provides a sound, tested means of assuring value for money and fair and reasonable prices by determining the price by the formula and requiring transparency.

21.7 The SSRO consulted on the possibility that the price formula might be disapplied in a limited set of cases in which it could be demonstrated on referral to the SSRO that:

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

21.8 The SSRO proposed that modified contract reporting requirements should apply in cases where it determined that the pricing formula may be disapplied.

Stakeholder feedback

21.9 One contractor opposed the proposal to make provision for alternative pricing, believing the Secretary of State's power to exempt contracts from the regime already provides a suitable alternative to the price formula. It is acknowledged that the regime has been functioning to date without special provision for alternative pricing, but this does result in reduced transparency, as indicated in paragraph 21.3 above.

21.10 Another contractor supported the consultation proposal, finding merit in a mechanism for disapplying the price formula in exceptional cases. This would define the circumstances in which disapplication is permitted, provide a clear control mechanism and result in greater transparency as contract reports would be submitted in respect of the resulting QDCs and QSCs.

21.11 Ten respondents supported making an alternative means of pricing contracts available, but in a different way than proposed in the consultation. This group of respondents included the MOD and industry respondents. These respondents preferred the regulatory framework to permit an alternative means of pricing to be applied at the discretion of the contracting parties.

21.12 The remaining respondents did not address the alternative pricing proposal directly, although one of these provided a relevant response regarding the decision to single source. Further aspects of the responses on alternative pricing are set out below.

Nature of any difficulty applying the price formula

21.13 The SSRO received limited information concerning the cases exempted by the Secretary of State to date. The indication was that a small number of contracts had been exempted in circumstances where the price formula could not reasonably be applied. Examples given were:

- a purchase made on a commodity market; and
- the purchase of software from an international supplier.

21.14 Two additional examples were provided of contracts to which the MOD considered it was impracticable to apply the price formula. One of these contracts had a component that could be priced according to the formula and components where it was considered the price formula could not be applied.

21.15 The SSRO does not have full details of the contracts that were presented as examples. However, from the information provided, the following features may be discerned of cases in which it has been considered impracticable to apply the price formula:

- The contract is for goods or services that are sold to multiple customers on a commercial basis.
- The price is not constructed on a basis that can be expressed on a cost and profit mark-up basis.
- The MOD's purchase represents a small proportion of the contractor's sales.
- Some evidence is available of what is a fair and reasonable price, based on information such as price lists or comparable sales.

21.16 These considerations would be relevant to establishing any alternative means of pricing.

Scope of any problem and availability of alternative pricing

21.17 The SSRO developed a proposal for consultation targeted at a relatively small number of contracts, currently the subject of exemption under the regulatory framework. However, feedback from the MOD and some industry respondents was that the circumstances in which contracting parties would seek to depart from the price formula may be more than exceptional. One contractor stated that: "This is potentially a bigger issue than the SSRO appears to believe as the MOD have a number of equipment supply contracts with outsourced suppliers". These respondents suggested that alternative pricing should be available at the discretion of the contracting parties.

21.18 The information made available to the SSRO does not provide a clear understanding of the number and value of contracts which may appropriately be priced by alternative means. The lack of information limits the SSRO's ability to make recommendations and raises concerns about unintended consequences. However, based on the limited information available, the SSRO can see merit in limiting any alternative to the price formula to cases in which:

- it can be demonstrated that it is impracticable to apply the price formula; and
- there is a credible alternative means of being satisfied the price is value for money and fair and reasonable.

21.19 The SSRO bases this view on the following:

- The price formula provides an objective, tested approach to demonstrating that prices are value for money and fair and reasonable.
- There should not be a parallel system of pricing that gives contracting officers unfettered discretion as to which approach to apply, placing pressure on the objectives of the regulatory framework.
- A clear basis should be specified for identifying when a contract may be priced by alternative means, consistent with the objectives of the regulatory framework.

21.20 If alternative pricing is permitted, it should only be available when it is impracticable to apply the price formula and the circumstances in which that condition may be satisfied should be prescribed. For example, the impracticability may result from the way the price is constructed or the MOD's lack of purchasing power. Alternatively, or in addition, the SSRO may be empowered to give statutory guidance on when it is impracticable to apply the price formula.

21.21 The difficulty in applying the price formula may apply only to one component of a proposed contract. Consistent with the SSRO's view that the price formula should generally be preferred, consideration should be given to limiting alternative pricing to such part of a contract as meets the prescribed conditions.

Commercially available

21.22 Several industry respondents proposed that the price formula should be supplemented to allow for the following:

- items subject to market prices;
- items with commercial price lists;
- commercial off-the-shelf (COTS) purchases;
- modified off-the-shelf (MOTS) purchases; and
- additional quantities of items previously competed.

21.23 The proposal appears to be that in any of these cases the contract may be priced by reference to the priced offered by the contractor and not the price formula.

21.24 The SSRO does not support this approach, as it involves no requirement to demonstrate that the proposed price is value for money and fair and reasonable. It may be that these objectives would be achieved in respect of the specified categories of purchases, but this will not necessarily be the case. For example, a supplier with a price list may nevertheless be selling at different prices to different customers for a variety of reasons. More information will likely be required to support analysis of whether a price is both value for money and fair and reasonable.

21.25 While the SSRO does not believe that commercial availability provides a sufficient basis for alternative pricing, there may be an argument for limiting alternative pricing to contracts for goods or services that are commercially available. Where goods and services are sufficiently widely available on a commercial basis, it may be possible to obtain evidence of comparable sales against which to judge the purchase price.

21.26 If departure from the price formula is made dependent on the purchased goods or services being commercially available, then the Regulations should define the circumstances in which the condition may be satisfied. It would be appropriate to specify when goods or services may be considered to be commercially available, how widely the goods or services should be available and to what extent modified versions of those goods or services may nevertheless be considered to be commercially available.

What may be the alternative approach to pricing?

21.27 The MOD proposed that value for money may be demonstrated by one of the following means:

- evidence of recent orders or invoices from other countries or clients;
- benchmarking;
- prices from recent competition; and
- verification from the governments of other countries.

21.28 The MOD considered the alternative approach would require oversight by the SSRO.

21.29 The MOD's proposal leaves open a number of matters that would need to be addressed if an alternative means of pricing were to be developed. Consideration would need to be given to matters such as:

- the appropriate test of whether a price is acceptable;
- the person who should be satisfied that the test has been met;
- the analysis required to determine that the test is met;
- the evidence that should be considered as part of the analysis and the source from which the evidence should be obtained.

21.30 The SSRO believes that any alternative means of pricing would need to be based on some objective test. The MOD's proposal refers to value for money, but the regulatory framework is currently aimed at achieving prices that are both value for money for government and fair and reasonable for contractors. There is an argument for requiring the Secretary of State to be satisfied that a price satisfies these objectives.

21.31 If one of the justifications for introducing alternative pricing is to provide structure for pricing contracts that would otherwise be dealt with by exemption, then the Regulations should prescribe how it may be concluded that a price is value for money and fair and reasonable. In the United States of America, the Federal Acquisition Regulation requires a price analysis, relevantly based on:

- Comparison of the proposed price to historical prices paid for the same or similar purchases. Before making a comparison, regard must be had to the relevance of the comparison, taking into account of matters such as time lapsed, differences in terms and conditions, quantities, market and economic factors and technical advice as to the comparability of the subject goods and services.
- Use of parametric estimating methods or rough yardsticks to identify inconsistencies in the proposed price that warrant additional inquiry.
- Comparison with published price lists, market prices of commodities, similar indices, and discount or rebate arrangements.
- Comparison of proposed prices with independent government cost estimates.
- Comparison of proposed prices with prices obtained through market research for the same or similar items.

- Analysis of data other than certified cost or pricing data provided by the contractor.

21.32 This kind of analysis should be carried out to determine whether a price is value for money and fair and reasonable. The analysis should be based on relevant evidence and contracting officers directed as to what must or may be considered. The MOD may hold relevant data or may be able to obtain it from third parties, including the SSRO. However, it may be that in some cases the pricing analysis will depend on information held by the contractor, such as data on prices at which the same or similar items have been sold previously. Provision would need to be made regarding:

- the circumstances in which data may or shall be requested from the contractor;
- whether the contractor is required to respond; and
- the protection provided to such information (for example whether it is information to which Schedule 5 of the Act applies).

21.33 If an alternative approach is applied, pursuant to which there is a price analysis to establish that a price is value for money and fair and reasonable, it is fundamental there should be no additional profit added. The profit formula model of Allowable Costs plus profit would not apply.

Transparency

21.34 If an alternative means or pricing is introduced, then the SSRO should be provided with transparency as to the following:

- the decision to disapply the price formula;
- the price analysis demonstrating value for money and a fair and reasonable price; and
- the awarded contract.

21.35 For the SSRO to keep under review any alternative means of pricing, it would need to have access to the decisions taken to disapply the price formula and the price analysis demonstrating that the price is value for money and fair and reasonable. The SSRO would not support any amendment that did not provide it with this information.

21.36 One of the potential benefits of permitting a contract to be priced by alternative means within the regulatory framework is to provide transparency over more single source spending. The SSRO would expect the contract reports in Part 5 of the Regulations to be required for a QDC or QSC priced by alternative means, subject to such modification as is necessary to reflect the different approach to pricing.

Referrals

21.37 The SSRO proposed a pre-condition that before applying an alternative means of pricing, a determination should first be made by the SSRO that the price formula may be disapplied. Some respondents addressed this specific proposal as follows:

- The MOD disagreed that all such cases should be referred to the SSRO.
- One contractor thought there should be no referral as it is a matter for the MOD and the contractor to agree.
- One contractor submitted that the SSRO should only be involved if asked for an opinion or a determination by one of the parties.

21.38 The regulatory framework permits either contracting party to make a referral to the SSRO for an opinion or a determination on matters concerning application of the price formula. If an alternative means is available for determining contract price, then either party should be able to refer questions to the SSRO regarding the choice of the alternative mechanism and its application.

Competition is unavailable

21.39 The SSRO proposed that pricing by reference to market prices should only be contemplated if competition is genuinely unavailable. In response, two contractors with QDCs expressed views regarding the availability of competition to the following effect:

- A competitive market delivers value for money by definition.
- There may technically be competition but nevertheless reasons to engage the contractor for additional work on rates that may not be the most competitive.

21.40 The SSRO disagrees that a single-source purchase in a competitive market necessarily delivers value for money. Competition may deliver value for money and is to be preferred, except in a limited set of circumstances permitted under the D&SPC Regulations 2011. In circumstances where a defence contract is single-sourced, value for money may be established by some other means, which the regulatory framework currently seeks to achieve by applying the price formula and transparency.

21.41 The suggestion that there may be reasons to make single-source purchases at prices that may not be the most competitive highlights the need to make the correct choice about whether to single-source. The SSRO remains of the view that this decision should be closely scrutinised if there is indeed a competitive market. An academic respondent considered that the topic of “single source contracts which should have been competed” requires further detailed and critical study and the SSRO supports that position.

Private finance initiatives (PFI) and public-private partnerships (PPP)

21.42 One defence contractor made representations concerning the difficulty of applying price regulation to PFI and PPP contracts under the regulatory framework. The SSRO recognises that the cash flow profile of such contracts may be very different from other QDCs or QSCs due to the upfront investment. This is a complex area, however, and before any alternative approaches are developed to pricing such contracts, the SSRO believes time needs to be taken to gather evidence concerning any affected contracts so that the nature of the problem can be explored and an appropriate solution devised, if any. The SSRO would be willing to further explore this issue if the MOD and defence contractors can provide the required information.

Conclusions and recommendation

21.43 The SSRO considers that the regulatory approach to permitting alternative means of pricing may be improved by:

- defining the circumstances in which an alternative means of pricing is permitted;
- specifying the means of ensuring value for money and fair and reasonable prices; and
- subjecting such contracts to greater transparency.

21.44 The SSRO lacks the detailed evidence required to make a positive recommendation for change. If the MOD introduces alternative pricing, then this should only be on the basis of:

(a) limiting availability to contracts for commercially available goods and services where it is impracticable to apply the price formula;

(b) applying alternative pricing only to such part of a contract as satisfies the conditions for disapplying the price formula;

(c) defining the circumstances in which goods and services may be considered to be sufficiently commercially available;

(d) specifying that the Secretary of State must be satisfied that an alternative price is value for money and fair and reasonable;

(e) specifying the price analysis required to demonstrate that an alternative price is value for money and fair and reasonable, as outlined in paragraph 21.31 above;

(f) specifying the evidence to be considered as part of the required price analysis and providing for provision of relevant evidence by the contractor;

(g) providing the SSRO with transparency regarding the decision to apply alternative pricing and the associated price analysis;

(h) requiring submission of contract reports, subject to appropriate modification;

(i) empowering the SSRO to issue statutory guidance regarding the conditions for alternative pricing, the required analysis and evidence; or

(j) providing an avenue for referral to the SSRO for opinion or determination on any of the alternative pricing steps.

21.45 The SSRO supports the proposal made by a respondent academic that a detailed study should be carried out on the choice to enter into single source defence contracts. This should examine single source contracts and whether there are any that should have been competed.

22. Other deferred stakeholder proposals

22.1 The SSRO consulted on changes to the regulatory framework that were proposed by stakeholders in responses to the SSRO's call for input. In relation to each proposed change, the SSRO indicated on a preliminary basis whether it supported the change, or whether there was insufficient information to reach an initial view. After considering the consultation responses, the SSRO considers that additional work is required on the proposals outlined below before it would be able to recommend a change to the regulatory framework.

Figure 6: Proposals raised by stakeholders requiring further consideration

Proposal	Comments
(1) It was proposed that the definition of "defence contract" in Regulation 32(6)(a) is amended to limit it to extant contracts.	No explanation was provided as to why this would be beneficial. The SSRO expressed a preliminary concern that the proposed change was unnecessary and may cause confusion. ADS and three contractors reiterated the proposal in response to consultation but identified this proposal as a lesser priority item, stating that further discussion may be deferred until after June 2017.
(2) It was proposed that 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.	ADS submitted that the Secretary of State should be required to notify the contractor of relevant events and was supported by six contractors. ADS considered this is a lesser priority item that may be deferred until after June 2017.
(3) It was proposed that 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.	ADS reiterated this proposal in its response to consultation and was supported by five contractors. ADS considered this is a lesser priority item that may be deferred until after June 2017.
(4) 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.	This proposal did not appear to be directly addressed in responses to consultation. However, respondents did address other aspects of Schedule 5, with ADS indicating that it considered such matters to be of lesser priority and capable of being deferred until after June 2017.

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

22.2 In cases where the SSRO determines the appropriate amount of a contract profit rate adjustment for a QSC, Regulation 65(9) modifies the SSRO's consequential power so that the SSRO may determine that 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.

22.3 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 a specified amount. The SSRO indicated support for an amendment to treat such cases 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.

22.4 Six respondents to the consultation directly addressed this proposal:

- Four respondents supported the proposal, including the MOD, two contractors with QDCs and a consultant.
- One contractor was concerned about a payment being made by the MOD to the sub-contractor in circumstances where the prime contractor is owed money by the sub-contractor. A further concern was raised that the change may lead to practical difficulties in managing and recording cost allocation and recovery, due to misalignment between sums paid out or recovered, or discrepancies between agreed contract figures and sums provided to or by the MOD. The suggestion was made that additional guidance would be required.
- One contractor opposed the change on the basis that the regulatory framework needs to operate for a longer period before there can be sufficient evidence of the need for change.

22.5 Having regard to the concerns raised in the response to consultation, the SSRO does not recommend a change to Regulation 64 to make provision for an adjustment payment to be made directly between the MOD and the sub-contractor following determination of the extent to which a cost in a QSC is Allowable. Instead, the MOD should give the matter further consideration, alongside considering whether there are practical issues arising from the current provision in Regulation 65(9) requiring a direct payment between the Secretary of State and the sub-contractor in the event of an adjustment to the contract profit rate of a QSC.

Cost allocation statement

22.6 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 or 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.

22.7 The MOD proposed that the cost allocation statement or QMAC be included in the actual and estimated rates claim reports to remove any uncertainty regarding the timing of submission. The SSRO included the proposal in its consultation. Six respondents to the consultation directly addressed this proposal:

- The MOD and one contractor with a QDC supported the change.
- Three contractors with QDCs and a consultant did not support the change.
- One contractor thought the change was unnecessary and would lead to a duplication of work without clear benefit. As the SSRO understands the proposal, it was not intended that the QMAC be duplicated, but that it be submitted along with the reports on overheads, if such reports are required.

22.8 Another contractor was concerned that the requirement would increase the overlap and blurring of lines between the roles of the SSRO and CAAS, with the potential for different views to be taken over cost allocation. The difficulty with this submission is that the roles of the SSRO and CAAS are quite different. The SSRO's functions arise from the regulatory framework and it would not be open to the SSRO to use the information in support of other functions. The SSRO's published compliance and review methodology makes clear the way in which it may raise queries in support of those functions.

22.9 One respondent opposed the change on the basis that the regulatory framework needs to operate for a longer period before there can be sufficient evidence of the need for change. The SSRO understands that the MOD perceives a benefit in the proposed change, which provides some evidence of need. However, having considered the consultation responses, this is a matter requiring further consideration before the SSRO can make a positive recommendation to change the regulatory framework.

Additional stakeholder proposals submitted during consultation

22.10 As set out in paragraph 3.6 above, ADS submitted a list of 93 issues in response to the consultation, or which:

- 10 items have been expressly withdrawn.
- 12 items are in scope of proposals given substantive treatment in this document.
- 71 items are identified by ADS as being of lesser priority and capable of being deferred for later consideration.

22.11 The SSRO has accepted the prioritisation given by ADS to the 71 items and makes no positive recommendations in relation to them. This is with agreement from the MOD that it will engage with the SSRO and seek its views on how the issues should be addressed if they are further considered as part of the Secretary of State's review.

22.12 There were some additional proposals put forward by stakeholders that would require further evidence and analysis. These could be explored as part of the Secretary of State's review and the SSRO would seek to be involved in such further development.

Proposals raised by stakeholders where the SSRO does not support changing the regulatory framework

23. Introduction

23.1 The SSRO consulted on changes to the regulatory framework that were proposed by stakeholders in responses to the SSRO's call for input. In relation to each proposed change, the SSRO indicated on a preliminary basis whether it supported the change, or whether there was insufficient information to reach an initial view. The table below identifies the proposals in respect of which the SSRO does not support changing the regulatory framework. Brief reasons are given for the SSRO's position, having considered the consultation responses.

Figure 7: Proposals raised by stakeholders and not supported by the SSRO

Stakeholder proposal	Comments
(1) If the contract price is based on actual rather than estimated costs, then submission of the contract pricing statement might be delayed (Regulation 23). This was based on a perceived difficulty in completing the contract pricing statement if the actual costs are only ascertained at times after the report is due.	No consultation responses addressed this proposal. The SSRO is concerned that the change would result in a loss of transparency. Our experience has not demonstrated any actual barriers to submitting the contract pricing statement in respect of cost-plus contracts. In such cases the reported information is based on agreed expectations.
(2) Step 5 of the process for determining a contract profit rate might be amended to permit a negative incentive adjustment (Section 17 and Regulation 11). This would permit the profit rate to be decreased if the contractor did not perform specified provisions of the contract.	One respondent stated that such adjustments "should be incorporated as a pre-determination of [liquidated damages]". No other respondent addressed the proposal, including the initial proponent. In the absence of evidence the SSRO remains unpersuaded there is a case for legislative change.
(3) The Secretary of State's consent should be required before the contracting parties may agree an incentive adjustment to the contract profit rate for a QSC. The legislation presently permits the contracting authority and the sub-contractor to agree an incentive adjustment at Step 5 of the process for determining the contract profit rate (Section 17 and Regulations 11 and 65(4)(a)).	No consultation responses addressed this proposal. The QSC price must ultimately satisfy the test of being an Allowable Cost under a QDC to which the Secretary of State is a party. The MOD will have the opportunity to challenge whether a sub-contract price that includes an incentive adjustment is appropriate, attributable to the contract and reasonable in the circumstances.

Stakeholder proposal	Comments
(4) The requirement to keep records should be limited to such records as would be available in normal accounting and financial data systems.	This issue was not addressed in responses to the consultation, although other proposals were made in relation to records. The proposal seems unduly restrictive given the purposes for which records are kept and which include matters such as performance monitoring and determining whether a contract is a QSC.
(5) The duty to keep records should reflect each contractor's reporting cycle and the need for internal audit and reconciliation.	This issue was not addressed in responses to the consultation, although other proposals were made in relation to records. The legislation has adequate safeguards in place by referring to records which may be reasonably expected and which are sufficiently up-to-date and accurate. To the extent the concern is about the proportionality of the MOD's action, the current regulations provide a mechanism under which the SSRO may review the exercise of functions in relation to records.
(6) The definition of "relevant record" should require the keeping of data rather than records (on the basis that record is taken to refer to completed, physical documents).	This issue was not addressed in responses to the consultation, although other proposals were made in relation to records. The SSRO considers the term "record" is sufficiently broad to encompass a wide range of data.
(7) 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 is committed to being open and transparent about the work it does, while seeking to maintain (when appropriate) the confidentiality of information it obtains in the exercise of its functions. Publishing the SSRO's analysis has number of advantages, in that it: • enables interested persons to engage effectively with the SSRO's work; • increases the impact of the SSRO's work and supports accountability; • improves the effectiveness and efficiency of our work, and • improves the quality and robustness of decision-making. The SSRO does not consider that the proposal requires legislative changes at this stage as the SSRO may work with the MOD to agree transparency of its studies.

Stakeholder proposal	Comments
(8) The words "concerning" or "directly concerning" should be used in place of "relating" throughout the regulatory framework.	One contractor addressed this issue in its consultation response, stating that "relating" has application potentially wider than the contract itself whereas "concerning" limits the application to the contract as intended. 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. The SSRO cannot discern a material benefit from replacing the word "relating" with "concerning" in any of these instances and for this reason does not support the proposed change.
(9) 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.	An informal response received during consultation suggested that this is a matter that may be dealt with in guidance. The regulatory framework requires the SSRO to deal with some referrals but gives it discretion in respect of others (examples of discretion can be found in Sections 18(3), 20(5), 27(3) and s30(4)(b)). No clear explanation was put forward as to why it should be mandatory for the SSRO to carry out reviews under Section 23(6). The evidence is that the SSRO has dealt with all referrals received to date (one mandatory and three discretionary) and has not yet received a referral under Section 23(6). There may well be a case in which it would be appropriate to refuse a referral of this kind, for example if there had a been a previous referral on the subject.
(10) 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.	An informal response received during consultation suggested that this is a matter that may be dealt with in guidance. It is not clear why a compensation provision is required. Compliance costs may be Allowable under the regulatory framework if they satisfy the AAR test. Either party may refer to the SSRO to determine the extent to which a cost is Allowable.

24. Capital servicing adjustment

Background

24.1 On an informal basis during the consultation period, and prior to submitting a formal response, ADS proposed three changes in relation to Step 6 of the process for determining the contract profit rate for a QDC or QSC (the capital servicing adjustment). Section 17(2) of the Act sets out the requirement for the capital servicing adjustment as follows:

Step 6

Take the amount resulting from step 5 and add to or subtract from it an agreed amount ("the capital servicing adjustment"), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract.

This adjustment –

(a) is to be made having regard to the capital servicing rates determined under section 19, but

(b) does not apply to the extent that the costs of the fixed and working capital employed by the primary contractor are Allowable Costs under the contract.

24.2 Regulation 11(8) requires that:

In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:

(a) must have regard to the capital servicing rates in force at the time of the agreement;

(b) must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are Allowable Costs under the contract; and

(c) may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor's obligations under the contract.

24.3 The SSRO issues statutory guidance that contracting parties must have regard to when applying as the capital servicing adjustment. The guidance is principles based and is reliant on the professional judgement of the contractor to identify the capital employed in the business unit most relevant to the QDC or QSC and the MOD's scrutiny of that assessment.

Consultation and feedback

24.4 The SSRO did not consult on specific proposals with respect to the capital servicing adjustment, having considered the following responses to its call for input in 2016:

- The MOD thought that the issue was worth exploring but practicalities needed to be addressed.
- Industry respondents considered that Step 6 should remain, with some specifying that it should remain in its current form and some considering that greater experience is required before considering eliminating the capital servicing adjustment.

24.5 At the time of consultation, the SSRO explained that it was open to any additional recommendations for change from respondents. On an informal basis during the consultation period, and prior to submitting a formal response, ADS proposed three changes in relation to 'Step 6' (the capital servicing adjustment) as set out in Section 17(2) of the Act and quoted at paragraph 24.1 above:

(1) Delete the words "for the purpose of enabling the primary contractor to perform the contract".

(2) Delete the words "having regard to" from paragraph (a) and insert instead "taking".

(3) Insert the word "direct" before "allowable costs" in paragraph (b).

24.6 The changes suggested by ADS were the subject of a workshop between ADS, the MOD and the SSRO during the consultation period. No specific examples were provided demonstrating any practical difficulties arising from the current wording of the legislation in respect of the capital servicing adjustment.

First proposal: removing the requirement that capital be used to enable contract performance

24.7 It was explained to the SSRO that in practice, the calculation of the capital servicing adjustment may need to include assets in the capital employed that are legitimately held for defence purposes but in respect of which it may be difficult or impractical to identify specific capital as enabling the contract. The intention of the first proposed change was to make it easier for such capital to be included in the calculation of capital employed.

24.8 The SSRO understands there is a desire not to unnecessarily restrict or make difficult the identification of an appropriate capital value for the purposes of calculating the capital servicing adjustment. However, for the following reasons the SSRO believes the current control linking the return at Step 6 to capital employed in performing the contract is appropriate and should remain:

- It is difficult to justify such a return where it is not determined regarding a valuation of the capital which is employed on the contract in question.
- Removing the control may allow a return that is more generous than that which might be considered fair and reasonable given the capital employed on the contract, and would not be consistent with value for money for the government.

24.9 Even with the control in place, it remains possible to apply a practical approach to identifying the capital associated with deliver of a particular contract. Section 17 of the SSRO's guidance on the application of 'Step 6' provides a degree of flexibility in the recognition of the appropriate value of the capital employed for the purposes of the capital servicing adjustment.

Second proposal: requiring the capital servicing adjustment to be based on the capital servicing rates

24.10 The replacement of "having regard to" with "taking" in paragraph (a) would mandate the use of the capital servicing rates to calculate the capital servicing adjustment. The SSRO does not see the need for this change. The requirement to have regard to the capital servicing rates is reflected in the SSRO's statutory guidance, which the contracting parties must also have regard to and which directs the parties to apply the capital servicing rates in a particular way. The effect of Section 17(2) and the statutory guidance is that the capital servicing rates will be applied when calculating the adjustment unless the contracting parties have a clear reason for agreeing the adjustment on a different basis.

Third proposal: only excluding the adjustment if the costs of capital are direct Allowable Costs

24.11 In its present form, paragraph (b) in Step 6 is aimed at preventing double-counting. The proposal to make paragraph (b) refer to direct Allowable Costs assumes that the costs of capital could not be included in overheads. The basis of this assumption is unclear and the SSRO believes the provision should remain in its current form to prevent double-counting if the costs of capital are included in overheads.

Conclusions and recommendation

24.12 Having considered the issues raised, the SSRO communicated its views on the proposals to ADS and the MOD. In its response to the consultation ADS withdrew the first and third proposals and deferred the second proposal as being of lesser priority and something that could be dealt with in guidance. In the circumstances, the SSRO is making no recommendations to change the regulatory framework in relation to Step 6.

24.13 The SSRO is currently undertaking a review of its Allowable Cost guidance which will be relevant to the treatment of capital in the pricing of contracts. If any further clarification is required following the review, it would most appropriately be dealt with through the statutory guidance on the application of Step 6.

Future review

25. Introduction

25.1 The SSRO has an ongoing duty to keep the provision of the regulatory framework under review. The Secretary of State's review will continue to provide a focus for this function until December 2017 but the SSRO will be planning the longer-term direction of its reviews. This will include consideration of issues identified in the SSRO's review that have not resulted in recommendations at this time. The SSRO's reasons for not recommending changes to the regulatory framework are set out below.

25.2 The SSRO may recommend changes to the regulatory framework to the Secretary of State at any time. However, it understands that after the Secretary of State's first formal review is completed in December 2017, the next formal review is not required until December 2022.

26. Compliance and enforcement

26.1 The SSRO has recommended changes to the regulatory framework as part of this review to make it work effectively to achieve good value for money for government and fair and reasonable prices for contractors. Ultimately, however, the framework may only deliver these objectives if it is being applied as intended. The enforcement mechanisms within the regulatory framework should be subject to ongoing review, with particular focus on whether voluntary compliance with pricing control is successful and whether the system of compliance and penalty notices is being operated in respect of the elements of the framework to which they relate.

Enforcing price controls

26.2 The SSRO consulted on whether provision should be made for additional means of enforcing the price controls imposed by the regulatory framework. It did so in circumstances where:

- The price controls (outlined in paragraph 17.2 above) are key elements of delivering good value for money for the government and fair and reasonable prices for contractors.
- The SSRO is charged with keeping under review the provision of the regulatory framework and, to inform its understanding, has raised contract-related queries with the MOD about application of the price formula for both contract profit rate and Allowable Costs matters.
- The primary responsibility for ensuring compliance with price control rests with the contracting parties and the SSRO may only determine the extent to which costs are Allowable or whether adjustments to the baseline profit rate are appropriate if asked to do so.

26.3 In consulting on this issue, the SSRO did not formulate a draft recommendation but nevertheless raised two options for change. First, that the SSRO be authorised to initiate determinations in relation to the pricing of QDCs or QSCs. Secondly, that provision be made for contracting parties to apply to the SSRO for a determination that the price formula may be disapplied in an appropriate case.

26.4 One respondent, a not for profit body, supported the SSRO having greater scope to enforce price controls, stating that it cannot be in the public interest to have the specifier of price be also the enforcer of price without effective regulation. The SSRO finds force in this argument, but is not recommending a change while issues connected with flexible pricing are being considered.

26.5 Industry and the MOD opposed the SSRO being given an enhanced enforcement role. This is a factor that the SSRO has considered in deciding not to make a recommendation for change. It should be noted, however, that the SSRO is unpersuaded by the following reasons given in opposition:

- The industry body, ADS, and some of its members stated that the SSRO's functions do not include enforcement of price controls and that its other functions are sufficient to deliver its aims of ensuring good value for money in government expenditure on QDCs and that contractors are paid a fair and reasonable price under those contracts. It is correct that the SSRO presently has a limited role in enforcement, but these assertions do not address the question of whether adequate provision is made for enforcement of the price controls imposed by the regulatory framework. The SSRO has queried the application of the price formula in numerous cases and will be in a better position to judge whether there is a weakness in enforcement requiring legislative change when more of the issues it has raised with the MOD have been responded to.
- One respondent, a consultancy body, asserted that the SSRO's independence and impartiality would be undermined if it acted as a pricing authority on matters other than where there was a reference from the contracting parties. The SSRO welcomes suggestions to strengthen its independence. However, the assertion that it would be unable to exercise discretion in an independent way was not evidenced. Nor is there any necessary reason why calling a matter in for determination should mean the SSRO is unable to decide in accordance with the requirements of natural justice.
- The MOD feared that if the SSRO could intervene and make legally binding changes to single source contract prices, then suppliers would be unlikely to sign contracts unless the SSRO had agreed that the price is in accordance with the formula. The MOD asserted the SSRO would be negotiating contract prices while the MOD would own the risks over military capability following a failure to agree prices. The assertion that the SSRO would be negotiating contract prices seems overstated. There is a need to guard against unintended consequences, particularly anything that may jeopardise military capability, but that does not mean the primary enforcement mechanism should be agreement between the contracting parties.
- The MOD was concerned that the SSRO would not be able to act as the arbiter of prices that it had already approved and an additional body would need to be established to take on this role. This seems an unnecessary concern for two reasons. First, the SSRO's determinations are presently subject to Judicial Review and there is no reason why a different form of review should be introduced based on who instigated the determination.

Secondly, if the soundness of the initial determination was not reviewed, there should be no need to re-determine the same question. If a different question arose under the same contract, then the SSRO would be able to determine that. Indeed, the possibility already exists for there to be successive referrals on different questions under the same contract.

26.6 The SSRO intends to keep under review how best to ensure enforcement of price controls under the framework.

Compliance and penalty notices

26.7 The SSRO consulted on proposed amendments to transfer responsibility from the MOD to the SSRO to issue compliance and penalty notices in respect of reporting and QSC assessments. The proposal was made having regard to the following:

- The SSRO has supported contractors to comply with regulatory requirements, by issuing guidance, SSRO answers and responses to helpdesk queries. In addition, direct contact is made with contractors in respect of reporting issues to try to resolve these without the need for enforcement action.
- There have nevertheless been failures by contractors to adhere to reporting requirements that the SSRO has felt necessary to escalate to the MOD, with issues ranging from failure to submit reports, to omitting key information and providing poor quality information. In response, the MOD had not issued any compliance or penalty notices.
- The SSRO would be well-placed to take responsibility for issuing compliance and penalty notices in respect of reporting requirements, as it already has the duty keep under review the extent to which people are complying with their obligations. The SSRO proposed additional transparency in relation to QSC assessments, which may place it in a better position to know when enforcement is needed.

26.8 The SSRO has an interest in ensuring appropriate enforcement action is taken in these areas. The SSRO's operation depends on QDCs and QSCs being brought correctly within the regime and QSC assessments are a key part of this. It relies on analysis of reported data to discharge its functions, which gives it an interest in taking appropriate action to ensure reports are submitted with the required information.

26.9 Three non-industry stakeholders supported this proposal. The response from the network of UK regulators noted that enforcement powers are an essential tool within the regulatory toolbox to ensure compliance with legislation, including in relation to the submission of information and data reporting, to ensure the data is accurate and up to date to inform evidenced based regulatory decisions. The Taxpayers' Alliance noted that the SSRO's proposal to amend the Act to empower it to issue compliance and penalty notices is consistent with the OECD's best practice principles and would bring its powers into line with other statutory regulators in the UK, both points that the SSRO agrees with.

26.10 Although some respondents supported the proposal, the SSRO has not recommended a change to the legislation at this time, principally for the following reasons:

- It is considering the extent to which appropriate levels of compliance may be achieved without legislative change, for example through enhanced transparency.
- In relation to enforcement of reporting requirements, the MOD is considering compliance issues raised by the SSRO and it is proposed to see whether subsequent action addresses the SSRO's fundamental concerns.
- In relation to QSC assessments, the SSRO has proposed an enhanced level of transparency (section 10 above) that should both support it to keep the provision of the regulatory framework under review but also assist the MOD to identify cases where enforcement may be appropriate.

26.11 Both areas will need to be kept under review.

26.12 In deciding not to recommend a change, the SSRO has taken into account responses submitted in disagreement to its proposal, including the MOD and industry respondents. It does not agree, however, with the following reasons given.

26.13 Industry respondents asserted that the MOD is best placed to assess the appropriateness of enforcement action. The SSRO's view is that the effectiveness of enforcement measures needs to be kept under review.

26.14 It was asserted by industry respondents that the SSRO's function of being an impartial arbiter would be undermined, particularly as it would be able to issue notices to contractors but not to the MOD. It is not accepted that there is a reasonable basis for this conclusion. The SSRO is already required to form a view as to whether reporting requirements are being complied with and may recommend the MOD takes enforcement action. The fact that it takes a view about such matters does not prevent it from dealing with referred matters on their merits and in accordance with procedural fairness.

26.15 The MOD considered that the SSRO's proposal to establish an appeals panel of independent members would not have credibility with industry, nor would it be able to resolve a perceived conflict of interest. The SSRO would challenge these perceived obstacles, as appropriate provision may be made to ensure that a panel operates independently. There are examples where the regulator takes enforcement action and also acts as the appeals body. Within the UK Regulators' Network, Ofgem is an example of one such body. The independent panel created to hear appeals is tasked with only that function, is staffed by dedicated specialists and clear separation is maintained between decision-making functions on enforcement and appeal.

26.16 One respondent, a contractor with a QDC in the regime, asserted that enforcement by the SSRO would impact UK defence capabilities. It was proposed that suppliers, particularly overseas suppliers, would choose not to operate in the UK defence market as a result of inappropriate enforcement by the SSRO. No evidence was provided in support of these predictions and the SSRO considers they are not well founded. There is no basis for concluding the SSRO would enforce in an inappropriate way in circumstances where it committed to applying a clear, written enforcement policy. The SSRO would be well-placed to objectively consider whether enforcement is appropriate, without either dismissing or over-emphasising the need to maintain ongoing relationships.