

SSRO

Single Source
Regulations Office

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.

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1. Introduction

- 1.1 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') 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). 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.
- 1.2 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.
- 1.3 This document contains an anonymised version of the SSRO's determination and associated commentary on the matter referred. The following sections of this document explain:
- a. the requirements of the referred contract and the circumstances giving rise to the referral (Section 2);
 - b. the matter the SSRO was asked to determine (Section 3);
 - c. the relevant legislation on contract pricing and guidance on the determination of allowable costs which has guided the SSRO's determination (Section 4);
 - d. the SSRO's determination on the extent to which the referred costs are allowable under the referred contract (Section 5);
 - e. the matters the SSRO has considered in making its determination (Section 6); and
 - f. certain other observations on the case which the SSRO considers present opportunities for wider learning about the application of the regulatory framework for QDCs (Section 7).
- 1.4 The determination and associated commentary in this document 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. The approach taken by the SSRO to investigate and make its determination on the matter referred was consistent with the SSRO's published procedures.¹

¹ SSRO (2021) *Guidance on the SSRO's Referrals Procedures for Determinations Under the Defence Reform Act 2014*.

2. Background to the referral

2.1 This section sets out the requirements of the referred contract and the circumstances giving rise to the referral.

The referred contract

2.2 In 2018, the Secretary of State for Defence entered into a contract with the contractor to undertake work of a mechanical nature.

2.3 Following a competitive tendering process conducted jointly with the MOD to identify a sub-contractor to undertake the contracted work, the contractor entered into a service level agreement with supplier A (a sub-division of the contractor) that it had established for the purpose of performing the contracted work. Staff were employed by supplier A on fixed-term contracts to match the delivery schedule agreed with the MOD.

2.4 The methodology and parts for the contracted work were to be supplied under a sub-contract by supplier B. The parts being supplied by supplier B included items manufactured by supplier B and items purchased by supplier B from another supplier (supplier C) under a further sub-contract. All these items were manufactured in the European Union and were scheduled for delivery to supplier A on a just-in-time basis to meet the delivery schedule for the contracted work and minimise the need for storage space at the contractor's facility in the UK.

2.5 The contracted work was to be completed over a three-year period from 2018 to 2021.

The contract price at the original time of agreement

2.6 The contract met the requirements to be a QDC under section 14 of the Act. Section 15(2) of the Act and regulation 10(1) require the price payable under a QDC to be determined in accordance with the formula:

$$(CPR \times AC) + AC$$

2.7 In the pricing formula, 'CPR' is the contract profit rate for the contract, determined in accordance with section 17 of the Act and regulation 11. 'AC' is the primary contractor's allowable costs determined in accordance with one of the six regulated pricing methods described in paragraphs (4) to (11) of regulation 10. The contract price was agreed using the firm pricing method. Regulation 10(4) provides that under the firm pricing method, the allowable costs used to determine the contract price are the allowable costs as estimated at the time of agreement.

2.8 The MOD, acting for the Secretary of State, and the contractor agreed a total firm price for the referred contract comprised of estimated allowable costs and profit.

2.9 The Regulations require a QDC contractor to report information about the agreed price of a QDC, including any risk contingency element included in the allowable costs.² The contractor reported to the SSRO in 2018 that the allowable costs used to price the referred contract did not contain any risk contingency element.³

² Regulation 25(2)(c)(i).

³ Data provided by the contractor in statutory contract reports submitted to the SSRO.

- 2.10 In determining the contract profit rate for a QDC, section 17(2) of the Act and regulation 11(3) require the parties to the contract to '[a]djust the baseline profit rate by an agreed amount which is within a range of plus or minus 25 per cent of the baseline profit rate, so as to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs'.⁴ The contractor reported to the SSRO in 2018 that the agreed cost risk adjustment for the referred contract was a negative adjustment.⁵

The impact of COVID-19 on performance of the referred contract

- 2.11 In early 2020, a novel coronavirus (COVID-19) spread rapidly across the world. In the UK, on 16 March 2020, the Government encouraged the public to stop non-essential contact and travel to reduce the transmission of COVID-19. On 23 March 2020, the UK Prime Minister announced the UK's first COVID-19 lockdown, requiring people to stay at home except for very limited purposes, such as travelling to and from work where this could not be done from home.⁶ On 25 March 2020, the Coronavirus Act 2020 received Royal Assent, giving powers to the Secretary of State to issue directions prohibiting certain activities.⁷ In May 2020, the UK Government issued a range of guidance for employers and employees on measures that could be taken in workplaces to maintain social distancing and promote safe-working during the COVID-19 pandemic.⁸
- 2.12 Until March 2020, it appears that the referred contract had been performed to schedule. Early changes to the specification of the contracted work requested by the MOD had been agreed by the parties, with associated changes made to the price of the contract through formal amendments.
- 2.13 From March 2020, the contractor reported that supplier A had experienced severe disruption in its delivery of the contracted work as a result of operational changes it had made in response to COVID-19. These changes had led to a loss of productive labour hours and a consequential slow-down in the rate at which the contracted work could be performed.
- 2.14 In March 2020, supplier B notified the contractor that it had temporarily closed its manufacturing facility in response to its suppliers announcing short-term production or delivery stops due to measures being taken to contain the COVID-19 pandemic. It claimed this was a force majeure event under the terms of its contract with the contractor.⁹ The SSRO understands from the contractor that deliveries of parts manufactured by supplier B did not resume until May 2020.

⁴ The SSRO issues guidance on the determination of the contract profit rate for a QDC, to which the parties to the QDC must have regard. The SSRO's guidance on the cost risk adjustment to be made at step two of the process to determine the contract profit rate for a QDC states that '[a] negative adjustment should be made where the MOD and the contractor agree there is a lower (or no) risk of actual Allowable Costs differing from estimated Allowable Costs'.

⁵ Data provided by the contractor in statutory contract reports submitted to the SSRO.

⁶ Prime Minister's Statement on Coronavirus (COVID-19): 23 March 2020. COVID-19 restrictions on social interaction and travel were in place at various times nationally and in local areas in England until February 2022.

⁷ Institute for Government (2022) *Timeline of UK Government Coronavirus Lockdowns and Restrictions* March 2020 to December 2021, available at <https://www.instituteforgovernment.org.uk/data-visualisation/timeline-coronavirus-lockdowns> (accessed 12 July 2023).

⁸ For example: HM Government (2020) *Working Safely During COVID-19 in Factories, Plants and Warehouses*; HM Government (2020) *Working Safely During COVID-19 in or from a Vehicle*.

⁹ Broadly, force majeure can be described as an unforeseeable act, event or circumstance beyond a contracting party's control, generally falling into categories specifically described in a relevant contract, which excuses the contracting party from, or entitles the suspension of, performance of the contract without liability.

- 2.15 From late March 2020, at the MOD's request, the contractor provided regular updates on the impact of COVID-19 on the performance and costs of the referred contract. The contractor informed the MOD that as a result of staff sickness, self-isolation and the changes in working practices at supplier A in response to COVID-19, the rate at which the contracted work was performed had slowed. The reported effect of this was that:
- a. materials to undertake the contracted work were not being used at the rate expected, increasing the requirements for storage;
 - b. from March to May 2020, the contracted work was expected to be behind schedule so that, without remedial action, the contractor would be unable to meet the contracted delivery schedule – with the consequent risk that the contractor would become liable to pay liquidated damages to the MOD;¹⁰ and
 - c. the contractor anticipated it would need to incur additional staff costs, for example, paying staff to work additional shifts or at weekends to meet the contracted delivery schedule or extending various staff contracts to enable delayed work to be performed beyond the end of the contracted delivery schedule.
- 2.16 During April 2020, the contractor provided the MOD with various assessments of the impact of COVID-19 on the referred contract, which, by then, it considered to be a force majeure event under the referred contract. These updates considered the short-term impacts of changes in contract delivery during the period from March to May 2020 and longer-term assessments of how the contract might be delivered depending on how long COVID-19 restrictions would endure.
- 2.17 In April 2020, in response to an email from the contractor,¹¹ the MOD told the contractor that it recognised the challenges presented by COVID-19 and would consider requests for contractual relief on a case-by-case basis in line with recently updated Cabinet Office guidance. It sought further clarification on the contractual relief the contractor was seeking related to 'unforeseen, unavoidable costs that [were] a direct result of COVID-19', taking account of whether any costs were already part of routine contingency planning. The MOD noted specifically that it considered the contractor was responsible for determining how and when to provision itself to meet the requirements of the contract and it did not consider a claim by the contractor for additional storage costs fell within the scope of contractual relief directly attributable to COVID-19.
- 2.18 In April 2020, the contractor sought payment from the MOD of an additional sum of £[REDACTED] – its estimated costs related to the impact of COVID-19 for the period from March to May 2020 – although it acknowledged that this was not an amount the MOD was legally obliged to pay.¹² The amount claimed included the additional staff costs the contractor said it had incurred or would incur to keep the facility undertaking the contracted work open and undertake the delayed work

¹⁰ The referred contract provided that in the event the contracted work was not completed in line with the contracted delivery schedule, the contractor would pay the MOD a specified amount for each day's delay (including bank holidays and weekends) as liquidated damages.

¹¹ The email contained estimates of the cost of storing parts provided by supplier C from April 2020 to August 2020 and of additional staff costs arising due to changes made in the process for the contracted work from March to May 2020.

¹² This claim was distinct from the contractor's reported assessment of the potential impact of COVID-19 on the performance and costs of the referred contract after May 2020.

at a future time and an amount of £[REDACTED] related to the costs of storing parts provided by supplier C which, the contractor said, were being delivered at a faster rate than they were being used. The amount claimed for storage costs was based, the contractor said, on a quotation for storage provided by a local haulier,¹³ although it also told the MOD that it was making space available for the parts at its own facility by relocating presently stored materials to other sites operated by the contractor. The contractor said it had chosen to store the parts for the contracted work at its own site as the contractor's Board had determined not to commit to any expenditure with third parties while the company was experiencing a significant reduction in business due to COVID-19.¹⁴

- 2.19 In relation to longer-term considerations, the contractor told the MOD that completing the contracted work programme by the date agreed would depend on having all the parts provided by suppliers B and C at its site by October 2020, to mitigate the risk of future schedule delays resulting from any further supply chain disruption. The contractor told the SSRO that supplier B and supplier C agreed to accelerate delivery of the parts for the contracted work at no extra cost but the contractor estimated in April 2020 that there would be a cost of £[REDACTED] associated with storing the parts from supplier B (£[REDACTED]) and the parts from supplier C (£[REDACTED]). The contractor told the SSRO that these estimates were based on its experience of working with hauliers.
- 2.20 In May 2020, the contractor asked the MOD to set out its formal contractual position regarding the impact of the COVID-19 pandemic.

Contract amendment

- 2.21 In June 2020, the MOD provided its response to the contractor's claim for additional costs.
- a. It noted that the contractor could no longer meet the contractually agreed schedule for the work for which liquidated damages would apply. It said it was willing to agree a revised delivery schedule – with the contracted work to be completed three months later than initially agreed – to be incorporated into the referred contract by formal amendment.
 - b. It said the MOD could not accept a force majeure claim to pay additional costs as a result of the impact to the delivery schedule of COVID-19 or revisions to shift working patterns and that no increase would be made to the overall contract price in relation to the additional staff costs claimed.
 - c. It noted the contractor's intention to expedite delivery of the parts from suppliers B and C required for the contracted work and proposed to amend the payment schedule under the contract to provide agreed payments for these materials at the point of delivery (rather than on completion of the contracted work as previously agreed) and to pay the associated retention on those costs¹⁵ over a mutually agreed period before the original contract completion date.

¹³ The SSRO noted that this amount was the same as a quotation provided to the contractor by a local haulier for storage of a specified number of the parts from supplier C from April 2020 to August 2020 which the contractor had sent to the MOD earlier in April 2020.

¹⁴ The contractor noted that its usual charge for storage at its facility was £[REDACTED] per space per day (which would accommodate a specified number of the parts from supplier C). If the contractor were to charge the MOD at this rate the storage costs would be £[REDACTED], but the contractor considered this would be 'unacceptable' to the MOD.

¹⁵ A percentage of the payments due that was retained until agreed delivery milestones had been met.

- d. It confirmed that it was 'willing to pay the ~£[REDACTED] storage costs' associated with accommodating the parts from supplier C at the contractor's site.
- 2.22 In responding to the contractor, the MOD indicated that the proposals set out in c) and d) above were offered as 'gesture[s] of goodwill'.¹⁶
- 2.23 In July 2020, following further email exchanges, the MOD wrote to the contractor offering an amendment to the referred contract which included the following changes:
- a revised delivery schedule for the contracted work;¹⁷
 - changes to the payment arrangements under the contract; and
 - a new item in the Schedule of Requirements related to the additional storage costs associated with the storage of parts from supplier C with an associated firm price of £[REDACTED].¹⁸
- 2.24 The MOD's offer letter indicated that:
- the agreed revised delivery schedule was the result of the COVID-19 pandemic;
 - the changes to the payment arrangements were in support of the contractor's cash-flow;
 - the inclusion of additional storage costs in the Schedule of Requirements was a 'gesture of goodwill in full and final settlement of all associated storage costs'.
- 2.25 The letter also specified that the offer of amendment would constitute:
- '...full and final settlement of all Contractor claims arising from the COVID-19 pandemic. However, should the Authority be unable to meet any of its contractual obligations and/or dependencies as a result of the COVID-19 pandemic, the Contractor shall be entitled to make a claim for any reasonable costs incurred as a direct result of such consequences and/or revise its Delivery/Acceptance Schedule accordingly. All other terms and conditions of the Contract remain unchanged.'*
- 2.26 The contractor confirmed its acceptance of the terms of the contract amendment in July 2020. It told the SSRO that it welcomed the amendment as:
- the schedule extension reduced its risk of exposure to liquidated damages for late delivery, which it had estimated could be £[REDACTED]; and
 - the changes to the contract payment schedule supported the company's cash-flow, which was a corporate priority at that time due to the majority of the company's operations having been suspended due to COVID-19.

¹⁶ The SSRO understands this to mean that the MOD did not consider it was under any obligation to offer the amendments.

¹⁷ Under the revised schedule, the contracted work was to be completed by the contractor one month later than the previously agreed contract completion date.

¹⁸ The contract amendment also included another change to the Schedule of Requirements for the contract and an associated change in the price of that item, but that change is not considered to be material to the matter being determined.

The parties' engagement on costs following completion of the referred contract

- 2.27 The contractor told the SSRO that, following the contract amendment in July 2020, it continued to deliver the contract, taking further steps to mitigate the impact of COVID-19 on the programme of work. It said that supplier A had been able to improve its processes for performing the contracted work under the COVID-19 regulations and took steps, for example, buying staff leave and extending shifts, to expedite delivery of the contracted work. As a result, all the contracted work was completed ahead of the revised delivery schedule in the referred contract.
- 2.28 In June 2021, the contractor submitted the contract completion report (CCR) and contract costs statement (CCS) for the referred contract, as required by regulations 28 and 29 (respectively), providing details of the outturn costs and outturn profit earned on the contract.
- 2.29 On the same date, the contractor wrote to the MOD to request a discussion concerning the application of a final price adjustment¹⁹ to the contract price in respect of the additional costs it had incurred to perform the contract, including those incurred in response to COVID-19.
- 2.30 Over the next 21 months, the parties exchanged a number of communications in relation to this matter.
- 2.31 In March 2023, the contractor wrote to the SSRO seeking a determination on the allowability of the costs it incurred as a result of the impact of COVID-19 on performance of the referred contract.

¹⁹ Section 21 of the Act and regulations 16 and 17 provide that, in circumstances specified in the Regulations, a final price adjustment may be made to the price of a QDC. Further details on the final price adjustment mechanism are provided in section 4 of this document.

3. The matter referred

- 3.1 The contractor asked the SSRO to make a determination under section 20(5) of the Defence Reform Act 2014 on the extent to which particular costs are allowable costs under the referred contract. The costs whose allowability the SSRO was asked to determine were:
- a. Staff costs (£[REDACTED]) – which the contractor said it paid to supplier A in respect of changes supplier A made to its working practices for performing the contracted work in response to COVID-19 and associated regulations and guidance introduced by the UK Government. (Hereafter, 'the referred staff costs'.)
 - b. Storage costs (£[REDACTED]) – which the contractor said it paid to supplier A to store parts required for the contracted work. (Hereafter, 'the referred storage costs'.) The contractor reported that it had accelerated the delivery of 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

- 3.2 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.
- 3.3 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.

4. Relevant legislation and guidance

- 4.1 The relevant legislation on contract pricing and guidance on the determination of allowable costs which has informed the SSRO's determination on the matter referred are set out below.

The pricing formula

- 4.2 Section 15(2) of the Act and regulation 10(1) require that the price payable under a QDC to the primary contractor must be determined in accordance with the formula:

$$(CPR \times AC) + AC$$

- 4.3 'CPR' is the contract profit rate for the contract, determined in accordance with section 17 and regulation 11 and 'AC' means the primary contractor's allowable costs determined in accordance with one of the six regulated pricing methods described in paragraphs (4) to (11) of regulation 10.

The regulated pricing methods

- 4.4 Regulation 10(2) provides that the parties to a QDC may agree which of the regulated pricing methods is to be used for that QDC. Under regulation 10(3), the parties to a QDC may agree that different regulated pricing methods are to be used for defined components of that contract.
- 4.5 Regulation 10(4) requires that under the firm pricing method, the pricing method that the parties agreed to use for the referred contract, the allowable costs are the allowable costs as estimated at the time of agreement.
- 4.6 Regulation 2 gives the meaning of 'time of agreement' in the case of a contract which is a QDC by virtue of section 14(3), such as the referred contract, as being either:
- a. the date the contract is entered into; or
 - b. if the price payable under the contract is re-determined in accordance with the Schedule [to the Regulations], the date of that re-determination.

Re-determining the price of a QDC

- 4.7 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.
- 4.8 With effect from 1 April 2019, the Regulations were amended²⁰ 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. 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'.

²⁰ The Single Source Contract (Amendment) (No. 2) Regulations 2018.

- 4.9 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. The types of pricing amendment are shown in Appendix 2.
- 4.10 Where the parties to a QDC propose to make a single pricing amendment to a QDC, paragraph 3(2) of the Schedule provides that it does not matter whether the parties also propose to make any other amendment to the contract at the same time as making the pricing amendment.
- 4.11 Where the parties to a QDC propose to make two or more pricing amendments to a QDC at the same time, paragraph 12 of the Schedule sets out the order in which they should be dealt in re-determining the contract price, depending on the types of pricing amendment concerned. Paragraph 11(2) of the Schedule provides that it does not matter whether the parties also propose to make any other amendment to the contract at the same time as making multiple pricing amendments.

The requirements of allowable costs

- 4.12 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.
- 4.13 Section 20(3) of the Act requires that in determining whether the requirements of allowable costs ('the AAR test') 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 SSRO has issued relevant guidance, which is extracted in Appendix 1 and outlined below.
- 4.14 Section 20(4) of the Act provides that the Secretary of State or an authorised person may at any time require a primary contractor to show (whether by reference to guidance issued by the SSRO or otherwise) that the requirements of allowable costs are met in relation to a particular cost claimed by the primary contractor as an allowable cost under a QDC.

The SSRO's guidance on allowable costs

- 4.15 The SSRO publishes guidance to assist the Secretary of State and contractors to determine whether costs are allowable costs under QDCs. The SSRO updates its allowable costs guidance from time to time, in consultation with stakeholders, to reflect changes in legislation, good practice and learning from experience. The guidance the SSRO has considered in making this determination is version 5, which was published in March 2020 and applied to QDCs entered into or amended on or after 1 April 2020. This was the guidance in force at the time the July 2020 amendment to the referred contract was negotiated and agreed.
- 4.16 The guidance notes that (as provided for by section 20(4) of the Act) the Secretary of State may require the primary contractor (in the case of a QDC) to show that the requirements of allowable costs are met in relation to costs claimed by the

contractor as allowable under the QDC. In such cases, the burden of proof rests with the contractor. Whether or not the Secretary of State requires the contractor to show that the requirements of allowable costs are met, the Secretary of State and the contractor must be satisfied that the costs are Allowable Costs.

The AAR principles

- 4.17 Section 3 of the SSRO's Allowable Costs Guidance (Version 5) sets out the typical characteristics of costs that meet the requirements of allowable costs. The guidance makes clear that the requirements of allowable costs apply whether the contractor's costs are estimated or actual, and whether they are applied to the contract as a direct cost or as an indirect cost.
- 4.18 The guidance notes that determining whether each requirement of allowable costs is met for a particular cost requires judgement to be applied, including regarding:
- a. the relative importance of the characteristics identified in the guidance to the particular cost under consideration; and
 - b. the type and standard of information that is required to be satisfied that the cost demonstrates the characteristics identified in the guidance.
- 4.19 Paragraphs 3.11 to 3.14 of the guidance set out the typical characteristics of costs that meet the requirements of Allowable Costs. These should be considered when evaluating whether a particular cost incurred by a contractor meets each requirement of allowable costs.

Guidance on specific categories of cost

- 4.20 Section 5 of the Allowable Costs Guidance provides additional guidance to assist users in determining whether specific categories of cost are allowable costs. Part H in Section 5 addresses risk and uncertainty. The guidance on risk and uncertainty in version 5 of the Allowable Costs Guidance was incorporated into the guidance in March 2020. It was first published in January 2020 and was the subject of public consultation in 2019.

The final price adjustment

- 4.21 Section 21 of the Act and regulations 16 and 17 provide that, in circumstances specified in the Regulations, a final price adjustment may be made to the price of a QDC where either the outturn profit rate for the contract exceeds the agreed contract profit rate or the contractor's outturn costs (its actual costs under the contract which meet the requirements of allowable costs) exceed the contract price.
- 4.22 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.

Matters to which the SSRO has had regard in making the determination

- 4.23 In carrying out its functions under Part 2 of the Act, the SSRO must aim to ensure:
- a. that good value for money is obtained in government expenditure on QDCs; and
 - b. that persons (other than the Secretary of State) who are parties to QDCs are paid a fair and reasonable price under those contracts.

- 4.24 When making a determination under section 20(5) of the Act, the SSRO is required by regulations 19(3) and 54 to have regard to a number of matters. These relate principally to the regulations or statutory guidance relevant to the matters referred and the extent to which these have been followed, the information available to each party at the time of agreement and representations made by the parties to the contract. We considered each of the paragraphs in regulations 19(3) and 54 in our determination and references to the material considerations are included in this document.

5. The SSRO's determination

- 5.1 This section sets out the SSRO's determination on the extent to which the referred costs are allowable costs under the referred contract.

Determination on allowable costs

- 5.2 The SSRO's determination under section 20(5) of the Act is as follows.
- a. The referred staff costs (£[REDACTED]) are not allowable costs under the referred contract.
 - b. The amount of the referred storage costs (£[REDACTED]) that are allowable costs under the referred contract is £[REDACTED – an amount equal to 8 per cent of the referred storage costs].
- 5.3 An explanation of the factors that the SSRO has taken into account in making its determination on the referred costs is provided in section 6 of this document.

Determination on the price payable under the contract

- 5.4 Section 20(6) of the Act provides that the SSRO may determine that the price payable under the contract is to be adjusted by an amount specified by the SSRO in consequence of a determination under section 20(5), having regard to the extent to which the cost in question was treated as an allowable cost when the price payable under the contract was determined (or last determined) in accordance with section 15.
- 5.5 In light of the determination described above, the SSRO determines that no adjustment is required in the price payable under the referred contract as a result of the determination. The SSRO has determined that no amount of the referred staff costs are allowable costs under the referred contract. The amount of the referred storage costs which the SSRO has determined are allowable costs is considered to have been included in the price of the referred contract by the July 2020 contract amendment in respect of additional storage costs for parts provided by supplier C.
- 5.6 On the basis of the evidence presented, the SSRO also considers that the amount by which the contract price was amended in July 2020 in respect of additional storage costs for parts provided by supplier C was not calculated fully in accordance with the requirements of the Regulations. Specifically, it appears that no profit was applied to the agreed costs when determining the price of the 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 referred contract in July 2020.
- 5.7 Some further observations on this case are provided in section 7 of this document. The SSRO considers these present opportunities for wider learning about the application of the regulatory framework for QDCs.

Determination on referral-related costs

- 5.8 When making a determination under the Act and Regulations, section 35(4) of the Act empowers the SSRO to require the payment of such costs as the SSRO considers appropriate by one party to the referral to the other. The SSRO has published guidance on requiring the payment of referral-related costs. This makes clear that the SSRO will only consider requiring the payment of referral-related costs by one party to the other when requested to do so by one or other party.
- 5.9 No claim for referral-related costs has been made by either party to this referral. Accordingly, the SSRO does not propose to require either party to make a payment of referral-related costs in this case.

6. Matters considered in making the determination

- 6.1 The principal matters considered by the SSRO in making its determination on the extent to which the referred costs are allowable costs under the referred contract are discussed below.

The requirements of the referred contract

- 6.2 When determining the extent to which a contractor's particular costs are allowable costs under a QDC, the SSRO's Allowable Costs Guidance requires that the parties to the contract (and the SSRO on referral) have regard to the specification in the contract of the goods, works or services (the requirements) that the contractor is expected to deliver under the contract.²¹ In making its determination in this case, the SSRO has considered the requirements of the referred contract when it was first entered into in 2018 and the requirements following agreement by the parties of the amendment in July 2020. Where necessary to understand the intended scope of the referred contract's requirements, the SSRO has had regard to contemporaneous communications between the MOD and the contractor, as identified elsewhere in this document.
- 6.3 The purpose of an SSRO determination on allowable costs is to answer the question of whether the referred costs are allowable costs under the referred contract and, consequently, whether an adjustment should be made to the contract price. It is not the purpose of an SSRO determination on allowable costs to redefine the requirements agreed by the parties and specified in the contract.

The regulated pricing method and allocation of cost risk

- 6.4 The parties agreed a price for the referred contract using the firm pricing method. Regulation 10(4) provides that under the firm pricing method the allowable costs are the allowable costs as estimated at the time of agreement.
- 6.5 The referred staff and storage costs were not included in the original estimate of allowable costs in 2018 as the contractor did not expect to incur them. A contract priced using the firm pricing method does not provide for costs that were not estimated at the time of agreement to be included in the allowable costs that determine the contract price, unless:
- a. the contract expressly provides otherwise; or
 - b. the contract is subsequently amended to permit them.
- 6.6 In the absence of either provision, the contractor bears the risk that its actual costs to deliver the contracted output may vary (positively or negatively) from the estimate used to price the contract. This includes cost variations that arise from risks and events that the contractor has not foreseen.²²

²¹ See paragraphs 3.11a, 3.12b, 3.13a and 3.14b in *Allowable Costs Guidance, Version 5* (reproduced in Appendix 1 to this document). Earlier versions of the SSRO's guidance on allowable costs included similar requirements to consider whether a cost, for example, 'might be expected to be incurred in the delivery of the QDC'; 'is necessary to fulfil the requirements of the contract'; 'is incurred in fulfilling the requirements of the contract'; and 'is congruent with meeting the contract requirements'.

²² In circumstances specified in the Regulations, the final price adjustment mechanism (see paragraph 4.21) may limit the extent to which a contractor gains or loses as a consequence of variations between its estimated and actual allowable costs.

- 6.7 The contractor told the SSRO that the COVID-19 pandemic was not a risk that it could have foreseen at the initial time of agreement and it was not discussed with the MOD when pricing the contract. The MOD, conversely, said that it considered risk associated with a pandemic was a risk that had been known for some time when the referred contract was agreed, was featured in the UK Government's national risk register and should have been on the contractor's risk register. It considered it was part of the general set of risks borne by companies.
- 6.8 Whether the risk of a global pandemic was foreseen or not by the contractor at the time the referred contract was entered into (or discussed with the MOD), in the absence of any contrary contractual provision, the contractor bore the risk that it might incur the additional costs that arose due to COVID-19 and the changes supplier A made to working practices in response to the UK Government's safe-working regulations and guidance.
- 6.9 The parties to the referred contract did not identify any specific provisions in the contract which would transfer to the Secretary of State the risk of the contractor's costs increasing due to COVID-19. The referred contract did contain 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 but made no provision regarding the contractor's costs. The relevance to this case of the provisions of the force majeure clause of the referred contract are discussed in section 7.
- 6.10 Under the regulatory framework, subsequent to the original time of agreement, the parties to a firm-priced QDC might agree to amend the price of the contract or change the pricing method, as provided for by regulation 14 and the Schedule to the Regulations. Such changes might transfer a liability for a particular cost from one party to the other or change how the risk of cost variation is allocated between the contracting parties. However, there is no obligation on the parties to a firm-priced QDC to agree to amend a contract that has been entered into, either in response to a change in the contracting authority's requirements or if the contractor's expected costs to deliver the contract change. The nature of any contract amendment is a matter on which the mutual consent of the contracting parties is required.
- 6.11 In this case, the parties did agree to amend the referred contract in July 2020 in response to the impact of COVID-19 on contract performance. The SSRO duly considered whether the changes made to the contract at that time resulted in any amount of the referred costs being allowable costs under the contract (as discussed below).

The requirements of the Schedule to the Regulations in respect of the contract amendment

- 6.12 In July 2020, among other changes, the contract amendment:
- a. amended the delivery schedule for the contracted work – without any related amendment to the price of the referred contract; and
 - b. included a new item in the Schedule of Requirements in the referred contract related to additional storage costs associated with the storage of parts from supplier C – with an associated firm price of £[REDACTED].

- 6.13 The SSRO considered how the Schedule to the Regulations, concerning re-determination of the price of a QDC, applied to each of these amendments. The SSRO's related conclusions are set out below.

Extension of the delivery schedule for the contracted work

- 6.14 The Schedule to the Regulations applies if the parties to a QDC propose to amend a QDC in a way that would affect the original (or previously re-determined) contract price – referred to in the Schedule as a 'pricing amendment'. In the case of the referred contract, the parties did not amend the price of the contracted work when extending the delivery schedule for this work. Accordingly, this contract amendment did not meet the definition of a pricing amendment under the Schedule to the Regulations. The Schedule to the Regulations did not, therefore, apply to this amendment.
- 6.15 It is also the SSRO's view that the extension of the delivery schedule for the contracted work was not the cause of the contractor incurring the referred staff costs. The contractor said that the referred staff costs were incurred as a consequence of COVID-19 and the changes supplier A made to its working practices in response to the safe-working regulations and guidance. No evidence was presented by either party that would indicate the referred staff costs were specifically incurred as a consequence of the change to the contractually agreed delivery schedule for the contracted work. There is no reason to believe that the referred staff costs would not have been incurred by the contractor if the contracted delivery schedule had not been amended.
- 6.16 The SSRO does not consider there was any legal (or other) obligation on the MOD to propose or agree to amend the price of the contracted work when agreeing to extend the delivery schedule for this work. Equally, there was no obligation on the contractor to agree to the extension of the delivery schedule. If the contractor had believed that the proposed extension of the delivery schedule in the referred contract would cause it to incur additional costs which met the requirements of allowable costs and found the MOD unwilling to agree to amend the contract price to include those additional allowable costs, the contractor was at liberty not to agree to the contract amendment. The SSRO notes, however, that the contractor welcomed the extension to the contracted delivery schedule as it reduced the risk that it might incur liquidated damages for late delivery of the contract requirements. This was a clear benefit to the contractor given the challenges it faced to meet the originally contracted delivery schedule.
- 6.17 For the referred staff costs to be allowable costs under the referred contract they would need to satisfy the requirements of allowable costs and have been determined in accordance with the regulated pricing method used for the contract. Under the firm pricing method, the allowable costs are the allowable costs estimated at the time of agreement. The SSRO's determination is that, as the referred staff costs were not included in the estimate of allowable costs when the referred contract was entered into and the change to the delivery schedule agreed in July 2020 did not require a re-determination of the price for undertaking the contracted work, the referred staff costs are not allowable costs under the referred contract.

Additional storage costs

- 6.18 Notwithstanding the MOD's presentation in June and July 2020 of the inclusion in the referred contract (by amendment) of additional storage costs associated with the storage of parts provided by supplier C as a 'gesture of goodwill', it is clear that this change constitutes a pricing amendment under, and subject to, the Schedule to the Regulations as the parties agreed that the amendment would increase the price of the contract by £[REDACTED]. Consequently, the SSRO considered whether any amount of the referred storage costs should have been included in re-determining the contract price in July 2020 in respect of this amendment.
- 6.19 The SSRO considers that the storage costs pricing amendment was a pricing amendment of the type described in paragraph 7 of the Schedule – Change to a contractual requirement: contract or defined component not using cost-plus method. (The SSRO's reasoning for this categorisation is explained in Appendix 2.) For such a pricing amendment, paragraph 7 of the Schedule to the Regulations requires that the price payable under the amended contract is the total of the original contract price²³ and the price payable in respect of the amendment. The price payable in respect of the amendment must be determined in accordance with the following formula and may be a negative amount:

$$(CPR \times AC) + AC$$

In the formula:

- a. 'CPR' is the contract profit rate for the amendment, and
 - b. 'AC' means the amount (which may be a negative amount) by which the amendment will change the original allowable costs.
- 6.20 To enable the SSRO to determine the amount by which the storage costs pricing amendment changed the original estimate of allowable costs, the SSRO considered what the intended scope of the amendment was, having regard to information available at the time of the amendment concerning:
- a. to which of the items requiring storage the amendment applied; and
 - b. over what period storage was to be provided under the amendment.
- 6.21 With regard to a), the item in the Schedule of Requirements to the referred contract that was introduced by the contract amendment is clearly specified as relating to additional storage costs associated with the storage of parts provided by supplier C.
- 6.22 With regard to b), the amount by which the parties agreed to amend the contract price in respect of the storage costs pricing amendment was the amount that the contractor proposed in April 2020 that the MOD should pay for storage as part of the contractor's claim for additional costs related to the period from March to May 2020.

²³ Paragraph 1(2) in the Schedule to the Regulations gives the meaning of 'original contract price' in relation to a QDC as either:

- a. the price determined in accordance with regulation 10; or
- b. where the contract has previously been amended in a way that affects the price payable under the contract, the price determined or, as the case may be, last determined in accordance with this Schedule.

- 6.23 While the contractor also provided the MOD with estimates of the costs associated with storage of parts provided by suppliers B and C whose delivery it planned to bring forward to mitigate the risk of further supply chain disruption, and told the SSRO there were other storage requirements, the SSRO does not consider that the contracting parties intended that the storage costs pricing amendment relate to these requirements or any associated costs.
- 6.24 Accordingly, the SSRO concludes that the storage costs pricing amendment relates only to the storage of parts provided by supplier C (unspecified in amount) from March to May 2020.²⁴ In the light of this, the SSRO's consideration of whether any amount of the referred costs satisfy the requirements of allowable costs for the purpose of calculating the price payable in respect of the storage costs pricing amendment is set out below.

The requirements of allowable costs

Appropriate

- 6.25 The SSRO is satisfied that the referred storage costs meet the requirement of being 'appropriate' under the amendment to the referred contract, being a type of cost that could reasonably be considered to enable performance of the contract²⁵ and which would withstand public scrutiny.²⁶

Attributable to the contract

- 6.26 The SSRO considers that the intended scope of the storage costs pricing amendment means that only those referred costs which relate to the storage of parts provided by supplier C from March to May 2020 can be considered to enable the performance of the referred contract²⁷ and, thereby, meet the requirement of being 'attributable to the contract' under the amendment. For costs to be attributable to the contract they must also have been (or, in the case of estimated costs, be expected to be) incurred by the contractor.²⁸ The contractor provided the SSRO with internal invoices from supplier A²⁹ to demonstrate that the contractor had incurred the referred storage costs and this was not contested by the MOD.

24 The SSRO noted that the charge the contractor proposed in April 2020 for storage of parts from supplier C from March to May 2020 (a period of 69 days) was the same as the cost estimate for storage by a local haulier of up to a specified number of these parts from April 2020 to August 2020 (a period of 111 days). The number of parts being stored in the period from March to May 2020 was not specified by the contractor. The contractor provided no explanation to the MOD at the time as to why this was an amount that would meet the requirements of allowable costs and the MOD told the SSRO it did not interrogate this.

25 SSRO (2020) *Allowable Costs Guidance, Version 5*, paragraph 3.11a.

26 SSRO (2020) *Allowable Costs Guidance, Version 5*, paragraph 3.11b.

27 SSRO (2020) *Allowable Costs Guidance, Version 5*, paragraph 3.12b.

28 SSRO (2020) *Allowable Costs Guidance, Version 5*, paragraph 3.12a.

29 The invoices provided by the contractor that related to storage covered the period from April 2020 to October 2020. Two of these invoices covered storage in April and May 2020 with a combined total of £[REDACTED]. The material presented did not indicate what amount of this total relates to the storage of parts provided by supplier C.

Reasonable in the circumstances

- 6.27 The SSRO noted that the storage costs pricing amendment was agreed using the firm pricing method which requires the allowable costs to be estimated at the time of agreement, not determined retrospectively. Accordingly, the SSRO considered what estimates had been available to the parties at the time the storage costs pricing amendment was agreed. In April 2020, the contractor proposed to the MOD that the MOD should pay £[REDACTED] for storage of the parts provided by supplier C from March to May 2020 and the MOD accepted this proposal. While neither party made any explicit reference to the requirements of allowable costs in their communications on this amount, the SSRO considers that this was the amount of costs that both parties thought, at that time, was 'reasonable in the circumstances' given the scope of the storage costs pricing amendment. This is supported, in the SSRO's view, by the contractor having identified in April 2020 that the charge supplier A would otherwise have made for storing these parts at its facility³⁰ (£[REDACTED] – based on a charge of £[REDACTED] per space per day) would be 'unacceptable' to the MOD. The SSRO infers from this that either:
- a. supplier A's storage charge was unreasonably high given market rates for similar storage;³¹ or
 - b. that this amount did not demonstrate sufficient regard for economy and efficiency in the use of resources³² for the MOD to pay that amount when there was (apparently) an option to store the parts elsewhere at a lower cost.

- 6.28 Accordingly, the SSRO considers that the amount of the referred storage costs which satisfy the requirement of being 'reasonable in the circumstances' under the amendment to the referred contract is £[REDACTED].

Conclusion

- 6.29 The amount of the referred storage costs which meet the requirements of allowable costs and are allowable for the purpose of determining the price of the storage costs pricing amendment is £[REDACTED] – the amount proposed by the contractor in April 2020 and accepted by the MOD.
- 6.30 The storage costs pricing amendment was agreed using the firm pricing method and the MOD's offer letter in July 2020 made clear that the storage costs pricing amendment was 'in full and final settlement of all associated storage costs' and that the contract amendment 'shall constitute full and final settlement of all contractor claims arising from COVID-19'. Given this, the SSRO considers that 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.

SSRO statutory aims

- 6.31 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

³⁰ The only other estimate provided that related to the identified storage requirement.

³¹ SSRO (2020) *Allowable Costs Guidance, Version 5*, paragraph 3.14a.

³² SSRO (2020) *Allowable Costs Guidance, Version 5*, paragraph 3.13d.

b. persons (other than the Secretary of State) who are parties to QDCs are paid a fair and reasonable price under those contracts.

6.32 These aims are achieved when contracts are priced on the basis of allowable costs and a contract profit rate that has been determined in accordance with the requirements of the Regulations.

6.33 The SSRO considered whether its determination on the referred costs would result in a price for the referred contract that satisfied the statutory aims set out above. It noted the following points.

a. The determination upholds the pricing agreement made between the parties to the referred contract in 2018 and amended in July 2020. The agreement was struck on a firm-priced basis taking account of the information available to the parties about the costs required to deliver the referred 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 QDC 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. The contractor reported incurring higher costs to deliver the referred contract than it had expected when the contract was entered into and earned an outturn profit rate that was 2.1 percentage points lower than the contract profit rate the parties agreed. However, the contractor's 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.

6.34 In the light of these observations the SSRO's conclusion is that the determination on the extent to which the referred costs are allowable costs under the referred contract does support the statutory aims set out in paragraph 6.31.

6.35 The SSRO has also noted in this document 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 referred contract in July 2020.

7. Other observations and wider learning

7.1 This section highlights certain aspects of the case referred which, though not directly relevant to the SSRO's determination, the SSRO considers present opportunities for wider learning about the application of the regulatory framework for QDCs.

Application of the Schedule to the Regulations

7.2 The parties to the referral told the SSRO that they had not considered the requirements of the Schedule to the Regulations when agreeing the July 2020 contract amendment and re-determining the contract price. The SSRO noted, specifically, that the parties did not apply the method prescribed in the Schedule to the Regulations when determining the price of the storage costs pricing amendment which the SSRO considered to be of the type described in paragraph 7 of the Schedule to the Regulations.³³

7.3 Paragraph 7(2) of the Schedule to the Regulations requires that the parties determine a price for the amendment by determining the amount by which the amendment would change the allowable costs previously agreed and applying profit to this using a contract profit rate for the amendment determined in accordance with the six-step process described in section 17(2) of the Act and regulation 11.

7.4 It is the SSRO's view that the amount the contractor proposed the MOD pay in respect of storage of parts provided by supplier C from March to May 2020 (£[REDACTED]) is the amount of costs which met the requirements of allowable costs. No profit was applied to this amount when determining the amount by which the referred contract price would change due to the storage costs pricing amendment.

7.5 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.

7.6 The SSRO does not currently have specific powers to issue guidance for the parties to QDCs on the application of the Schedule to the Regulations when re-determining the price of a QDC, although the SSRO does provide guidance for QDC contractors on how pricing amendments should be reported in statutory reports.³⁴ The Procurement Bill presently before Parliament proposes a new power that would enable the SSRO to issue guidance on the application of the Schedule

³³ The SSRO noted that there were other instances of the parties to the referred contract agreeing changes to the contractual requirements with associated changes being made to the contract price. The SSRO did not examine whether any other pricing amendments to the referred contract were made in accordance with the requirements of the Regulations, either:

a) before 1 April 2019, in accordance with regulation 14; or

b) on or after 1 April 2019, in accordance with the Schedule to the Regulations.

³⁴ See paragraph 9.14 of the SSRO's *Reporting Guidance on Preparation and Submission of Contract Reports* v11.1 Sept 2022 ([link](#)). The SSRO's Amendments Spreadsheet and examples of how this might be completed for different types of pricing amendment can be found at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>.

to the Regulations and the SSRO's investigation of this referral suggests there would be merit in the SSRO doing so, once so empowered.

- 7.7 In the meantime, it would be beneficial for both the MOD and contractors under the regime to ensure 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.

Defining the scope of a pricing amendment under the Schedule to the Regulations

- 7.8 The Schedule to the Regulations:
- a. defines what a pricing amendment is;³⁵
 - b. anticipates a number of different types of pricing amendment with different methods for re-determining the contract price;³⁶
 - c. provides that the parties to a QDC may propose to make two or more pricing amendments at the same time;³⁷ and
 - d. provides that it does not matter if the parties to a QDC also propose to make any other amendment to the contract at the same time as making one or more pricing amendments.³⁸
- 7.9 The SSRO considered whether the July 2020 contract amendment, under which a number of changes were made to the referred contract, including a change to the contract price, should be viewed in its entirety as a pricing amendment under the Schedule to the Regulations (and the contract price be re-determined accordingly) or whether the constituent parts of that contract amendment should be considered separately for the purpose of applying the Regulations on re-determining the contract price.
- 7.10 The SSRO concluded that for the purpose of applying the Schedule to the Regulations the constituent parts of the contract amendment should be considered separately. If the contract amendment were to be viewed in its entirety as a single pricing amendment, paragraph 10 (Other amendments) of the Schedule would apply as none of paragraphs 4 to 9 of the Schedule would be applicable. This would require the price payable under the whole contract to be re-determined in accordance with the pricing formula in regulation 10(1).
- 7.11 Re-determining the price of the whole contract would seem to negate the facility provided in the Schedule to the Regulations for a granular approach to be taken to re-determining the price of a QDC taking into account the specific changes that are being proposed to the contract or a defined component thereof. Not only would this be administratively burdensome for the contracting parties but the SSRO considers this would also be less likely to accord with the intention of the parties to the referred contract or to achieve the statutory 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.

³⁵ Paragraph 1(1).

³⁶ Paragraphs 4 to 10.

³⁷ Paragraph 11(1).

³⁸ Paragraph 11(2).

The requirements of allowable costs

- 7.12 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.³⁹
- 7.13 Section 20(4) 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 and the contractor in a QDC must have regard to the guidance issued by the SSRO about determining whether costs are allowable under QDCs. Having had regard to the SSRO's guidance, contracting parties may deviate from it if there is a clear and proper reason to do so.
- 7.14 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 on amendment in July 2020. While both parties were in agreement in July 2020 as to the amount by which the contract price should be changed in respect of the additional storage costs, it is not entirely clear how the parties were satisfied at that time that:
- a. the costs claimed by the contractor and included in the price of the contract by the amendment met the requirements of allowable costs; or
 - b. the costs claimed by the contractor and excluded from the price of the contract did not meet the requirements of allowable costs; or, consequently,
 - c. the amended price of the contract would achieve good value for money for government and be fair and reasonable for the contractor.
- 7.15 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 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.

³⁹ Section 20(2) of the Act. Together, the requirements of allowable costs.

Risk and uncertainty in allowable costs

- 7.16 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.
- 7.17 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 2019.⁴⁰ 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).
- a. The extent to which any risk contingency element (including a contingency for unknown unknowns) might be included in the allowable costs of a contract will depend on the extent to which the contracting parties are satisfied this meets the requirements of the guidance. This includes matters such as how the risk contingency is quantified and there being a proportionate evidential basis to support its inclusion. The guidance in Part H.2 of Section 5 of the Allowable Costs Guidance indicates matters to which consideration should be given in determining whether the amount of any risk contingency element is reasonable in the circumstances.
 - b. Where the probability of a risk occurring is very low, estimated costs affected by the risk may not be considered reasonable in the circumstances and would not, therefore, be included in the Allowable Costs of the contract. There are a range of ways that the contracting parties may deal with such potential costs, for example, through the purchase of insurance, which might meet the requirements of Allowable Costs, or through the use of a pricing method based on actual Allowable Costs, or other terms and conditions of the contract.
- 7.18 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.

⁴⁰ SSRO (2020) *Allowable Costs Guidance Review 2019: Summary of Consultation Responses*.

The final price adjustment mechanism

- 7.19 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.
- 7.20 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.
- 7.21 The MOD told the SSRO that it did not contest that the referred costs were actual costs incurred by the contractor which met the requirements of allowable costs for the purpose of calculating any final price adjustment for the referred contract. However, in this case, no final price adjustment was due.
- 7.22 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.
- 7.23 The SSRO noted in this case that the contractor notified the MOD of its intention to seek a final price adjustment in June 2021 and that the MOD informed the contractor that no final price adjustment was due in January 2023. It is not clear why it took the MOD so long to conclude on whether a final price adjustment was due and to notify the contractor of its conclusion. The SSRO considers it would be beneficial for the MOD to review its processes for considering cases where a final price adjustment is claimed, or where the MOD considers an adjustment may be due, to ensure that in cases where it appears evident that the Regulations do not provide for a final price adjustment, as in the case of the referred contract, this is communicated to the contractor at the earliest opportunity.

Force majeure

- 7.24 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. For present purposes, the relevant effect (had force majeure been established within the terms of the referred contract) would have been to relieve the contractor of its liability to pay liquidated damages in respect of an ascertained period (capped at three months) for its failure to comply with the delivery schedule under the contract.
- 7.25 Under the referred contract, a force majeure event was defined as one of the following:
- acts of nature;

- war;
- hostilities;
- fire at any of the contractor's premises or those of its suppliers except to the extent that the fire was caused by their own negligence;
- foreign government policy;
- changes in law relevant to the contract performance; or
- national strikes.

- 7.26 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. It repeated this assertion in May 2020 when seeking the MOD's formal position on the impact of COVID-19 on the referred contract. The MOD, in line with the extant guidance from the Cabinet Office,⁴¹ did not accept that COVID-19 or the consequential regulations and guidance were a force majeure event under the contract.⁴²
- 7.27 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 (by up to three months) of the timetable for delivering the contract requirements.
- 7.28 The MOD did not accept that COVID-19 and the introduction of related regulations and guidance was a force majeure event under the contract but did agree to extend the contracted delivery schedule for the contracted work.
- 7.29 While not required by the force majeure clause of the referred contract, had the parties agreed to re-determine the price of the contract in response to COVID-19, the Schedule to the Regulations would have prescribed how the price should be re-determined depending on whether the proposed pricing amendment was:
- a. a change of regulated pricing method used for the contract or a defined component of the contract;
 - b. a change to a defined element of allowable costs under the contract or a defined component of the contract; or
 - c. a change to a contractual requirement of the contract or of a defined component of the contract.
- 7.30 In re-determining the price of a QDC, the parties must be satisfied that the relevant costs – whether they are those associated with the contract, a defined component of the contract, or the pricing amendment – meet the requirements of allowable costs. The contractor must demonstrate to the contracting authority (or the SSRO upon referral) how its claimed costs meet the requirements of allowable costs,

⁴¹ Cabinet Office (2020) *Defence Procurement Policy Note 01/20: Responding to COVID-19*.

⁴² Had the contractor wished to pursue its force majeure claim, there was a mechanism under the contract for dispute resolution (DEFCON 530 (Edn. 12/14) – Dispute Resolution (English Law)). The contractor did not pursue its force majeure claim through this route.

having regard to guidance issued on this by the SSRO. These statutory obligations operate independently of whether there is any contractual mechanism that enables a contractor to claim costs under a QDC.

- 7.31 Where there is any inconsistency between a provision of a QDC and the provisions of the Act and Regulations, the Act and Regulations prevail.⁴³

Applicability of the determination to other contracts

- 7.32 While the contractor's referral was specific to the referred contract and the determination has been made in consideration of the specific circumstances of this case, the SSRO considers its findings will help inform the application of the regulatory framework to other QDCs. In particular, the case has highlighted the need for:
- a. parties entering into QDCs to fully consider how cost risk is to be allocated and reflected in the contract price; and
 - b. the parties to QDCs to have regard to the provisions of the Schedule to the Regulations when they propose to amend a QDC in a way that would affect the contract price.

⁴³ Section 43(5) of the Act.

Appendix 1: The SSRO's Allowable Costs Guidance

AAR principles

- A.1.1 Section 3 of the SSRO's [Allowable Costs Guidance](#) (version 5) sets out the typical characteristics of costs that meet the requirements of allowable costs as follows:

Appropriate

- 3.11 A cost is appropriate if it is of a type and arising from an activity that:
- a. a reasonable person informed of the facts would consider enables the performance of the QDC or QSC in question; and
 - b. would withstand public scrutiny.

Attributable to the contract

- 3.12 A cost is attributable to the contract if it:
- a. is incurred by the contractor;
 - b. enables the performance of the QDC or QSC in question;
 - c. is applied directly or indirectly to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State; and
 - d. has not been and is not anticipated to be recovered, directly or indirectly, from another source, as Allowable Costs must only be recovered once.

Reasonable in the circumstances

- 3.13 A cost is reasonable in the circumstances if it is of an amount that:
- a. a reasonable person informed of the facts would consider consistent with enabling the performance of the QDC or QSC in question;
 - b. would withstand public scrutiny;
 - c. is consistent with costs incurred by the contractor in similar circumstances; and
 - d. demonstrates due regard for economy and efficiency in the use of resources.
- 3.14 Consideration must be given to the circumstances of the case when determining whether costs are reasonable. Circumstances which may influence costs, and which may, therefore, be considered when determining if a cost is reasonable in the circumstances, include, but are not limited to:
- a. the level of competitiveness and/or market testing undertaken in the supply chain;
 - b. the particular specification and performance requirements of the contract;
 - c. the capability necessary to perform the contract;
 - d. uncertainty and risk affecting estimated costs;
 - e. the impact on actual costs of events which were not anticipated at the time of

agreement;

- f. the economic environment;
- g. the statutory provisions in place at the time of contracting; and
- h. any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'.

Appendix 2: Determining the type of the storage costs pricing amendment

- A2.1 The SSRO considered that the inclusion in the referred contract in July 2020 of additional storage costs associated with the storage of parts provided by supplier C was a pricing amendment under the Schedule to the Regulations as the parties agreed that the amendment would increase the price of the contract by £[REDACTED]. The SSRO considered what type of pricing amendment the parties had agreed.
- A2.2 Paragraphs 4 to 10 of the Schedule to the Regulations define different types of pricing amendment (see below) and the method that should be used in each case to re-determine the price of the QDC.

Paragraph	Type of pricing amendment
4	Amendment of the regulated pricing method used for a QDC
5	Amendment of a regulated pricing method used for a defined component of a contract
6	Amendment affecting a defined element of allowable costs
7	Change to a contractual requirement: contract or defined component not using cost-plus method
8	Change to a contractual requirement: contract or defined component which uses cost-plus method – distinguishable costs
9	Change to a contractual requirement: contract or defined component which uses cost-plus method – costs not distinguishable
10	Other amendments – none of paragraphs 4 to 9 applies in relation to the amendment that the parties propose to make to the contract.

- A2.1 The SSRO considered that the amendment was evidently not of the types described in paragraphs 4, 5, 8 and 9 of the Schedule.
- A2.2 The SSRO then considered whether it might be an amendment of the type described in paragraph 6 – Amendment affecting a defined element of allowable costs. The SSRO noted that there was no specific item in the Schedule of Requirements related to storage prior to the July 2020 contract amendment. Some judgement would be required, therefore, to determine which defined element of allowable costs was affected by the amendment. The SSRO considered how the contract price would be re-determined if the defined element of allowable costs that was considered to be amended was the item in the Schedule of Requirements related to the contracted work. Paragraph 6(4) requires that the price payable under the amended contract is the total of:
- a. the original contract price less the adjustment amount; and
 - b. the price payable in respect of the amendment.

- A2.3 The 'adjustment amount' is the amount of the original contract price which can be attributed to the defined element of allowable costs that is being changed. The price payable in respect of the amendment must be determined in accordance with the formula $(CPR \times AC) + AC$, where 'CPR' is the contract profit rate for the amendment and 'AC' means the defined element of allowable costs after it is changed, determined in accordance with the qualifying regulated pricing method used for the contract or defined component.
- A2.1 Accordingly, the SSRO noted that re-determining the price of the contract for this type of pricing amendment would require the entirety of the costs and profit associated with the contracted work ('the adjustment amount') to be deducted from the previously determined contract price and an amended amount of costs plus associated profit (calculated at the time of the amendment and in accordance with the six-step process) ('the price payable in respect of the amendment') to be added to the result. The SSRO considered this approach to re-determining the price of the referred contract was ill-suited to the specific change made to the contract and would not accord with the intentions of the contracting parties.
- A2.2 The SSRO then considered whether it might be an amendment of the type described in paragraph 7 – Change to a contractual requirement: contract or defined component not using cost-plus method. The SSRO concluded that the additional storage was a change to a contractual requirement – in this case a change to the specification of the services procured under the contract or a defined component of the contract – and noted that the contract did not use the cost-plus pricing method. The SSRO also noted that the method for re-determining the price of the contract for this type of pricing amendment would only require the price payable in respect of the amendment to be calculated and added to the contract price previously determined. In this case, the price payable in respect of the amendment would be the allowable costs associated with the additional storage plus the associated profit (calculated at the time of the amendment and in accordance with the six-step process). The SSRO considered this approach to re-determining the price of the referred contract was well-suited to the specific change made to the contract and would accord with the intentions of the contracting parties.
- A2.3 Having determined that this was a pricing amendment of a type described in paragraph 7, it was evidently not a pricing amendment of the type described in paragraph 10 – Other amendments.

Method for re-determining the price of a QDC

- A2.1 Paragraph 7(2) of the Schedule to the Regulations requires that the price payable in respect of an amendment to which paragraph 7 of the Schedule applies must be determined in accordance with the following formula and may be a negative amount:

$$(CPR \times AC) + AC$$

where—

- a. 'CPR' is the contract profit rate for the amendment; and
- b. 'AC' means the amount (which may be a negative amount) by which the amendment will change the original allowable costs.

- A2.1 For the purposes of paragraph 7(2), 'original allowable costs' means the allowable costs under the contract or defined component, as determined for the purposes of calculating the original contract price.
- A2.2 The price payable under the amended contract is the total of—
- a. the original contract price; and
 - b. the price payable in respect of the amendment.