SSRO

Single Source
Regulations Office

Recommendations to the Secretary of State

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

June 2021

Contents

1. Executive summary

1.1 The regulatory framework for single source defence contracts has been operating successfully since 2014. Its key achievements include setting profits by reference to an objective benchmark, greater focus on the allowability of costs, and increased access by the MOD to information about suppliers and their costs.

1.2 The SSRO is recommending improvements to the regulatory framework to further optimise its operation and better enable the SSRO to provide support. Our recommendations are intended to inform the Secretary of State's review of Part 2 of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations).

1.3 In making these recommendations, we have been guided by our statutory aims of ensuring good value for money for the government in its expenditure on qualifying defence contracts and a fair and reasonable return for contractors. The recommendations are consistent with the speed and simplicity objectives in the Government's Defence and Security Industrial Strategy and we provide advice in support of the incentivisation objective.

1.4 Our recommendations are based on our ongoing review of the regulatory framework. The SSRO was established to support the framework and, since 2014, we have gained extensive experience from our work with the MOD and industry on pricing qualifying contracts, the provision of statutory reports and realising benefits from increased transparency. We have consulted extensively on improvements to the regime and the feedback has informed these recommendations.

1.5 The MOD and industry remain keenly interested in the profit paid on qualifying contracts. We have drawn attention to evidence that the regulatory framework is successfully delivering fair profits. The baseline profit rate provides an objective benchmark of profit earned by the average company carrying out activities similar to those in qualifying contracts. Profits across the portfolio of qualifying contracts are broadly consistent with relevant comparators.

1.6 If the Secretary of State wishes to increase the focus on fair profits at the level of individual contracts, then we see merit in an approach based on activity types. By considering the activities involved in qualifying contracts and applying benchmarks provided by the SSRO, profits can be guided by reference to the different capital intensities and inherent risks in the market for the goods and services being procured. We have also outlined how an alternative approach could be pursued based on cost risk, which involves an adjustment for the lowest risk contracts based on the cost of capital, and additional allowances where the risk exceeds the market risk premium reflected in the cost of capital.

1.7 We make several recommendations to optimise contract pricing. To support calculation of profits, the cost risk adjustment should be better defined to emphasise the importance of who carries the risk. Adjustments to ensure profit is earned only once on a cost should be made through costs rather than profits. We propose changes to enable differential application of pricing controls to parts of contracts in circumstances where contracts become qualifying contracts following amendment and where more than one profit rate is sought to be applied in a contract. We suggest matters that the Secretary of State should consider if introducing alternative approaches for commercially priced items.

1.8 We make relatively few recommendations in relation to reporting requirements. In part this is because work continues on the MOD's information requirements and in part because many improvements can be achieved through changes to guidance and our Defence Contracts Analysis and Reporting System (DefCARS). We recommend a threshold change so that contractors are not required to report trivial variances. We also recommend changes to improve transparency over qualifying sub-contracts and for the MOD to provide contractors with information needed to understand their reporting requirements.

1.9 We continue to seek ways to support the MOD's use of reported data while keeping reporting requirements proportionate. This includes inputting to the MOD's review and pursuing improvements to the reporting of amendments and variances and the treatment of overheads. Our work with the MOD and industry on overheads aims to facilitate the agreement of allowable costs and refine reporting requirements to provide useful data.

1.10 The MOD's review is a wide-ranging and ambitious programme considering more than one hundred change proposals of differing scale. These include recommendations from the SSRO and proposals for change initiated by industry. We have been engaging closely with the MOD and industry in support of this review. We provide evidence, where possible, and indicate matters to consider if proposals are to proceed. We have indicated some proposals to the MOD that need to be clarified or that we do not support in their current form. In many instances, the merit of the proposed changes will only become clear when the proposed legislation is disclosed by the MOD. We will continue to input to this process.

1.11 The SSRO has a critical role to play in supporting implementation. We recommend expansion and simplification of the mechanisms provided in the legislation for the MOD and contractors to refer questions to the SSRO. We also recommend changes to enable the SSRO to provide statutory guidance on a broader range of questions.

1.12 We are planning how we will support implementation of legislative changes through the SSRO's guidance and DefCARS. This is likely to require a programme of significant development and change over time and we are engaging with the MOD as to how this can best be resourced and delivered.

2. Introduction

2.1 The SSRO was established to support the operation of the regulatory framework for single source defence contracts. Our functions include keeping under review the provision of Part 2 of the Act and the Regulations and making recommendations for change to the Secretary of State. In carrying out our functions, the SSRO aims to ensure that:

- good value for money is obtained in government expenditure on qualifying defence contracts, and
- contractors are paid a fair and reasonable price under those contracts.

2.2 These recommendations are intended to inform the Secretary of State's periodic review of the framework. We have been advised that the review will complete in September 2021, in advance of the statutory deadline of 17 December 2022, and that recommendations made by 17 June 2021 will be considered by the Secretary of State as part of the review.

2.3 Our recommendations are designed to improve the operation of the regulatory framework in line with the SSRO's statutory aims. In making these recommendations we have considered the Government's **Defence and Security Industrial Strategy** published in March 2021 (DSIS). Our recommendations focus on improving the efficiency of the regime and align with the DSIS objectives of simplicity, speed and incentivisation. We have included relevant references to DSIS when setting out our recommendations.

2.4 In making these recommendations, we have considered evidence gathered from our ongoing review of the regulatory framework and from delivering our functions in support of the framework. Our key sources of evidence include:

- DefCARS, which contains a growing body of data about qualifying contracts and defence contractors, and our published analysis of this data;
- explorations of how the provision of the regulatory framework is operating, including substantial reviews leading to our **2017 recommendations** and **2020 findings**;
- feedback from extensive engagement with the MOD and industry and multiple public consultations on improvements to the framework, our guidance and methodologies;
- compliance reviews and records from the support we provide to the MOD and contractors;
- annual profit recommendations to the Secretary of State, associated publications and analysis and supporting data from sources such as Orbis and Bloomberg.

2.5 The SSRO's 2017 recommendations followed a broad ranging review that considered all aspects of the regulatory framework. Our 2020 findings involved a more targeted exploration of aspects of contract pricing and the transparency requirements placed on defence contractors, reflecting the two key elements of the regulatory framework. In both reviews we carried out extensive engagement, issuing working papers to key stakeholders before consulting publicly on our proposals.

2.6 Since publishing our 2020 findings, we have been moving forward with improvements to the regulatory framework, including through our reporting guidance and projects on overheads and the reporting of amendments and variances. We have also engaged actively in the MOD's programme of work in support of the Secretary of State's periodic review. These recommendations reflect our views based on the evidence currently available.

Recommendations

3. Overview

3.1 The SSRO's recommendations for legislative change are listed in the Appendix. The recommendations are further described in the following sections of this document under three main areas:

- pricing (section 4);
- transparency (section 5); and
- the SSRO's supporting role (section 6).

3.2 All recommendations are intended to optimise the operation of the regulatory framework. They contribute to the speed and simplicity objectives of DSIS by:

- removing ambiguity and errors (recommendations 1, 6 and 7);
- appropriately limiting application of the regulatory framework (recommendations 2, 4, 5 and 11);
- supporting approaches to contracting that contracting parties want to apply (recommendation 3); and
- better enabling the SSRO to support implementation (recommendation 12).

3.3 Some of the recommendations are aimed at assisting contractors to discharge their regulatory obligations (recommendations 8 to 10). They aim to clarify the timing of qualifying sub-contract assessments and the matters that must be notified, as well as providing contractors with the information needed to know when to report.

3.4 There are some areas where we have not recommended legislative change but have provided advice for the Secretary of State to consider. This includes advice on profit rates and alternative pricing (section 4) and the defined pricing structure (section 5). We have addressed matters related to the review process and implementation in sections 7 and 8.

3.5 Where appropriate, we have footnoted references to the evidence and considerations which support our recommendations. This material is contained in publications, which we have previously provided to the Secretary of State and which are available from the **SSRO's website**.

4. Pricing matters

4.1 In this section, we address the DSIS objective of introducing new ways of incentivising suppliers to innovate, take risk and support government objectives. We also outline our recommendations for legislative change. We draw attention, where relevant, to our earlier work aimed at improving the efficiency of the regulatory framework, which we believe will simplify its operation and speed up contracting.[1]

Range of contract profit rates

4.2 DSIS announced that the MOD is seeking to change the legislation such that:

"suppliers can earn higher profits where there is a significant transfer of risk, or they achieve outstanding performance against contract deliverables or wider government priorities. Conversely the profit rate available for low risk work or less challenging performance would be lower."[2]

4.3 The SSRO considers a "fair" profit to be that which tends to reflect the outcome of a competitive market which would:

- justify a firm keeping its capital employed for the purpose of delivering single source defence contracts over the long term; and
- be sufficiently attractive over the course of a contract for the contractor to assume the risk the MOD is seeking to transfer.

4.4 In practice, the contract profit rate for a qualifying contract, when applied to allowable costs, should enable the contractor to earn a return commensurate with that achieved by firms in a competitive market for the supply of goods and services which are the product of comparable economic activities. This is an important guiding principle.

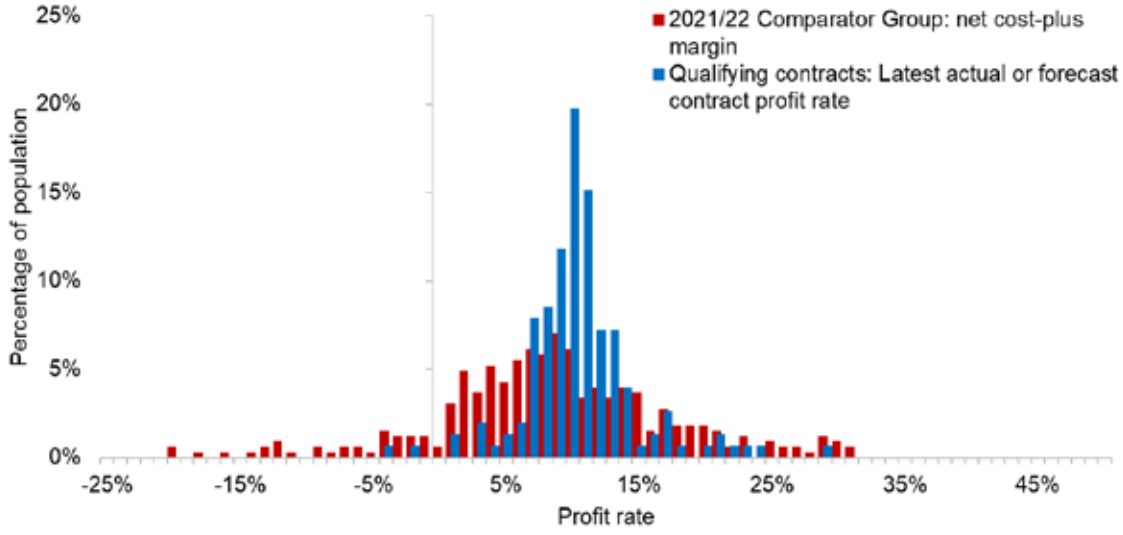
4.5 In seeking to replicate the profit outcome of a competitive market, the SSRO performs two key activities:

- it recommends capital servicing rates based on the actual market cost of debt (an element of the cost of capital); and
- it recommends the baseline profit rate (BPR) based on the average actual profit of companies undertaking activities comparable to those in QDCs and QSCs.

4.6 The SSRO's approach and the operation of the pricing framework are successful in delivering profits in QDCs similar to those earned by companies in competitive markets supported by comparable economic activities, as illustrated in chart 1.

1 2017 recommendations and 2020 findings
2 DSIS, page 27.

Chart 1: Actual profit rates of baseline profit rate benchmark companies and actual/ forecast profits in qualifying contracts[3]



4.7 While the profits across the portfolio of QDCs appear fair at an aggregate level by comparison with competitive markets, it is more difficult to judge how close profit is to a fair rate at the granular level of individual contracts. Our preferred approach to achieving greater granularity in relation to fair profits is to consider the role of activity type in the determination of contract profit rates. Having profits guided by activity type has merit because:

- It places more weight on determining profit by reference to something which can be directly observed and measured (i.e. the activities involved and rate of profit they typically attract), which can then be employed to make further refinements to reflect the circumstances of a specific contract. The pricing frameworks in the US and Australia use contract activity to help navigate a wider range of profits than is available via the Single Source Contract Regulations.
- Activity-based profit rates are useful for distinguishing between industries which have different capital requirements and inherent market risks, before resorting to more complex and contestable bottom-up approaches.
- The SSRO publishes profit benchmarks for companies undertaking different economic activities which would support setting multiple baseline profit rates. These have been stable measures of profit over time using the SSRO's established baseline profit rate methodology.

4.8 We have recommended legislative changes to support the implementation of multiple baseline profit rates, which will facilitate this approach. This includes the facility to refer the choice of baseline profit rate to the SSRO if there is disagreement about the applicable activity-driven rate. We will support the MOD in progressing any further work to increase the role of activity type in setting contract profit rates.

3 Notes: Qualifying contracts includes 168 contracts that have provided an update or completion report as at 31 December 2020; the latest actual or forecast contract profit rate reflects the figures reported in DefCARS in the most recent report. The comparator group includes the Develop and Make and Provide and Maintain comparator groups, including loss-makers. Contracts and companies are grouped into 1 per cent bands. The X axis is truncated for readability, excluding 6 comparator companies with profit rates of -43%, -28%, 55%, 56%, 74%, 67%. Source: DefCARS, Orbis from Bureau van Dijk

4.9 A complementary approach to achieving greater granularity in the fairness of contract profit rates is to adjust the range of the cost risk adjustment (CRA) which can be applied to the BPR. The regulatory framework could aim to set contract profit rates such that:

- in the lowest cost risk contracts, the rate of return on capital is calibrated to cover the cost of capital related to the assets utilised by the firm in undertaking the contract; and
- additional allowances are provided using the CRA at step 2 to compensate for the uncertainty over future profits associated with the contract, over and above the market risk premium which is already reflected in the cost of capital.

4.10 If this approach is followed, the placement of the lower band of the CRA would be informed by establishing a cost of capital of the MOD's single source suppliers and the mark-up on contract costs that companies must earn to cover it. Concluding where the lower band of the CRA should sit, so that it is suitable for the full range of suppliers under qualifying contracts, is challenging. The relationship between the cost of capital, return on capital and profit on allowable cost is not fixed and will vary from contract to contract. This increases the risk that:

- contract profit rates could inadvertently be set too low to be viable for some suppliers; or
- the lower band of the CRA produces profits which are not fair to all when applied to all low risk contracts.

4.11 A suitable compromise is required which balances the need to pay contractors a fair profit with the payment of lower profits for less risky work. The evidence on cost of capital available to the SSRO is insufficiently developed at this time to reach a firm conclusion and we have not made any recommendations in this respect.

4.12 The placement of the upper band of the CRA will depend on the extent to which the MOD wishes to pursue risk transfer. It should be possible to put a value on the highest levels of risk the MOD might wish to transfer to contractors and set the gap between the upper and lower band of the CRA accordingly. The current regime allows for an increase of up to 67 per cent on the lowest rate of profit at step 2. The MOD should consider a contractor's own tolerance and capacity to bear risk, noting that at some point the amounts of compensation required to transfer cost risk become uneconomical.

Cost Risk Adjustment: other matters

4.13 Section 17(2) of the Act and regulation 11(3) provide for an adjustment to the BPR "…*so as to reflect the risk of the primary contractor's actual Allowable Costs under the contract differing from its estimated Allowable Costs*". Regulation 11(3) specifies that the cost risk adjustment (CRA) is to be an "*amount which is within a range of plus or minus 25% of the baseline profit rate*".

4.14 The SSRO reviewed how the cost risk adjustment is defined and operationalised and considered whether this could be improved and we concluded that it is essential to identify the party that bears the risk when setting the CRA.[4] We recommend legislative change to clarify this requirement (recommendation 1).

4 **2020 findings**, section 4.

4.15 We support the intent of a more structured approach to setting the CRA and incentive adjustment, particularly if the available adjustments are made wider in scope. Clear and applicable statutory guidance from the SSRO will assist MOD contracting officers and suppliers to properly navigate any increased flexibility in setting contract profit rates. There is a strong case for the CRA to be guided by the choice of contract pricing method, alongside other relevant matters, and statutory guidance remains in our view the most appropriate route to achieve this. We will continue to observe and contribute to the development of any proposals from the MOD on these matters. We can consult on updates to the SSRO's statutory guidance on the baseline profit rate and its adjustment once the MOD has made known its decision on the range of profits and how it intends the navigation of the CRA and incentive adjustment to operate.

Incentive adjustment

4.16 The regulatory framework allows profit to be increased to give the contractor a financial incentive to perform specified provisions of the contract. Section 17(2) of the Act and regulation 11(6) provide for an increase to the amount resulting from step 4 of the determination of the contract profit rate "…*so as to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State*" (the incentive adjustment). Regulation 11(6) specifies that the amount of the increase cannot exceed two percentage points.

4.17 The SSRO has considered the incentive adjustment, without concluding that the limit on the adjustment should be increased.[5] We accept that performance-based rewards are useful tools for aligning the incentives of contracting parties that might not otherwise choose to act in each other's interests. The successful application of the incentive adjustment requires identifying instances of misaligned incentives and making the incentive payment work in a way that acts to correct the issue. We can see a risk that relatively low baseline rewards and relatively large performance inducements may result in behaviours changing in ways that are unanticipated and potentially undesirable. Our current view is that for an expanded incentive adjustment to improve performance outcomes, the MOD would need to ensure that:

- the contractor could in theory deliver the performance desired, but that it is not currently in its interest to do so;
- increases in the contract profit rate are a motivating factor for those individuals who can affect the change in the performance the MOD is seeking; and
- the size of the reward for successfully delivering the performance outcome and the likelihood of achieving it are sufficiently high to motivate the contractor to change its behaviour.

4.18 We consider that increasing the limit of the incentive adjustment would provide greater discretion to contracting officers and should, at a minimum, be accompanied by:

- better guidance; and
- greater transparency.

4.19 The SSRO will review its statutory guidance in support of an increased incentive adjustment but getting this right will depend on input from the MOD and industry.

5 **2017 recommendations**, section 20.

4.20 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 to demonstrate that 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.

QDCs by amendment: incurred and committed pre-amendment costs

4.21 The SSRO has identified a pricing issue when contracts become qualifying contracts following an amendment.[6] The regulatory framework requires that the whole contract price must conform to the price formula and statutory contract reports need to cover the contract period in respect of the entire contract. We consider that this creates inconvenience and potential unfairness and presents a barrier to contracts being brought into the regime following amendment. Costs incurred or committed prior to a contract being brought into the regulatory framework, and associated profit, should not be subject to the price formula.[7]

4.22 The SSRO recommends legislative change for QDCs by amendment to enable:

- the price formula to be applied to only a defined component of a contract, consistent with the above proposals; and
- the contract price to 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 (recommendation 2).

4.23 There is also a need to clarify reporting requirements in situations where a contract becomes a qualifying contract after it was entered into. For example, a QDC by amendment is subject to regulation 22(5) which requires a contractor to report annual profiles covering the period from when the contract was originally entered into.

Multiple baseline profit rates and segmentation of contract profit rates

4.24 The SSRO recommends two changes to the regulatory framework to expand the available approaches to pricing qualifying contracts:

- expressly provide for a range of baseline profit rates, depending on the types of acquisition, to reflect the ranges of profit achieved across the different markets which contribute to the defence sector; and
- permit a profit rate for components of a contract, each determined by the application of a six-step process beginning with the appropriate baseline profit rate (recommendation 3).

4.25 In March 2021, the Secretary of State announced two baseline profit rates, one of which would apply in the limited circumstances involving a qualifying contract with a company wholly owned by the UK Government. We support in principle the determination of multiple baseline profit rates, which we believe can be used to better arrive at fair contract profit rates.

4.26 The legislation should make consequential provision to assist the MOD and industry to apply multiple rates when pricing and reporting on contracts. For example, where at step 1 of the profit rate formula in section 17(2) of the Act the parties are required to "[t]ake the baseline profit rate…which is in force at the relevant time", this may benefit from being amended to require that the parties "[t]ake the *appropriate* baseline profit rate…".

6 **2017 recommendations**, section 6.
7 **2017 recommendations**, recommendations 1(1) and (2).

4.27 The regulatory framework permits contracting parties to use different regulated pricing methods for defined components of a qualifying contract, enabling allowable costs to be determined differently depending on the component. However, save in relation to amendments which affect the contract price, no provision is made for different profit rates to be determined for defined components of a contract. The regulatory framework accommodates only a single contract profit rate for a qualifying contract which is determined by applying a single six-step process, beginning with the baseline profit rate. This is at odds with our observations of contracting practice and we can see potential for the objectives of good value for money and fair and reasonable prices to be enhanced by enabling different profit rates for defined components of contracts.

4.28 There are a number of considerations for the MOD to take into account if pursuing legislative change in this area.[8] These include that enacting the proposals would likely increase reporting requirements since data currently collected in respect of the six steps, contract profit rate and annual profiles of costs and profit, would potentially be multiplied by the number of defined components in a contract. The SSRO's support for the proposal is contingent on there being no diminution in the level of data reported.

Alternative means of pricing qualifying contracts

4.29 DSIS proposes new ways of determining a fair price for the procurement of goods and services which are sold in open markets, other than by applying the price formula currently set by the legislation. We have not recommended that the MOD pursue this aspect of alternative pricing, but we have presented a number of factors that the MOD should carefully consider if taking forward legislative change such that there is an objective test for determining that the price represents value for money and is fair and reasonable.[9] These include:

- the appropriate test of whether a price is acceptable and the extent to which modified versions of those goods or services may nevertheless be considered acceptable;
- the person who should be satisfied that the test has been met;
- the analysis required to determine that the test is met; and
- the evidence that should be considered as part of the analysis and the source from which the evidence should be obtained.

4.30 The SSRO suggests that any alternative pricing mechanism should apply by exception, and to such parts or defined components of the contract as meets the conditions prescribed.

8 2017 recommendations, section 8.
9 2017 recommendations, section 21.

Profit on cost once (POCO)

4.31 The SSRO recommends legislative changes to make the POCO adjustment operate more efficiently (recommendation 4). The proposed changes involve:

- removing the option of adjusting the contract profit rate, so that the POCO adjustment is made to contract costs;
- extending the adjustment to situations where there is influence over sub-contractors, rather than just control, and to part-ownership arrangements;
- providing that where the parties are unable to identify the attributable profit in a sub-contract, they should base the adjustment on an assumed profit rate equivalent to the contract profit rate of the qualifying contract;
- increasing the value threshold at which sub-contracts are considered; and
- reporting the amount of attributable profit.[10]

4.32 These changes will support the DSIS objectives of simplicity and speed by providing clarity and making it easier to apply the POCO adjustment.

Target price contracts

4.33 The SSRO recommends a legislative change to improve the operation of the regulatory framework for target price contracts (recommendation 5). We think it is reasonable for the agreed target price to adjust in line with index changes that affect costs which make up the target price.[11]

Final price adjustment

4.34 We have identified an error in regulation 17, which specifies how the final price adjustment is calculated. The regulation confuses percentages and percentage points and we recommend that the error is addressed (recommendation 6).

10 2020 findings, section 5.
11 2020 findings, paragraph 3.25.

5. Transparency

5.1 The SSRO is committed to ensuring that the data collected under the regulatory framework is used in support of single source procurement and we consider that the regulatory framework should collect a proportionate amount of data that has value for the MOD. We have been supporting the MOD's consideration of the statutory reports and the information it needs and we will continue to input into the MOD's policy development.

5.2 Our legislative and compliance reviews have indicated that the MOD is still in the early stages of systematic use of data collected. We consider that data may well have significant value to the MOD, even if it is not yet being used, and we recommend caution before taking action to remove reporting requirements. In some instances, legislative change may be required to promote use of the data (e.g. reporting actual rates), while in others it may be better to pursue implementation and further explore use of the data before concluding that legislative change is required (e.g. use of the defined pricing structure).

5.3 We have been pursuing ways to support the MOD's use of reported data through our projects on overheads and amendments and variance. We expect this work to result in changes to guidance and DefCARS. There is potential for legislative change to improve data collection and use in relation to overheads and we refer to this further below.

Overheads

5.4 The SSRO has been restricted by the available evidence in relation to overhead reports, such that our recommendations for legislative change are, at this stage, limited to addressing a technical error and to support of the ability to make referrals in this area (recommendations 7 and 12).[12] We have identified the following issues and questions to explore as part of our planned further work on overheads:

- the impact of not recording agreed rates and costs in the overhead reports;
- whether collecting the data is likely to advance the purposes of the overhead reports; and
- the best way to collect the data if it is needed in the overhead reports to support the MOD's consideration of rates and agreement of contracts.

5.5 In order to explore these issues, the SSRO has initiated a further review of overheads incorporating consideration of both pricing and reporting under the regulatory framework. We have issued several working papers and held discussions with the MOD and industry.

5.6 Part of our work has been to further explore the benefits of collecting agreed rates. Further engagement with industry and MOD stakeholders has sought to identify the value of collecting agreed rates in the regime relative to the incremental cost to the MOD of paying contractors to supply this information.

5.7 The benefits of effective reporting include enhanced transparency to negotiate rates to reduce the likelihood of over- or under-recovery of overhead costs, and improved contract management to incentivise greater efficiencies in cost control. The scale of the benefits is conditional on the action the MOD takes to exploit this data and this needs to be weighed up against the incremental resource required by the supplier to prepare and submit the data in DefCARS, and for the SSRO and MOD to review it following agreement of the rates. We are considering how the submission of agreed rates could be operationalised in an efficient manner, to minimise any additional reporting burden, and how the data might be used to maximise its value. We will seek to further engage the MOD and industry on this matter.

12 **2020 findings**, section 8.

Defined Pricing Structure

5.8 The regulatory framework requires contractors to split costs in some reports by a defined pricing structure (DPS) to support the MOD's long-range estimating and budgeting. We have identified issues with the operation of DPS requirements,[13] but have not recommended legislative changes at this time because we consider that:

- improvements could be made through statutory guidance and DefCARS, some of which have already been made; and
- time should be allowed for the DPS data to mature and for the MOD to consider how it may best be used.

5.9 One area in which we consider that legislative change may be beneficial following wider review is the frequency with which contractors are required to split costs by the DPS. We consider that the approach should be proportionate and support the MOD's estimating for budget purposes. Our view is that it will be most useful for the DPS to be applied at the start and end of a contract, with interim reporting as needed to meet the MOD's estimating needs.

5.10 It is clear that more use could be made of DPS data, which would in turn assist the MOD in better recognising its long-term benefits. We consider that the dataset will continue to grow and add value in coming years, as existing contracts complete and a greater breadth of contracts come under the regulatory framework. We continue to believe that more time should be allowed to assess the benefits of the data and we do not recommend limiting the application of the DPS by contract type or by making its application optional. If such changes are proposed, it would be preferable to enable any relaxation of requirements to be applied through the SSRO's statutory guidance.

5.11 The requirement to report output metrics was intended to provide a useful source of data to support the MOD's parametric estimating. We suggest that revised statutory guidance could support better reporting of metrics and assist with linking metrics to the DPS. A proposal by the MOD to de-couple output metrics and the DPS does not conflict with our suggestion, but we do not recommend doing so as we are concerned that this may reduce the ease with which DPS data can be analysed and potentially reduce the value of the reported data.

Time limits for QSC assessments and notice of a positive assessment

5.12 The regulatory framework does not bring QSCs into the regulatory framework unless and until the contracting authority provides notice in writing of a positive QSC assessment to the Secretary of State and the prospective sub-contractor (regulation 58(6)). Regulation 61 sets out the requirement to undertake a QSC assessment when it is proposed to enter into a relevant sub-contract but does not impose a time limit or deadline by which either the QSC assessment must be undertaken or notice of a positive QSC assessment must be given.

5.13 The SSRO regularly encounters instances of contracting authorities failing to provide written notice of a positive QSC assessment to the Secretary of State and the sub-contractor. Since contractors are not required to report the date a QSC assessment is undertaken, it is not clear whether the delay in providing notice is attributable to the delay in carrying out the QSC assessment or only in providing the notice. In many cases notice is provided several months after the QSC is entered into, at which time a sub-contractor would be deprived of the right to challenge the QSC assessment, since no appeal may be brought after the sub-contract has been entered into (regulation 62(3)). A sub-contractor in those circumstances would also have failed to submit their initial contract reports which are due within one month of the sub-contract being entered into and may therefore receive a compliance notice under section 31 of the Act.

13 **2020 findings**, section 6.

5.14 The Act provides that the Secretary of State may issue a compliance or penalty notice to a contracting authority who fails to carry out a QSC assessment or to give the required written notice. In practice, a contracting authority that fails in one or both of these requirements does not face sanctions. This may be in part because the legislation does not impose a timeframe within which the contracting authority must carry out the assessment or provide notice of the assessment.

5.15 That the legislation deprives a sub-contractor of the right to challenge a positive QSC assessment upon entry into a sub-contract may be inequitable in circumstances where, through no fault of the sub-contractor, the contractor has delayed in serving notice of the positive QSC assessment. The SSRO sees merit in disposing with the restriction imposed by regulation 62(3) and aligning the deadline by which a notice of appeal can be issued with the deadline which would otherwise apply under regulation 62(5)(b).

5.16 For the reasons set out above and drawn out in our earlier work[14] the SSRO recommends legislative change to require a QSC assessment to be completed (and any resultant positive QSC assessment to be notified to the Secretary of State and the prospective sub-contractor) before the sub-contract is entered into, and to delete regulation 62(3) (recommendation 8).

Reporting the outcome of a QSC assessment

5.17 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.

5.18 Prior to September 2019 there was no duty to notify negative QSC assessments to the MOD, which limited the extent to which the MOD was made aware of cases in which non-compliance may have arisen.[15] In cases where the QSC assessment was reported in one of the contract reports, the requirement was to specify the outcome of the assessment, which meant that the only information provided was whether or not the contract was considered a QSC. The MOD would therefore be required to interrogate every assessment in order to understand the reasons for a negative assessment. From the SSRO's perspective, this also hampered the review of the regulatory framework as the grounds preventing contracts becoming QSCs were not made known.

5.19 Additional reporting requirements were introduced by the Single Source Contract (Amendment) Regulations 2019, which aimed to address the lack of supply chain transparency in sub-contracts below the QSC threshold of £25m. However, the reporting requirement to specify the outcome of the assessment was not revised, and the SSRO continues to see contracting authorities reporting only whether or not the contract is a QSC.

5.20 The SSRO considers that the purpose of the requirement to report the outcome of the assessment, being to enable greater transparency in the supply chain and to enable enforcement action for incorrect negative assessments, would be better served if contractors were required to specify the reasons for any negative assessment by reference to which of the conditions under section 28 of the Act and regulation 58 are not satisfied in each case (recommendation 9).

14 **2017 recommendations**, section 10.
15 **2017 recommendations**, section 10.

Notification of reporting requirements

5.21 Contract value is used to determine whether a contract is a QDC or QSC and is calculated in accordance with regulation 5. 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. The contract value is also used to determine whether Quarterly Contract Reports (QCRs) are required and the content and frequency of Interim Contract Reports (ICRs).

5.22 A contracting authority's determination of the contract value may take into account information it has not shared, and does not wish to share, with the contractor or sub-contractor. If the contractor or sub-contractor is unaware of the contract value or the contract reporting requirements to which they are subject, this can result in non-compliance. A contracting authority should be required to notify the contractor or sub-contractor of their reporting requirements arising from the assessed value.[16]

5.23 The Single Source Contract (Amendment) Regulations 2019 attempted to deal with the informational asymmetry between a contracting authority and a contractor or sub-contractor in the context of contract value. It did this by replacing the requirement for a contractor to report contract value with a requirement to report either the contract price or the price that the contracting authority is committed to paying for the contract. This does not, however, assist contractors or sub-contractors with understanding whether they are required to submit QCRs nor the content and frequency of ICRs. The SSRO considers that this remains a problem and one which should be resolved through some notification process (recommendation 10).

Variances

5.24 The SSRO considers that it would ease the burden on contractors to introduce a materiality provision for the reporting of variances,[17] and makes a recommendation for legislative change (recommendation 11).

16 **2017 recommendations**, recommendation 10(a).
17 **2020 findings**, section 7.

6. The SSRO's supporting role

6.1 The SSRO is empowered to support the operation of the regulatory framework by:

- giving expert opinions and making determinations on specific questions referred by the Secretary of State or contractors; and
- issuing statutory guidance for applying aspects of the regulatory framework, to which all parties must have regard.

6.2 In both cases, the SSRO's role is significantly circumscribed. We consider that the SSRO should be able to provide more general advice and assistance to further enhance the effectiveness of the regulatory framework. Our recommendation is designed to remove some of the limitations and complexities associated with the restricted specification of circumstances in which referrals can be made to the SSRO and in which the SSRO can issue statutory guidance (recommendation 12).

6.3 It is proposed that the SSRO's ability to advise and assist is supplemented, so that it can provide support in more circumstances and respond better to the range of requests from stakeholders without the need for on-going legislative change. This would align with the aspirations of DSIS to simplify the regulatory framework, speed up the contracting process, improve the pace and agility of acquisition and better enable suppliers to innovate.

Referrals

6.4 The SSRO can give expert opinions and make determinations in circumstances set out in the Act and the Regulations. These decisions help to resolve disagreement or uncertainty as to the proper application of the regulatory framework. The SSRO's powers are only activated where specified persons make a referral. The powers have been rarely utilised and the SSRO has highlighted evidence of several barriers to referrals which we summarise as follows:

- The matters that a single party may refer are over-specified, leading to complexity in framing referral questions and making it difficult for parties to refer the questions they actually wish to ask.
- Referred questions must relate to an agreed or proposed qualifying contract, which can be challenging where there is a point of principle that may relate to one or more future contracts (e.g. calculating the recovery rates for a business unit).
- There is a catch-all provision that enables any question to be referred in relation to an actual or proposed qualifying contract, but this requires the Secretary of State and the contractor or proposed contractor to refer the matter jointly, which provides an opportunity for one party to frustrate a referral.[18]

6.5 We would like these barriers to be removed so that it is easier for parties to refer questions to the SSRO if they wish. We recommend the following measures for increasing the opportunities for parties to make referrals:

- provide for the Secretary of State or a party to a qualifying contract to be able to refer questions to the SSRO about the operation of the regulatory framework without the need to identify a specific contract or for the referral to be made jointly with the other interested party or parties;

18 2020 findings, section 8 and 2017 recommendations, section 12.

- expand the grounds of referral on the contract profit rate steps to all six steps, rather than only steps 2, 3 and 6 as currently provided by section 18(3) of the Act;
- enable referrals in relation to whether a contract or proposed contract meets the conditions to be a QDC or QSC; and
- enable referrals in relation to the agreement of rates that may be used in the pricing of QDCs and QSCs.

Guidance

6.6 The SSRO's functions include giving guidance on the following aspects of the regulatory framework:

- determining whether costs are allowable costs;
- the contract profit rate steps;
- preparing statutory reports; and
- the penalties to be applied to a penalty notice.

6.7 The SSRO has issued statutory guidance on each of these subjects, which assists with application of the regulatory framework. The SSRO works closely with key stakeholders to regularly review and update its guidance. It would be helpful for the SSRO to be able to provide guidance on other aspects of the regulatory framework, such as:

- QSC assessments;
- application of the exclusions under the regulatory framework;
- application of the QDC and QSC definitions; and
- pricing amendments to QDCs and QSCs.[19]

6.8 It may be that other areas will emerge in which guidance would be of assistance. To avoid piecemeal additions to guidance that depend on repeated legislative change, we recommend that the Act and Regulations are amended to enable the SSRO to issue guidance in respect of any aspect of the regulatory framework. Contracting parties should be required to have regard to such guidance. This will leave it open to parties to depart from the SSRO's guidance if there are clear reasons to do so.

19 **2017 recommendations**, recommendations 2(2), 4(3), 7(3) and 8(d).

The review process and implementation

7. MOD review

7.1 We have welcomed the opportunity to participate alongside industry in workshops organised by the MOD to discuss its policy on changes to the regulatory framework. We have provided input to the discussions based on our experience of the regime and the available evidence and we intend to continue to support this process.

7.2 The discussions have been wide-ranging and spanned all aspects of the regulatory framework and have included proposals initiated by the MOD, the SSRO and industry. We have indicated support for proposals which have potential to improve the operation of the regulatory framework.

7.3 There are some proposals in respect of which we have not been able to provide support or have expressed caution. These include proposals that, in our view, are as yet insufficiently well-described, unnecessary, or appear unlikely to further the aims of the regulatory framework.

7.4 We have supported the MOD's intention to improve the operation of the defined pricing structure, as set out in section 5. We have expressed caution, however, about making the defined pricing structure optional, as we feel this is premature and likely to result in a potentially valuable data source being truncated before its application has been properly tested.

7.5 We understand that the MOD would like to be able to pay higher costs in respect of riskier contracts. We do not support the proposal that this should be achieved by paying costs to cover the possibility that a contractor will incur liquidated damages for delays in delivery. We have offered to meet with the MOD to discuss an alternative approach.

7.6 It has been recognised as part of the process that the efficacy of any proposals will only become clear once the proposed legislation is made available. We understand that the MOD intends to involve us in the legislative drafting process and we welcome the opportunity to continue to provide further input as proposals for change are developed.

8. Changes to guidance and DefCARS

8.1 It is expected that the Secretary of State's review will result in legislative reform and changes to the regulatory framework. The SSRO produces statutory guidance on contract pricing and the preparation of statutory reports and provides the system through which contractors submit statutory reports (DefCARS). We anticipate that legislative change will require us to prepare substantial updates to our statutory guidance and developments to DefCARS.

8.2 We continue to welcome engagement with the MOD and industry that enables us to support the Secretary of State's review of the legislation and give effect to legislative changes through development of statutory guidance and DefCARS. The importance we place on implementation is reflected in our Corporate Plan 2021-2024, which has been developed to enable us to adapt our programmed activities in order to respond flexibly and appropriately to the legislative timetable and outcome of the reform.

8.3 We would welcome a reasonable period between the new legislation's passage and its commencement in order that the SSRO has appropriate time to develop changes to guidance and DefCARS. We draw attention to the following in this context:

- We will need to see the legislative changes before we can settle our understanding of what is required by way of implementation.
- Our typical development timeframe for guidance changes is nine months where this involves issuing working papers to stakeholders and consulting on change proposals. This reflects our evidence-based approach and we believe it results in better guidance.
- We aim for more flexible and rapid approaches to development where appropriate, but these are likely to be most suitable where changes are minor and uncontroversial and we do not expect the legislative changes following the review to be minor.
- Stakeholders have generally supported an approach where we allow time for familiarisation before changes to guidance take effect.

8.4 Notwithstanding those challenges, the SSRO is committed to engaging positively and proactively with both the MOD and industry to support the implementation of the new legislation. We have commenced discussions with the MOD about implementation and are developing a broad timetable for implementing guidance and DefCARS changes.

8.5 While the future of DefCARS remains a priority for the SSRO, developing it to accommodate changes arising from the Secretary of State's review of the legislation and to realise other developments will likely require additional financial investment. If we are unable to obtain the investment needed, we may struggle to respond at the required pace.

8.6 We have shared our initial plans for the system with the MOD and will provide our assessment of the likely additional funding required to make DefCARS ready for the new legislation. We will continue to work closely with the MOD as the legislative timetable progresses, and we will be clear in our communication with key stakeholders about our plans and work in this area.

Appendix: Recommendations

Aspect of the regime	Recommendation for legislative change
Pricing recommendations	
R1 Cost Risk Adjustment	Section 17(2) of the Act and regulation 11(3) should be amended to provide that the adjustment to the baseline profit rate at step 2 should reflect the contractor's exposure to cost risk if it materialises, in addition to reflecting the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs.
R2 QDCs by amendment: incurred and committed pre-amendment costs	A new section should be inserted in the Act to permit the Regulations to provide that the price formula may be applied to a defined component of a contract. A new regulation should be added to specify that where a contract becomes a QDC by reason of an amendment, the price payable under the amended contract must be determined in accordance with the formula but excluding any incurred or committed price.
R3 Multiple baseline profit rates and segmented contract profit rates	The Act and Regulations should be amended to permit or better support: • a range of baseline profit rates, determined based on the type of acquisition; and • a profit rate for each defined component of a single contract, each determined by the application of a six-step process beginning with the appropriate baseline profit rate.
R4 POCO	The legislation should be amended to: • Replace some specified terms with principles that can be applied to the specific facts and circumstances of a contract, with facility for the SSRO to provide statutory guidance such that the following are achieved: i. POCO applies where the primary contractor has significant influence over the sub-contractor, replacing the existing test of whether a sub-contractor is 'associated', within the meaning of the Companies Act. ii. In addition to excluding sub-contracts that are the result of a competitive process from the scope of POCO, excluding sub-contracts if their price is equivalent to a competitive price. iii. The detail of what constitutes attributable profit is left to statutory guidance, in place of the definition in regulation 12(7) and (8). • Alternatively, aspects of the recommendations above could instead be addressed through additional legislation rather than guidance. We would be pleased to work with the MOD on the detailed legislative changes if that approach is preferred. • Delete the existing option to address POCO through the contract profit rate, thereby requiring any applicable adjustment to be made to allowable costs. • Raise the threshold sub-contract value for a POCO adjustment to £1 million while including provision for the contracting authority to include lower value contracts if the authority considers contracts have been sub-divided to avoid POCO. • Require contractors to report the attributable profit of sub-contracts where a POCO adjustment has been made, supplementing the existing reporting requirements about sub-contracts in a contract notification report, quarterly contract report, interim contract report and contract completion report.

Aspect of the regime	Recommendation for legislative change
R5 Pricing method: target price	Amend regulation 10(11) to additionally specify that the allowable costs estimated at the time of agreement may be adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different allowable costs).
R6 Final price adjustment	Amend regulation 17 as follows: • In paragraph (2), substitute "5% but less than 10%" with "5 percentage points but less than 10 percentage points" • In paragraph (3) substitute "10% but less than 15%" with "10 percentage points but less than 15 percentage points" • In paragraph (4) substitute "15%" with "15 percentage points"
Transparency recommendations	
R7 Overheads	Amend Regulation 37(7) to reflect the original intention of these requirements by aligning the QBU estimated cost analysis report (QBUECAR) reporting period with that of the estimated rates claim report (ERCR).
R8 Time limits for QSC assessments and notice of positive assessment	• Regulation 61 should be amended to add the requirement that a QSC assessment is to be completed, and a positive QSC assessment notified to the Secretary of State and the prospective sub-contractor, before the sub-contract is entered into; and • Regulation 62(3) should be deleted so that sub-contractors that receive a positive QSC assessment following entry into the sub-contract may appeal the assessment up to six months following receipt of the notice.
R9 Reporting the outcome of a QSC assessment	The Regulations should be amended so that in addition to reporting the outcome of a negative QSC assessment, a contractor is required to specify the reasons for the negative assessment by reference to which of the conditions under section 28 of the Act and regulation 58 are not satisfied.
R10 Notification of reporting requirements	Regulation 5 should include a requirement that the contracting authority notify the contractor of the reporting requirements arising from the assessed value.
R11 Variances	Regulations 26(6)(f), 27(4)(i) and 28(2)(i) should be amended to include a new materiality provision for reporting variances. Contractors should only be required to explain 90% of variances when the quantum of all variances exceed £100,000 or 1% of the contract price, whichever is the greater.
SSRO's supporting role recommendations	
R12 Referrals and guidance	The Act and Regulations should be amended to: • Enable the SSRO to: » give opinions, upon request, about the operation of the regulatory framework without the need for the referral to be made jointly with the other interested party or parties or for the referral to identify a specific contract; » make a determination in relation to adjustments under all six of the contract profit rate steps in section 17(2) of the Act; » make a determination in relation to whether a contract or proposed contract meets the conditions to be a QDC or QSC; and » make a determination in relation to the agreement of rates that may be used in the pricing of QDCs or QSCs. • Enable the SSRO to issue guidance in respect of any aspect of the regulatory framework and to require contracting parties to have regard to that guidance.