Bird & Bird

The Single Source Contracting Regime: is it about to change?

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On 24 January 2018 the Single Source Regulations Office (SSRO) published its recommendations to the UK Ministry of Defence (MoD) on the changes it thinks are needed to the single source contracting regime. One of the SSRO's roles is to keep the regulatory framework under review and this is the first review since the regime came into force in December 2014.

***Summary of the main recommendations**:*

- Allow the pricing formula to be applied to only a defined component of a contract.

- Where a contract becomes a QDC or QSC on amendment, any committed price should be excluded from the determination of the price payable under the amended contract.

- When pricing contract amendments for existing QDCs/QSCs, the default position should be changed so that if an amendment affects the contract price, the new contract price should be the total of the price payable before the amendment plus the increase or decrease from pricing the amendment.

- Empower the SSRO to request information from contractors and have the ability to issue compliance and penalty notices if contractors do not comply.

- Reduce the threshold for QSCs from £25 million to £10 million.

- Amend the 'international cooperative defence programme' exclusion to exclude any component of a contract made within the framework of an international cooperative defence programme unless the parties agree that that part of the contract may be a QDC or QSC. Currently the whole contract is excluded.

- Delete the 'intelligence activities' exclusion and instead exclude contracts if there is information required in reports for those contracts that would disclose the nature or timing of the procurement and disclosure of that information would cause a risk to national security.

- Mandate that QDC contractors complete a QSC assessment within 30 days, report negative QSC assessments and specify the reasons for a negative assessment.

- Expand the areas on which the SSRO may give an opinion or a determination to include all of the contract profit rate steps and whether a contract is a QDC or QSC.

- Change how the SSRO is funded - from 50% recovery from industry through an adjustment in the contract profit rate, to full cost recovery from industry through a levy.

The first thing to note about the SSRO's recommendation paper is that it is dated June 2017 but it has only just been published. We understand the delay in publication was to allow the MoD to carry out its own review of the framework but we do not known whether that review has been completed.

After two rounds of consultation with the MoD and industry, the SSRO finally recommends 14 changes to the regulatory framework which it says are all designed to improve the functioning of the framework. The framework is still quite new and so its recommendations are focused, they say, on areas where it has sufficient evidence to suggest that a change is needed.

This paper does not look at all 14 recommendations in detail but focuses on the main ones and what these changes may mean for industry. Not surprisingly, the common thread from the majority of the recommendations is a suggestion to extend the reach of the regulatory framework so as to include more contracts within it.

When we refer to the 'Act' in this paper we mean the Defence Reform Act 2014 and the 'Regulations', we mean The Single Source Contract Regulations 2014.

Contract Amendments for a Contract to become a QDC/QSC (Recommendation 1)

A contract that was not a qualifying defence contract (QDC) or qualifying sub-contract (QSC) when it was awarded may subsequently become one when it is amended.

Currently, any single source prime contract entered into before 18 December 2014 and any competed prime contract entered into at any time which is subsequently amended on a non-competitive basis (and in both cases otherwise meets the QDC criteria), is only brought within the regime on amendment if the contracting parties agree that it should become a QDC.

As for sub-contracts, there is no express provision in the Act or the Regulations for dealing with amendments and there is some disagreement between the SSRO and the MoD as to the construction of the legislation on this point. The SSRO believes a QSC assessment should be carried out (i.e. to determine if there is a QSC) if an amendment is made to the sub-contract that is more than immaterial or minor. The MOD's view is that material amendments to sub-contracts do not require assessment, and it advises contractors to this effect.

In the legislation, the question of materiality is not considered in the context of prime contract amendments and the SSRO and MoD have, to date, focused on materiality in the context of subcontracts. It should however follow that whatever logic is applied to a sub-contract amendment in terms of materiality should also apply to prime contracts. The SSRO seems also seems to adopt this view and takes the stance that £5 million should be the materiality threshold for both prime contract and sub-contract amendments because this is reflective of the QDC threshold.

The SSRO's concerns with the current position are mainly twofold: firstly that the application of the controls imposed by the regime is at the discretion of those who would be regulated, and secondly, that the application of the regime may be restricted. There is no obligation on the MoD or industry to report contracts that fall outside the regime.

The MoD's and industry's concern with including all amended contracts within the framework (if they meet the other QDC criteria) is that it might destabilise an already agreed profile of investment, risk and reward under the contract. In addition the MoD does not agree with the SSRO that it is always better for a contract to have QDC status than not, as making a contract a QDC may not always be value for money for the MoD.

Amended contracts are clearly an important point for the SSRO because they affect the breadth of coverage of the regime. The SSRO originally consulted on including a blanket threshold that contract amendments of £5 million or above be treated as if they involve entry into a new contract – the threshold chosen for the reason set out above. Notwithstanding the importance of this point to the SSRO, it does not make any recommendation for change – for now. Instead, it has asked the MoD to investigate the extent to which contracts have been or may be prevented from becoming QDCs or QSCs as a result of the contracting parties having to agree to an amended contract becoming one, and also the impact MoD's interpretation of the Act - that materially amended subcontracts are not subject to QSC assessments – has had or could have. The SSRO recommended that the MoD complete this investigation by December 2017; however this may still be a work in progress.

Throughout all of the above debate however the SSRO was clear that it does not believe that any price already committed under a contract should be regulated when a contract becomes a QDC or QSC following amendment. The extent of its recommendation for now therefore, which is also reflected in Recommendation 9 below, is that:

- the Regulations should provide that the pricing formula may be applied to only a defined component of a contract; and

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

The recommendation made is quite favourable to industry because it means that if the contracting parties do agree that the contract becomes a QDC, the committed price will not be affected. However determining what the 'committed price' is will be complex. This is obviously a carrot for industry to include more extant contracts within the regime and contractors must still pro-actively agree to include a contract within it, but the determination of the committed price will, no doubt, cause some debate. In the next review we may see the recommendations the SSRO really wants to make which will stipulate when a contract amendment would place a contract within the single source framework.

Pricing Amendments of existing QSCs/QDCs (Recommendation 9)

Linked to the first recommendation is one concerning the severability of costs on a contract amendment of an existing QDC or QSC.

Currently, the default position in Regulation 14 requires that on amendment, the entire contract price (including costs and profit already incurred and earned) must be re-determined if the amendment affects the price. However if the costs of the amendment are severable from the pre-amendment costs, then the new contract price is different – it is the total of the price payable before amendment, plus any increase or decrease attributable to the amendment.

This current default position has led to some bizarre results because it requires costs already incurred to be re-assessed as appropriate, attributable and reasonable and a profit already made, to be reassessed and made compliant with the contract profit rate calculation. The Regulations do not also currently provide any guidance on when costs of an amendment may be severable from pre-amendment costs.

The SSRO sees benefit in changing the default position currently set out in Regulation 14 and also sees benefit in introducing guidance on the severability of costs. It therefore recommends that the general requirement/default position becomes that if an amendment affects the contract price, the costs attributable to the amendment should be priced, and then the contract price should be the sum of the price payable before the amendment and the increase or decrease from pricing the amendment. It also recommends that the parties have regard to guidance issued by the SSRO when pricing an amendment.

This recommendation should be a welcome change because it reflects the most commercially sensible position and guidance on severability will be useful. It does not however address the more fundamental question of when Regulation 14 applies in the first place. For example, are QDCs/QSCs operating on a limit of liability/maximum spend basis, or those which contain pricing adjustment mechanisms, 'amended' for the purposes of Regulation 14 when the limit of liability/maximum spend is increased or the price is adjusted in accordance with the pre-agreed adjustment mechanism? What also of framework agreements which extend the activities under the contract through task approval forms (or similar)? Are these amendments which would 'affect the price determined under Regulation 10' and thus need repricing, or not? These questions have unfortunately not been addressed and will remain a grey area for now.

Access to Information (Recommendation 6)

One of the SSRO's biggest concerns is that it has no power to request information from contractors in addition to that provided in standard reports - and this is a stark difference between the SSRO and other regulators. It therefore recommends that it be empowered to ask defence contractors for information on the following basis:

- the SSRO may request information (or an explanation) that it considers reasonably necessary for carrying out its functions under the Act. Requests could be made to primary contractors in respect of QDCs, either party to a QSC, or an ultimate parent undertaking;

- the SSRO must publish a statement of policy on how it will exercise its functions on this point and an annual account of how it has exercised its functions;

- the SSRO will be empowered to issue compliance and penalty notices in circumstances in which there was a failure to comply with a notice for more information;

- Schedule 5 will apply to the information provided i.e. the restrictions on disclosing information, including the criminal offence penalty will apply; and

- an independent panel should be established by the SSRO to determine issues raised in respect of compliance and penalty notices issued by the SSRO.

This recommendation will probably be of the most concerning for contractors. Even though the SSRO shouldn't request information it doesn't need, what the SSRO thinks it needs will be out of the control of contractors who will have a legislative obligation to comply. The ability of the SSRO to issue compliance and penalty notices is likely to also cause concern. In its annual reports, the SSRO highlights the occasions on which it has notified the MoD of non-compliance issues and also reports that in many cases the MoD has not issued any consequent compliance or penalty notices. We suspect the SSRO will not be so resistant in issuing them.

It will be very interesting to see whether the MoD does adopt this recommendation because it has some sympathy with industry on the point but the SSRO is noticeably different as a regulator by not having this information-gathering power.

Lowering the QSC Threshold (Recommendation 3)

The SSRO believes that the regulatory framework is more likely to achieve value for money for government and fair and reasonable prices for contractors if single source sub-contracts of significant value become QSCs. It is therefore recommending that the current threshold for QSCs of £25 million be reduced to £10 million. It believes lowering the threshold will bring the QSC threshold into closer alignment with the QDC threshold, extend the regime to a larger proportion of QDCs and ensure that contracts of significant value are subject to an appropriate level of scrutiny and control. The MoD was not averse in principle to lowering the QSC threshold but felt there was not enough data to support changing the legislation. Notwithstanding that position, the SSRO has made this recommendation.

It is perhaps not surprising that the SSRO are suggesting this change because the gulf between the current QDC and QSC thresholds have never been fully understood. Again, the consequence of this change would be an increase in the number of contracts within the regime.

Excluded Contracts (Recommendation 4)

The Act excludes certain categories of contracts from being QDCs or QSCs. These currently are contracts to which the government of another country is a party (QDC only), contracts made within the framework of an international cooperative defence programme, contracts wholly for the acquisition of land, or the management or maintenance of land or buildings, and contracts wholly for the purposes of intelligence activities.

Since the regime came into force, the SSRO has received questions on the application of these exclusions and is concerned that they are open to different interpretations. The SSRO therefore recommends:

- that the international cooperative defence programme exclusion is amended so as to exclude from the regime any component of a contract made within the framework of an international cooperative defence programme unless the parties agree that that part of the contract may be a QDC or QSC. The current

position is that the whole contract would be excluded. It also suggests that the remaining parts of the contract may be a QDC or QSC if they meet the relevant requirements; and

- to delete the intelligence activities exclusion and instead exclude contracts if there is information required in reports that would disclose the nature or timing of the procurement and disclosure of the nature or timing of that procurement would cause a risk to national security.

The SSRO also wants to work with the MOD and industry to publish guidance on the application of the international cooperative defence programme exclusion.

The SSRO originally proposed to include government to government contracts within the regime but has not made a recommendation on this; instead it proposes to keep the issue of government to government contracts under review and recommends that the MoD is (more) transparent with the use of exclusions.

Guidance on the international cooperative defence programme exclusion will be welcome. However the objective of these recommendations, again, is to include more contracts within the regulatory net but it is not clear how much of an impact these changes will have.

Transparency of the supply chain (Recommendation 5)

The SSRO believes that there are issues with the transparency of the supply chain for QDCs - the lack of a deadline for carrying out QSC assessments, incomplete reporting of QSC assessments, lack of clarity on the reasons for negative QSC assessments, and limited information about sub-contracts.

The SSRO therefore recommends the following amendments to provide greater transparency:

- a QSC assessment must be completed within 30 days of the date the sub-contract was entered into or from the date of amendment that triggered the QSC assessment. Currently there is no deadline;

- the outcome of a QSC assessment must be reported to the Secretary of State and the SSRO within 30 days. Currently only positive assessments must be notified;

- adding a requirement to specify the reasons for any negative QSC assessment if the value of the sub-contract assessed meets the QSC threshold; and

- add requirements to specify for each sub-contract valued at £1 million or more whether it was the result of a competitive process and for each sub-contract valued at £5 million or more, whether it combines obligations for the purpose of enabling performance of contracts other than QDCs and QSCs.

The SSRO is concerned it does not have enough information and these recommendations address this concern. For industry, it means the reporting requirements will change, probably just as they are becoming familiar, and more information on sub-contracts will need to be provided.

Grounds for making a referral to the SSRO (Recommendation 7)

The Act and Regulations specify the circumstances in which referrals may be made to the SSRO. These range across the regulatory framework but do not cover all areas. The SSRO therefore recommends that two additional areas be added on which it may give an opinion or a determination:

- *any of the contract profit rate steps*: the SSRO should be requested to provide an opinion on, or determination of, the appropriate rate or adjustment at any of the contract profit rate steps. Currently it is limited to Steps 2, 3 and 6 and only an opinion may be sought on Steps 1, 4 and 5 if both parties agree to seek an opinion. Extending this to all steps the SSRO believes will be beneficial, especially if the parties do not agree to seek an opinion; and

- *whether a contract is a QDC or QSC*: a contracting party or the MoD could ask for an opinion on whether a contract meets the requirements for being a QDC or a QSC. The SSRO also recommends that it should

give guidance on the application of the requirements for a contract or proposed contract to be a QDC or QSC.

These changes are largely welcome as it has always seemed arbitrary why some of the contract profit rate steps were excluded, and referrals to the SSRO can provide clarity. This recommendation will not impact the day-to-day operation of the regime like some of the recommendations but may be helpful during contract negotiations and contractors will need to factor these changes, assuming they are adopted, into their general contract negotiation and management strategies.

Refining the QSC Definition (Recommendation 2)

This recommendation is quite minor but made by the SSRO because it should be an easy win. It is to clarify that a sub-contract may still be a QSC if it is entered into before the primary contract to which it relates. The argument has been run by a contractor that if a QDC technically did not exist at the time the sub-contract was entered into, the sub-contract could not be 'for the purposes of' a QDC and could not therefore be deemed a QSC.

In the spirit of wanting the regime to be as broad as possible, the SSRO is making this recommendation to place the position beyond doubt. For industry this change would mean that, provided the other QSC requirements are satisfied, sub-contracts entered into prior to a QDC being signed will now definitely be caught by the regime. If it is a sub-contract being amended the question will be whether the amendment is material (which we discuss above).

The SSRO has also recommended that it be empowered to issue guidance in relation to QSC assessments. This guidance would, no doubt, ensure as broad an application of the regime as possible.

SSRO funding adjustment (Recommendation 8)

Currently the SSRO is funded by the MoD, but from 2017/18, 50% of the SSRO's costs should be recovered from industry through the adjustment in the contract profit rate formula, meaning a reduction in the price payable on QDCs.

The SSRO sees a potential conflict of interest in the MoD exercising oversight as sponsor body for the SSRO whilst being subject to the regime. It therefore recommends a move to full cost recovery from industry through the introduction of a levy. The levy would be assessed in bands and consulted upon and the amount per band would depend on the extent to which a fixed proportion of costs are recovered from all contractors. The SSRO believes this levy would provide a more sustainable funding mechanism in line with other regulators who recover costs from industry and would positively impact on the SSRO's independence.

Introducing this recommendation would obviously mean more cost for industry at a time when the profit rate is still decreasing. Even if the decline in profit rate does abate next year as expected, this change will still not be welcome news because it will affect contractors' bottom lines. When the consultation on the levy begins it will be interesting to see what kind of numbers the SSRO has in mind and what impact this will have.

Other recommendations

There were a number of other more minor recommendations made which include:

- The regulatory framework uses the term 'contract price' in addition to 'contract value'. The Regulations should be amended to reflect the MoD's preferred approach of using 'value' for threshold purposes and 'value' or 'price' for reporting purposes.

- specifying that where only a defined component of a contract has been determined by the firm, fixed or volume-driven pricing methods, any final price adjustment calculation should only be applied to that component, not the whole contract.

Further work to be done

During the consultations the SSRO received other suggested changes from stakeholders which the SSRO is willing to consider but on which it requires further evidence and analysis. These areas are:

- permitting the contract profit rate to be determined for defined components of a QDC or QSC which are priced according to different regulated pricing methods;
- expanding the range of the cost risk adjustment (Step 2 of the contract profit rate six-step process) which currently provides for an adjustment of up to ± 25 per cent to the baseline profit rate;
- increasing the limit of the incentive adjustment (Step 5 of the six-step process) which currently only provides for an additional 2% to the profit rate; and
- permitting disapplication of the price formula and pricing by alternative means (such as the application of an external benchmark) in some cases.

Contractors may be disappointed that there are no recommendations to change the ± 25 per cent cost risk adjustment or the 2% incentive adjustment. The SSRO has not ruled changes out and once it has further evidence on these points it will consider whether to recommend any further changes.

What next?

The SSRO recommendations will not necessarily or automatically make their way into the regime. It is the SSRO's role to submit recommendations to the MoD for them to be considered as part of the Secretary of State's own review which was due to be completed in December 2017.

We know the MoD does not agree with all of the recommendations made by the SSRO and it will be interesting to see which ones make their way through. The SSRO clearly believes there are barriers to it being a proper regulator and there is some reluctance in allowing it to play a greater role. What is clear though is that the single source regulatory framework is here to stay and this first review is just the beginning of potential changes in the SSRO's role.

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