

SSRO

Single Source
Regulations Office

Summary of determination

The extent to which a contractor's particular unanticipated costs are allowable costs under a firm-priced qualifying defence contract

29 September 2023

The Single Source Regulations Office (SSRO) is an executive non-departmental public body, sponsored by the Ministry of Defence. It plays a key role in supporting the regulatory framework for single source defence contracts established by Part 2 of the Defence Reform Act 2014 and the Single Source Contract Regulations 2014.

The regulatory framework specifies how contracts that meet the requirements for being qualifying defence contracts or qualifying sub-contracts must be priced and requires transparency over those contracts and from the contractors who hold them. The SSRO may be asked to give an opinion or make a determination on matters related to the regulatory framework in circumstances set out in the Act and Regulations.

Introduction

1. The regulatory framework for single source defence contracts¹ specifies how contracts that meet the requirements for being qualifying defence contracts ('QDCs') must be priced. The price of a QDC is comprised of allowable costs (determined in accordance with one of six regulated pricing methods) and profit (a percentage mark-up on the allowable costs at a rate determined in accordance with the Act and Regulations).
2. The Act provides that allowable costs, whether estimated or actual, must satisfy the requirements of being appropriate, attributable to the contract, and reasonable in the circumstances. The SSRO publishes guidance to assist the parties to QDCs to determine whether a contractor's costs meet the requirements of allowable costs. Under section 20(5) of the Act, the SSRO may be asked to make a determination on the extent to which a particular cost is an allowable cost under a QDC.
3. In March 2023, a contractor asked the SSRO to make a determination on the extent to which particular costs were allowable costs under a firm-priced QDC entered into in 2018 between the contractor and the Secretary of State for Defence.² Under the firm pricing method, unless (and to the extent) the contract permits otherwise, the contractor bears the risk that its actual costs may vary from the estimate used to price the contract. The contractor indicated that it had not anticipated that it would incur the referred costs when the contract was first entered into.
4. This document contains an anonymised summary of the SSRO's determination and associated commentary on the matter referred. The determination and associated commentary reflects the SSRO's understanding of the facts of the case as presented by the parties to the referred contract during the SSRO's investigation of the referral.³

Background to the referral

5. Under the referred contract, the contractor was required to undertake work of a mechanical nature from 2018 to 2021. The contract was agreed with a firm price comprising estimated allowable costs and profit. The estimated allowable costs included the costs the contractor expected to incur, as agreed with the MOD:
 - a. under a service level agreement with supplier A (a sub-division of the contractor which had been selected with the MOD's approval following a competitive tendering exercise) to perform the contracted work; and
 - b. under a sub-contract with supplier B to supply the methodology and parts for the contracted work (including some parts purchased by supplier B from supplier C).⁴

1 Established by Part 2 of the Defence Reform Act 2014 ('the Act') and the Single Source Contract Regulations 2014 ('the Regulations').

2 Regulation 10(4) requires that under the firm pricing method the allowable costs are the allowable costs as estimated at the time of agreement.

3 An anonymized version of the full determination issued to the parties to the referred contract is available on the SSRO's website at: <https://www.government/publications/ssro-determination-on-the-extent-to-which-a-contractors-particular-unanticipated-costs-are-allowable-costs-under-a-firm-priced-qualifying-defence-con>.

4 The balance of the estimated allowable costs comprised other labour and other sub-contracts.

6. From March 2020, the contractor reported to the MOD that performance of the referred contract was affected by the global COVID-19 pandemic and changes that supplier A had made to its working practices in response to COVID-related safe-working regulations and guidance issued by the UK Government. The contractor considered this was a force majeure event under the terms of the referred contract. During April and May 2020, the contractor attempted to invoke a contractual force majeure mechanism and provided the MOD with estimates of the impact of supplier A's new working arrangements on both the costs the contractor expected it would incur to deliver the referred contract and the schedule for completing the contracted work. The contractor sought changes to the referred contract related to these matters.
7. The MOD did not accept the contractor's force majeure claim but, in July 2020, the parties agreed changes to the referred contract, including:
 - a. an extension to the contracted delivery schedule for the contracted work; and
 - b. an increase in the contract price related to additional costs to store certain parts needed for the contracted work.
8. The contractor told the SSRO that, following the contract amendment, it took further steps to mitigate the impact of COVID-19 on the contracted work, for example, buying staff leave and extending shifts. As a result, the contracted work was completed ahead of the extended delivery schedule.
9. After completing the contract, the contractor reported that, due to the additional costs it had incurred, its outturn profit on the contract was 2.1 percentage points lower than expected when the contract was entered into. It asked the MOD to consider making a final price adjustment under the mechanism specified in the Regulations in respect of the additional costs it said it incurred due to COVID-19. When the MOD advised the contractor that no final price adjustment was due under the Regulations, the contractor asked the SSRO to determine whether the additional costs it had incurred in response to COVID-19 were allowable costs for the purpose of determining the price of the referred contract.

The matter referred

10. The costs the contractor referred for determination by the SSRO ('the referred costs') were costs it said it had incurred that had not been included in the original estimate of costs used in pricing the referred contract. The referred costs comprised:
 - a. staff costs – which the contractor said it paid to supplier A in respect of changes supplier A made to its working practices for the contracted work in response to COVID-19 and associated regulations and guidance introduced by the UK Government ('the referred staff costs'); and
 - b. storage costs – which the contractor said it paid to supplier A to store the parts required for the contracted work ('the referred storage costs'). The contractor reported that it had accelerated the delivery of the parts to mitigate the risk that future supply chain disruption due to COVID-19 would impact on the delivery of the contracted work.

The parties' principal views on the matter referred

11. It was the contractor's view that the introduction by the UK Government of safe-working regulations in response to COVID-19 was a force majeure event under the contract or amounted to a change in the requirements of the referred contract. The contractor said it was not possible under the safe-working regulations for it to perform the contract as it previously intended. It believed the referred staff and storage costs met the requirements of allowable costs and should be added to the allowable costs used to determine the contract price.
12. The MOD accepted that the costs the contractor said it incurred due to changes it made in response to COVID-19 and the safe-working regulations introduced by the UK Government met the requirements of actual allowable costs (outturn costs) for the purpose of determining whether any final price adjustment was due under regulations 16 and 17 in respect of the referred contract. However, it did not consider these costs were relevant to the price payable under the referred firm-priced contract as under a firm-priced contract the contractor bears the risk of any cost variances.

The SSRO's investigation

13. The determination was made by a Referral Committee appointed in accordance with the requirements of the Act and Regulations and the SSRO's Corporate Governance Framework. In making the determination, the SSRO reviewed evidence submitted by the contractor at the time of referral and provided by both parties in response to the SSRO's requests for information. This included information on the referred contract; the amendment made to the referred contract in July 2020; the referred costs; the parties' views on the allowability of the referred costs; and the engagement that had taken place between the parties concerning the referred costs. The SSRO also considered information provided by the contractor in statutory contract reports for the referred contract. The SSRO held an oral hearing to allow both parties to present their cases to the Referral Committee and for the Committee to seek clarifications on evidence submitted. The SSRO held bilateral meetings with each party and sought and received feedback on a Statement of Facts shared with the parties to test the SSRO's understanding of the facts of the case.
14. The SSRO issued a provisional determination to the parties and invited them to identify any factual inaccuracies or relevant matters which they considered the SSRO should take into account before making its final determination on this matter. Relevant matters raised by the parties were addressed by the SSRO in making its final determination.

The SSRO's determination

15. Having considered the evidence available, the requirements of the regulatory framework established by the Act and Regulations, and the SSRO's statutory guidance on the requirements of allowable costs, the SSRO's determination is as follows:

- a. The referred staff costs are not allowable costs under the referred contract. The contract was agreed using the firm pricing method which, unless (and to the extent) the contract permitted otherwise, does not provide for costs that were not included in the estimate of allowable costs at the time of agreement to be included subsequently in the allowable costs that determine the contract price. Under the firm-priced contract, the contractor bore the risk that its costs might vary from the estimate used to price the contract. This included cost variations that arose from risks and events that the contractor had not foreseen. There were no contract provisions which would transfer to the Secretary of State the risk of the contractor's costs increasing due to COVID-19. While the parties agreed to amend the delivery schedule for the contracted work they did not agree to amend the price for this work and there was no legal (or other) obligation on the parties to do so. The amendment to the delivery schedule was not a pricing amendment under the regulatory framework for QDCs and did not require a re-determination of the price for undertaking the contracted work. Accordingly, no adjustment is to be made to the contract price in respect of the referred staff costs.
 - b. Eight per cent of the referred storage costs are allowable costs under the referred contract. This was the cost that the parties agreed in July 2020 for storage, from March to May 2020, of certain parts that were required to perform the contracted work. This amount was included in the price of the referred contract when the contract was amended in July 2020. As the storage costs pricing amendment was agreed using the firm pricing method, the remainder of the referred storage costs (relating to the storage of parts or to time periods not covered by the amendment) were incurred at the contractor's own risk and are not allowable costs under the referred contract. Accordingly, no adjustment is to be made to the contract price in respect of the referred storage costs.
16. Section 13(2) of the Act requires that the SSRO, in carrying out its functions under Part 2 of the Act, must aim to ensure that:
- a. good value for money is obtained in government expenditure on QDCs, and
 - b. persons (other than the Secretary of State) who are parties to QDCs are paid a fair and reasonable price under those contracts.
17. The SSRO is satisfied, for the following reasons, that its determination supports these aims.
- a. The determination upholds the pricing agreement made between the parties to the referred contract, which was struck on a firm-priced basis taking account of the information available to the parties about the costs required to deliver the contract and the associated risks and opportunities that might result in the contractor earning outturn profit that was lower or higher than expected at the time of agreement.
 - b. There is no reason for the SSRO to conclude that the referred contract did not provide the MOD with the capability it sought at a price which, at the time of agreement, both parties must have considered achieved the statutory aims.

- c. The nature of a firm-priced contract is to transfer cost risk and opportunity to the contractor. Where a firm-priced contract has been priced in accordance with the regulatory framework, unless (and to the extent) there is express provision in the contract or the regulatory framework for a price adjustment to be made, it would not be fair and reasonable for:
- i. the Secretary of State to be able to recover additional profit earned by a contractor due to outperforming its cost estimate; or
 - ii. the contractor to be able to recover lost profit due to under-performing against its cost estimate.
- d. While the contractor earned an outturn profit rate below the contract profit rate agreed by the parties when the contract was entered into, its loss of profit was not sufficient to trigger a final price adjustment under the statutory mechanism provided for by section 21 of the Act and regulations 16 and 17. Beyond thresholds prescribed in the legislation, the final price adjustment mechanism limits QDC contractors' losses arising from cost increases and ensures the Secretary of State shares any savings arising from cost reductions.

Other observations and wider learning

Regulatory requirements for redetermining the price of a QDC

18. Prior to 1 April 2019, regulation 14 specified how the price of a QDC should be re-determined where the Secretary of State and primary contractor proposed to amend a QDC (or a defined component of a QDC) in a way that would affect the price determined previously under regulation 10 or under regulation 14. With effect from 1 April 2019, the Regulations were amended such that regulation 14 now refers to the Schedule to the Regulations (inserted from that date) which makes provision for the re-determination of the contract price for a QDC.
19. The Schedule applies if the parties to a QDC propose to amend the contract in a way that would affect the original contract price or the price resulting from any previous amendments/re-determinations. Such an amendment is referred to in the Schedule as a 'pricing amendment'. Paragraphs 4 to 10 in the Schedule identify different methods for re-determining the price of a QDC dependent on the type of pricing amendment that is proposed by the parties to the contract.
20. The SSRO considers that the amount by which the price of the referred contract was amended in July 2020 in respect of additional storage costs was not calculated fully in accordance with the requirements of the regulatory framework. Specifically, no profit was applied to the agreed costs when determining the price of that amendment. While the SSRO is not empowered to determine an adjustment to the price of the contract in respect of this omission, the SSRO considers that the aims of the regulatory framework for QDCs would be better supported if profit was paid to the contractor at an appropriate rate on the additional storage costs which were included in the price of the contract in July 2020.
21. The MOD and contractors under the regime should ensure that staff who are agreeing amendments to QDCs are familiar with the requirements of the Schedule to the Regulations concerning re-determining the price of a QDC when making contract pricing amendments. Additional guidance from the SSRO may assist in this regard.

The requirements of allowable costs

22. Section 20(2) of the Act requires that in determining whether a particular cost is an allowable cost under a QDC, the Secretary of State or an authorised person, and the primary contractor, must be satisfied that the cost is:
 - a. appropriate;
 - b. attributable to the contract; and
 - c. reasonable in the circumstances.
23. Section 20(3) of the Act requires that in determining whether the requirements of allowable costs are met in relation to a particular cost, the Secretary of State or an authorised person, and the primary contractor, must have regard to guidance issued by the SSRO under section 20(1) of the Act. The evidence presented by the parties to the referral gave no clear indication as to how they had considered the requirements of allowable costs when determining the amount of costs that would be used to re-determine the price of the referred contract in July 2020.
24. Establishing the allowable costs for a pricing amendment to a QDC requires the parties to the contract to consider all of the following:
 - a. the regulated pricing method for the contract or defined component being amended;
 - b. the requirements of the Schedule to the Regulations which sets out for different types of pricing amendment what amount of allowable costs is to be determined – either the allowable costs for the contract or defined component being amended or the amount by which the proposed pricing amendment changes the allowable costs of the original contract; and
 - c. the requirements of allowable costs, set out in legislation and on which the SSRO provides guidance to which the parties must have regard.

Risk and uncertainty in allowable costs

25. A firm-priced contract provides a contractor with the opportunity to earn additional profit when it is able to outperform the cost estimate used to price the contract but when the contractor's outturn costs exceed the estimate used to price the contract it will earn less profit than expected and may make a loss. A contractor who is entering into a QDC whose price is determined on the basis of an estimate of allowable costs at the time of agreement should consider how risk and uncertainty may impact on the costs that they will actually incur. Neither party to a firm-priced QDC is required to compensate the other in respect of variances between the estimated allowable costs used to price the contract and the actual costs incurred by the contractor, other than through the final price adjustment mechanism or a specific provision of the contract.
26. The SSRO has issued detailed guidance for the Secretary of State and contractors in relation to risk and uncertainty when determining the allowable costs of a QDC. This guidance was incorporated into the Allowable Costs Guidance in March 2020 following engagement with key stakeholders and a public consultation in 2019.⁵ The SSRO's consultation addressed a number of questions including those related to costs arising from unforeseen events (or 'unknown unknowns') and risks with a very low probability of occurring but a very high impact (such as a global pandemic).

⁵ SSRO (2020) *Allowable Costs Guidance Review 2019: Summary of Consultation Responses*.

27. The SSRO has also issued guidance on the cost risk adjustment that may be made as part of the process to determine the contract profit rate for a QDC. The parties to QDCs should have regard to the SSRO's allowable costs and profit rate guidance when determining how risk and uncertainty is to be reflected in the pricing of those contracts.

The final price adjustment mechanism

28. For a QDC (or a defined component thereof) agreed using the firm, fixed or volume-driven pricing methods, the Act and Regulations provide a mechanism (the final price adjustment) by which the price of the contract (or component) might be adjusted after contract completion if:
- a. the outturn profit rate exceeds the agreed contract profit rate; or
 - b. the contractor's outturn costs (its actual costs under the contract which meet the requirements of allowable costs) exceed the contract price.
29. The amount of any final price adjustment is determined with reference to the extent of variance between the outturn profit rate and the agreed contract profit rate or between the outturn costs and the contract price.
30. Although the contractor did not make a loss in performing the referred contract, it incorrectly assumed that a final price adjustment might be due as a consequence of the variation between its estimated and actual allowable costs. The parties to QDCs should familiarise themselves with the provisions of regulations 16 and 17 which explain the procedure for determining the final price adjustment and its calculation. The SSRO considers there may be merit in providing guidance for the MOD and contractors on the application of the final price adjustment mechanism.

Force majeure

31. The referred contract contained a force majeure clause which provided that the contractor could claim additional time (up to three months) to deliver the contract if a force majeure event occurred. The contractor notified the MOD in April 2020 of its view that the impact of COVID-19 was a force majeure event under the contract. The MOD, in line with the extant guidance from the Cabinet Office,⁶ did not accept the contractor's force majeure claim.
32. The SSRO considers that the force majeure provisions of the referred contract have no bearing on the determination of allowable costs in this case. Even if the MOD had agreed that COVID-19 or the introduction of consequential regulations were a force majeure event under the contract, the force majeure clause made no provision for the price of the contract to be amended as a consequence. The only remedy available to the contractor under the force majeure clause was an extension of the timetable for delivering the contract requirements, which the MOD agreed to provide.
33. While not required by the force majeure clause of the referred contract, had the parties agreed to amend the price of the contract in response to a force majeure event, the Schedule to the Regulations would have prescribed how the price should be re-determined depending on the type of pricing amendment proposed. The statutory obligations on contract pricing, including the obligation to be satisfied that costs meet the requirements of allowable costs, operate independently of whether there is any contractual mechanism that enables a contractor to claim costs under a QDC.

⁶ Cabinet Office (2020) *Defence Procurement Policy Note 01/20: Responding to COVID-19*.

34. Where there is any inconsistency between a provision of a QDC and the provisions of the Act and Regulations, the Act and Regulations prevail.⁷

⁷ Section 43(5) of the Act.