



SSRO

Single Source
Regulations Office

Assuring value, building confidence

Single Source Regulations Office
Annual Compliance Report 2015

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1. Introduction and purpose

“We’ve now set up the Single Source Regulations Office as an independent regulator to implement the legal framework that came into force in December 2014 to ensure that our contracts do deliver value for money” **Secretary of State for Defence, February 2015**

1.1 The Single Source Regulations Office (SSRO) is pleased to publish its first Compliance Report. The report encompasses the SSRO’s work over the past year to assess compliance by the Ministry of Defence (MOD) and single source suppliers to the provisions of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations). This work is carried out under the Act, Regulations and the Framework Document agreed between the Ministry of Defence and the SSRO.

1.2 The Act states that “The SSRO must keep under review the extent to which persons subject to requirements under Section 24 or 25 (reports) are complying with them” (Section 36(2)).

“The SSRO will publish a report on an annual basis that summarises compliance by the MOD and single suppliers to the provisions of the DRA and SSPRs. This report will be publically available” **Framework Document for the SSRO, November 2014**

1.3 The annual Compliance Report is intended to be an effective tool to monitor and encourage compliance with the Act and the Regulations that make up the Single Source Procurement Framework (the Framework). It is central to the SSRO’s aspiration for a transparent and accessible regulatory framework, and is written in the context of the SSRO’s two statutory aims. These are to ensure that good value for money is obtained for the UK taxpayer in expenditure on qualifying defence contracts, and that single source suppliers are paid a fair and reasonable price under those contracts.

1.4 The SSRO developed its [compliance monitoring and rating methodology](#) in the summer of 2015, and published its final version of the methodology on 5 October after a six-week public consultation. Compliance assessments have been taking place since its inception in preparation for the publication of the first Compliance Report.



- 1.5 Following views expressed during the public consultation on the SRRO's compliance monitoring and rating methodology, the SSRO Board agreed that the first Compliance Report should only be published in the full format (with Red-Amber-Green compliance ratings for each QDC, defence contractor and the MOD) if enough data was received to ensure the results were sufficiently representative.
- 1.6 Given the low volume of QDCs and the small number of QDC reports received and analysed during the first compliance monitoring period, the SSRO has decided that its first Compliance Report will be a narrative report, focusing on compliance trends and themes. It does not include ratings, as publishing individual compliance scores for 2015 could create a disproportionate focus on early QDCs. This is discussed in greater detail in Section 5.
- 1.7 This report sets out:
- the SSRO's observations from compliance assessments conducted during the first compliance period;
 - wider observations on how the Framework has been functioning, to improve stakeholder understanding and ultimately lead to better compliance; and
 - an overview of the referral to the SSRO for an Opinion in September 2015, to highlight any lessons of relevance for future QDCs and parties to those QDCs.
- 1.8 The SSRO recognises that 2015 was the first year of operation of the Framework, and has consequently devoted resources towards assisting and working with defence contractors and the MOD to facilitate compliance.
- 1.9 Wherever possible the SSRO has worked with contractors so that they become compliant with the Framework. The SSRO intends for the first Compliance Report and all further reports to encourage compliance and provide insight into how the Framework is working.

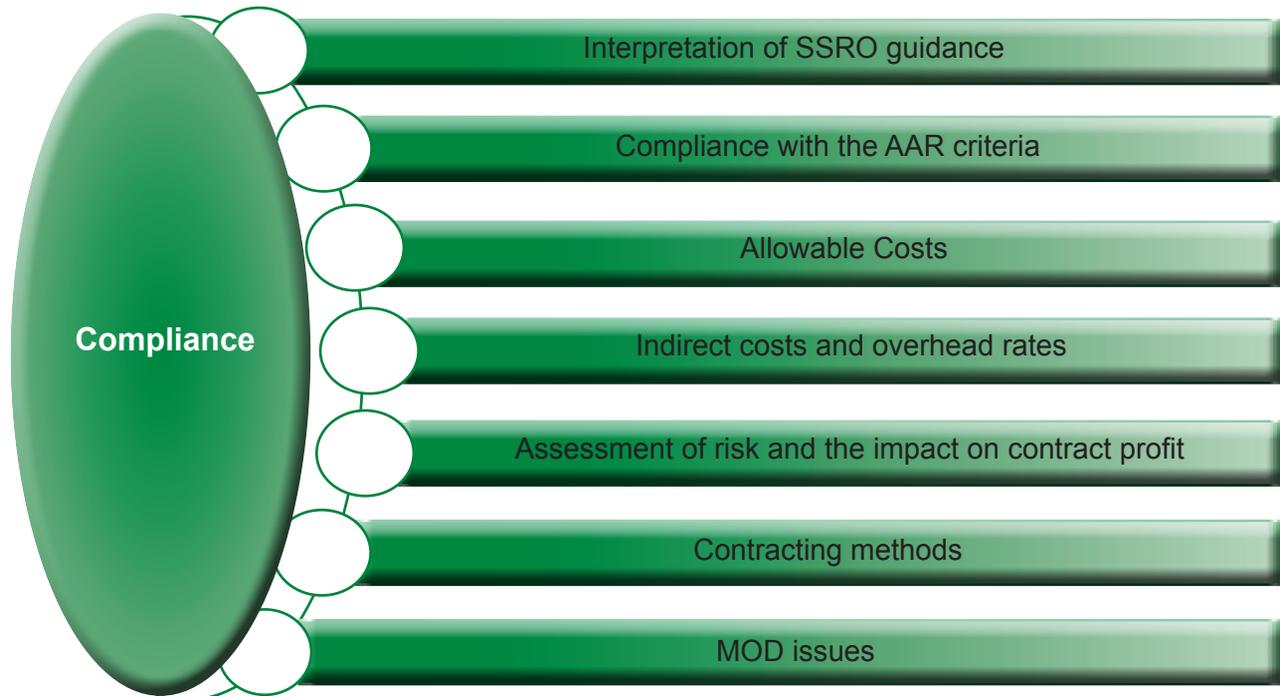
“The level of non-competitive contracts awarded by the UK MOD has exceeded 50 per cent over recent years. The UK government does have various measures in place to mitigate the risk posed by the high proportion of single sourcing, most notably the Single Source Regulations Office, which serves as an independent statutory regulator of single source procurement regime in defence”

Transparency International

2. Key findings

- 2.1 This report covers the SSRO's first compliance monitoring period from 18 December 2014 to 31 December 2015. The SSRO makes the following general observations about the compliance monitoring period:
- The quantity of QDCs has been significantly lower than the SSRO had expected in the first compliance monitoring period.
 - Defence contractors have largely met the submission date requirements for QDC reports.
 - Defence contractors have in some cases not provided the SSRO with adequate facts, information, descriptions or their assumptions that support the inclusion of costs or the calculation of the contract profit rate.
 - Defence contractors and the MOD have been willing to remove non-Allowable Costs identified by the SSRO.
 - Disagreements over the level of detail required to support and justify the inclusion of costs and the contract profit rate have often made it more challenging for the SSRO to assess compliance.
 - The SSRO has seen evidence of differing levels of understanding of the Regulations and the SSRO's guidance among contractors and MOD staff. The SSRO recognises that the Framework remains new, and will consequently continue to devote resources towards assisting and working with contractors to facilitate compliance, and will update its guidance to provide greater clarity when appropriate.
- Early and continued contact between a contractor and the SSRO leads to better quality QDC reports on time, first time. Again, we stand ready to engage with contractors to ensure a positive outcome.
 - Instances of deviation from the SSRO's statutory guidance have not always been notified to the SSRO or justified in the Contract Pricing Statement.
 - An improvement in the accuracy of report notification and a reduction in the use of provisional rates is needed for the SSRO to be able to place full reliance upon the data it receives in QDC reports.
 - The MOD's notification of QDCs to the SSRO has been predominantly accurate.
 - The MOD has not always notified the SSRO within five working days of QDC signature or award, although this improved towards the end of 2015.
 - The MOD has not always notified the SSRO of report verification.

This chart illustrates the range of issues or themes we have identified in relation to compliance with the Act and the Regulations.



- There has been evidence of misinterpretation of SSRO guidance. As a result, we endeavour to increase knowledge and understanding among contractors through the SSRO Operational Working Group; the SSRO reporting helpdesk; SSRO Answers; Q&A sessions with contractors' project and finance teams; and the publication of the anonymised summary of one referral for an opinion.

2.2 The framework is beginning to deliver savings, and there is potential for more:

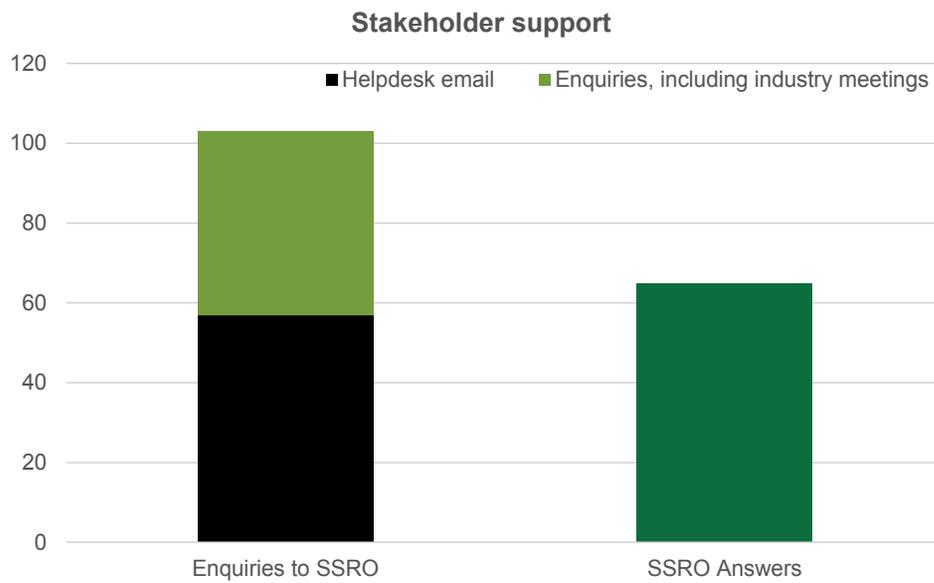
- In our first year of operation the SSRO has identified through the compliance process potential savings in QDCs of: circa £100,000 of agreed savings; in excess of £20 million identified potential savings; and £5.7 million of savings currently under investigation on the first six QDCs.

- The existence of the regime itself has created savings, by providing more opportunities for the MOD to act as an intelligent customer and seek efficiencies.
- Over the last nine years the average proportion of MOD spend on single source procurement was around 49 per cent¹. If this proportion were to continue, roughly £87 billion would be spent on single source procurement by the MOD over the life of the Equipment Plan (2015-2025). Taking the average MOD spend on single source procurement over the last three years alone (around 56 per cent), the MOD spend on single source procurement could be as high as £100 billion. This level of spend underlines the importance of an effective Framework for MOD single source procurement.

¹Average calculated from data of value of non-competitively awarded contracts as published online in the MOD Trade Industry contracts bulletin. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/378998/20141105-DSB_Trade_Industry_Contracts_13_Nov_2014-FINAL-O.pdf and https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/477128/20150824-NS_Bulletin_Working_-_FINAL.pdf

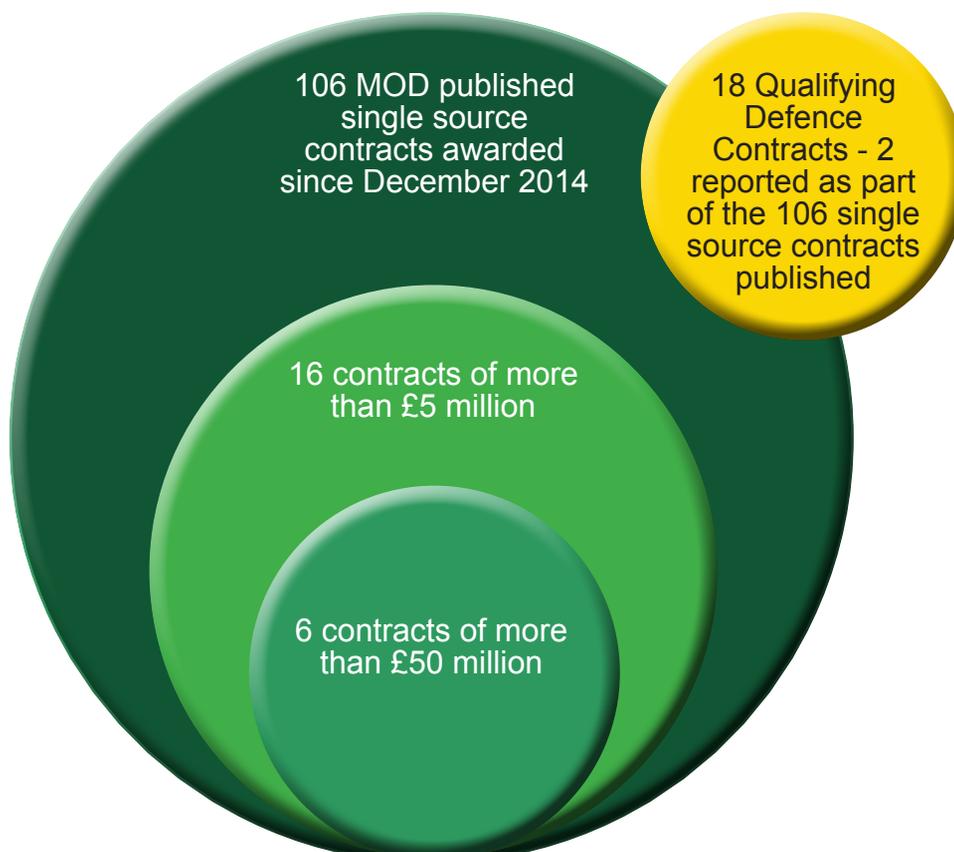
“The SSRO has demonstrated the expertise and independence to balance the need to secure value for money for the taxpayer, with a fair return to those companies delivering important defence equipment and services” **Paul Everitt, ADS, September 2015**

Stakeholder queries and published SSRO Answers



3. Facts and figures

- 3.1 The Defence Reform Act 2014 states: “a contract is a “qualifying defence contract” if:
- it is a contract under which the Secretary of State procures goods, works or services for defence purposes from another person (a “primary contractor”),
 - the value of the contract is of or above the amount specified in single source contract regulations,
 - the contract does not fall within a description specified in the single source contract regulations, and
 - subsection (3), (4) or (5) applies to the contract.”
- 3.2 The SSRO has received notification of 17 QDCs and 1 Qualifying Subcontract (QSC) signed with 10 different defence contractors during the first compliance monitoring period. A significant number of these QDCs were signed in the final two months of the period and as a result QDC reports have only been received for 12 QDCs from 8 contractors.



- 3.3 As at 9 December 2015, the Defence Contracts Bulletin had published details of 106 MOD single source contracts awarded since December 2014². Of these, 16 contracts were worth in excess of £5 million and therefore potentially within scope for being a QDC although they may include amendments or extended contracts which would require the agreement of the both parties to be a QDC.
- 3.4 Only two of the QDCs reported to the SSRO are included in the Defence Contracts Bulletin.
- 3.5 The Secretary of State for Defence is permitted under the Act to exempt a contract from being a QDC. The Act states that: "The Secretary of State may direct that a particular contract to which subsection (3) applies is not a qualifying defence contract even though the contract otherwise meets the requirements of subsection (2)."
- 3.6 The SSRO is aware of only two contracts that have been exempted by the Secretary of State during the compliance monitoring period.

"We also recognised that we needed to reset the relationship with industry, particularly around the large single source projects and for that reason we used the 2014 Defence Reform Act to reform single source procurement. This established a statutory governance framework to ensure that costs are fair to us and to our suppliers. We also set up the Single Source Regulations Office as an independent review body: operational now for 12 months. No longer will suppliers have carte blanche to set the terms of the trade and this will, we believe, help to ease concerns about defence inflation by imposing a much greater spotlight on transparency on the individual single source contracts, bills and invoices they submit." **Minister for Defence Procurement, Philip Dunne MP, 13 January 2016, Westminster Hall debate**

² Defence Contracts Bulletins Volume 13, Numbers 03 – 24, published 18/02/2015 to 09/12/2015.

4. Compliance observations

4.1 The SSRO has received and analysed a relatively small number of QDCs during the compliance monitoring period. However there are a number of key themes that we have identified:

- a low volume of QDCs;
- interpretation of the SSRO guidance: Single Source Costs Standards and Contract Profit Rate;
- QSCs and the supply chain; and
- MOD compliance.

Low volume of QDCs

4.2 The SSRO has noted the low volume of QDCs that have been entered into by the MOD. Whilst this issue does not strictly form part of the SSRO's compliance assessment we believe it is an issue of sufficient importance to warrant inclusion as part of our observations. During the compliance monitoring period, existing contracts have been amended and extended and therefore do not benefit from being within the scope of the Framework. This limits the SSRO's ability to assess compliance with the Regulations and can adversely affect the effectiveness of the regime.

4.3 The SSRO is not proactively notified by the MOD of non-QDC single source procurement although this is required by Annex B of the Framework Document³. The SSRO relies instead on the information published in the Defence Contracts Bulletin. Based on this and the SSRO's Register of QDCs, we estimate that the MOD awarded at least 106 single source contracts since December 2014 and either notified them to the SSRO as a QDC or published them in the Defence Contracts Bulletin as a single source contract that was not a QDC. Many of the contracts awarded were below the £5 million threshold to be a QDC.

4.4 Ensuring contracts are QDCs would bring the benefits of the SSRO's Single Source Costs Standards, and potentially generate savings through the identification and removal of non-Allowable Costs. It would also ensure that these contracts are subject to the greater open book reporting requirements and scrutiny that is at the heart of the Framework.

³ "The SSRO will be informed of new QDCs and QSCs by the MOD and through the receipt of reports such as the Contract Notification Report. The SSRO will also receive procurement data from the MOD on the single source contracts that have been signed."



Interpretation of SSRO guidance

- 4.5 Since its establishment, the SSRO has issued statutory guidance on [Allowable Costs](#) (the Single Source Cost Standards), the [contract profit rate](#), and [determining an amount for penalty notices](#). The SSRO held a public consultation for each draft statutory guidance document. A response document was published for each consultation, setting out the SSRO’s views on issues raised by stakeholders and outlining the amendments incorporated into the final published versions of the statutory guidance.
- 4.6 The Act states that the MOD and contractors party to a QDC “must have regard to any relevant guidance issued by the SSRO” when preparing reports (Regulation 22(9)).
- 4.7 Regulation 23(2)(c) requires the Contract Pricing Statement to “describe any known deviation” from the statutory guidance on the contract profit rate. Compliance with this regulation enables the SSRO to assess whether a deviation from the guidance is appropriate.

Allowable Costs

- 4.8 The SSRO developed the principles based guidance document entitled Single Source Cost Standards: Statutory Guidance on Allowable Costs, which was published on 26 January 2015 following public consultation. It is a legal requirement to have regard to this document when determining whether costs are Allowable.



- 4.9 The Single Source Cost Standards state that for a cost to be Allowable it must be Appropriate, Attributable to the contract and Reasonable in the circumstances (AAR).

- 4.10 The guidance states that “Section 20(4) of the Act places the onus upon the primary contractor of a QDC to demonstrate to the Secretary of State (if required) that costs meet those requirements set out in the guidance. The burden of proof rests with the contractor and it is essential that the MOD operates as an intelligent customer and has the ability to verify, challenge and agree the costings that are submitted as being Allowable”.
- 4.11 It is essential that defence contractors engaged in negotiating, signing and fulfilling QDCs with the MOD are able to clearly demonstrate, using supporting calculations and evidence, that costs comply with the AAR criteria. It is equally important that the MOD undertakes a sufficient level of scrutiny of the calculations and evidence provided by contractors.
- 4.12 The SSRO assesses compliance with the statutory guidance by scrutinising QDC reports and the supporting documents and calculations required under the Regulations. The SSRO assesses whether QDC costs are Allowable and identifies costs that it believes may not be Allowable.
- 4.14 Analysis undertaken of the first QDC reports has shown that:
- the SSRO has not been able to gain assurance that costs included in all QDC reports are compliant with the Single Source Cost Standards as the contractor has provided insufficient information;
 - for one of the QDCs, the SSRO is awaiting confirmation that identified non-Allowable Costs that the contractor has agreed to remove have now been removed, and the further investigation of potential non-Allowable Costs by the MOD before it can conclude that the contract is compliant with the Single Source Costs Standards guidance; and
 - contractors need to better demonstrate to the SSRO that they have considered the Single Source Cost Standards guidance and provide evidence to show that costs meet the AAR criteria by providing the information required by the Regulations.

“The SSRO will be able to... name and shame in its report if companies don't play fair”
**Secretary of State for Defence,
 Michael Fallon MP, 26 February
 2015**

“An element of corporate overheads flows into our contracts, and one of the ideas of the SSRO, on which they are very focused, is: how much of the corporate overheads of all organisations are we paying for, and is that an appropriate cost? I am expecting that, over time, the SSRO will begin to knock out, as it were, disallowable costs. The additional transparency of the legislation is to the benefit of the taxpayer.” **Permanent Secretary of the MOD Jon Thompson, Public Accounts Committee hearing, 14 October 2015**

- 4.13 To date, defence contractors have frequently provided insufficient supporting data and explanation to describe the “facts, assumptions and calculations relevant to each element of the allowable costs” as required by Section 23(2) of the Regulations. Consequently, the SSRO has been unable to gain sufficient assurance that the Single Source Cost Standards guidance has always been complied with.

4.15 To date the SSRO has identified a range of costs that are not Allowable that have been included in QDCs. Examples of such costs are included in the following paragraphs.

4.16 **Compliance with the Defence Reform Act 2014.** The SSRO has identified more than one QDC for which QDC reports detail the General and Administrative rate costs as having increased from prior year (2014) rates. Upon further enquiry, the SSRO learned that the contractor in question justified this increase by claiming that there were additional costs incurred in ensuring that the contract complied with the Act. The SSRO has questioned the reasonableness of these costs.

4.17 **Increasing direct labour rates.** The direct labour rates for one QDC notified to the SSRO have been calculated by applying labour rates to estimated hours across the life of the contract. The labour rate used for this particular contract is based on a base rate for 2015 plus an annual uplift of 3 per cent. While this may be compliant with the SSRO’s guidance, the contractor has provided neither the assumptions nor the calculations used to determine the base rate nor the forecast growth rate, leaving the SSRO unable to reach a view on whether the labour costs meet the AAR criteria.

4.18 **Faulty workmanship.** The SSRO has found that in certain instances contractors have not put in place the measures needed to accurately record the causes of rework. In the absence of such measures the SSRO cannot be assured that rework undertaken as part of a QDC is Allowable. The SSRO would expect defence contractors to ensure they have systems and processes in place to accurately record the causes of rework.

4.19 The cost of rework will only be Allowable if it meets the principle of being Appropriate, Attributable and Reasonable and is agreed between the contractor and the MOD, who must have regard to the Single Source Cost Standards. Examples of rework that is Allowable include:

- First in Class – rework that occurs during the process of manufacturing an item for the first time would generally be considered Allowable.
- Re-specification - rework that occurs due to a change in design specification from the MOD would generally be considered Allowable.

“There are still improvements to be made in the ways that Defence procures and supports equipment, which the Defence Equipment and Support transformation programme and the establishment of the Single Source Regulations Office are seeking to address” **Minister of State for Defence Procurement, Written Ministerial Statement for the MOD Equipment Plan, 22 October 2015**

4.20 Rework due to faulty workmanship or the consequences that result from faulty workmanship are generally not Allowable. Similarly, rework that is a result of a contractor not delivering a specification would generally not be Allowable.

4.21 **Contingency.** Where a contingency arises, and as a result a contractor incurs an expense, the expense may be an Allowable Cost if it follows the Single Source Cost Standards and meets the AAR criteria.

4.22 Contingency costs can be included within a contract price, but cannot be an Allowable Cost in non-firm/fixed price contracts if the contingency has not arisen and therefore the contractor has not incurred the expense. For a cost to be Attributable the contractor must have incurred an expense in the delivery of the QDC.

4.23 **Sales and marketing costs.** The Single Source Cost Standards states that marketing costs can only be considered Allowable if they are “demonstrably linked to a qualifying defence contract” (10.14). Additionally, marketing costs must be incurred in the delivery and conduct of the QDC in question for the costs to be Appropriate and Attributable (9.2 and 9.3).

4.24 We would not normally regard as Allowable marketing costs incurred on export campaigns in anticipation of potential future sales of the same product or services being delivered to the MOD under a QDC. We would however expect the MOD to be interested in securing some of the benefits of future sales to other customers for the UK taxpayer. This can be achieved through contract terms that provide for rebates to MOD contingent upon future sales. It is not a requirement of such arrangements that marketing costs should be paid for upfront by MOD.

QMAC and Allowable Costs

4.25 The SSRO has had to explain to a number of contractors during the compliance monitoring period that the inclusion of costs in a Questionnaire: Method of Allocation of Costs (QMAC) does not automatically make them Allowable. Although the QMAC is completed by the contractor and describes how they will allocate and apportion costs, this does not mean that costs included in the QMAC are automatically Allowable. As is the case for all contract costs, indirect costs included in the QMAC will only be Allowable if they meet the AAR principles and are agreed between the MOD and the contractor.

Indirect and overhead rates

4.26 Indirect and overhead costs are defined as those costs which, though necessarily having been incurred during the performance of the QDC for the conduct of the contractor’s business in general, are apportioned over a number of contracts, products or services. The costs must still satisfy the AAR criteria to be Allowable.

4.27 These costs may include items such as electricity used to operate the equipment, depreciation on factory equipment, rent and property taxes.

4.28 The attribution of costs between indirect and direct recovery must be agreed between the MOD and individual contractors.

4.29 The SSRO has noted that, in many circumstances, there has been difficulty in gaining assurance that indirect costs are Allowable, due to delays in the MOD and contractors agreeing overhead rates.

4.30 In supporting documentation for some QDCs, evidence presented to the SSRO demonstrates that overheads are often recovered by reference to the direct labour incurred on the contract. For some contracts there is no evidence of the split between the direct labour rate and the indirect (for example overhead) rate; no evidence provided of an analysis of overheads; or evidence of the calculation of overhead recovery rates. This is not sufficient and has led to the SSRO having to seek clarification from the contractor. In the absence of evidence that costs meet the AAR criteria the SSRO will regard the QDC as non-compliant with the Framework.

- 4.31 Indirect costs and overhead rates, whether agreed or still estimated at the time that QDC reports are due to be submitted, must be shared with the SSRO as part of the Contract Notification Report.
- 4.32 In 2016 the SSRO will be receiving the first supplier reports, which include Actual Rates Claim Report (Regulation 34), QBU Actual Costs Analysis Report (Regulation 35), Estimated Rates Claim Report (Regulation 36), QBU Estimated Costs Analysis Report (Regulation 37), Estimated Rates Agreement Pricing Statement (Regulation 38) and the Rates Comparison Report (Regulation 39).

Contract profit rate

- 4.33 Section 17(2) of the Act and Regulation 11 sets out the steps for determining the contract profit rate for QDCs. Such steps provide for adjustments to be made based on the rate and funding adjustments described in Section 19(1) of the Act.



- 4.34 The SSRO scrutinises the figures and calculations used to determine the contract profit rate for pricing QDCs. It also assesses, through the QDC reports submitted by contractors, whether a contract complies with the SSRO's contract profit rate guidance.
- 4.35 The SSRO has been unable to properly assess compliance for some QDCs due to the limited data that it has received or because the calculations provided have been insufficiently clear. Capital servicing and risk adjustments in particular have not been well evidenced in a number of cases. The SSRO

has requested additional evidence and documentation to substantiate a QDC's contract profit rate calculation where necessary.

- 4.36 A particular area of concern is the application of the risk adjustment to the contract profit rate and this is discussed below.

Assessment of risk and the adjustment to the baseline profit rate

- 4.37 Section 17(2) of the Act, and Regulation 11(3), set out the requirement for the cost risk adjustment:

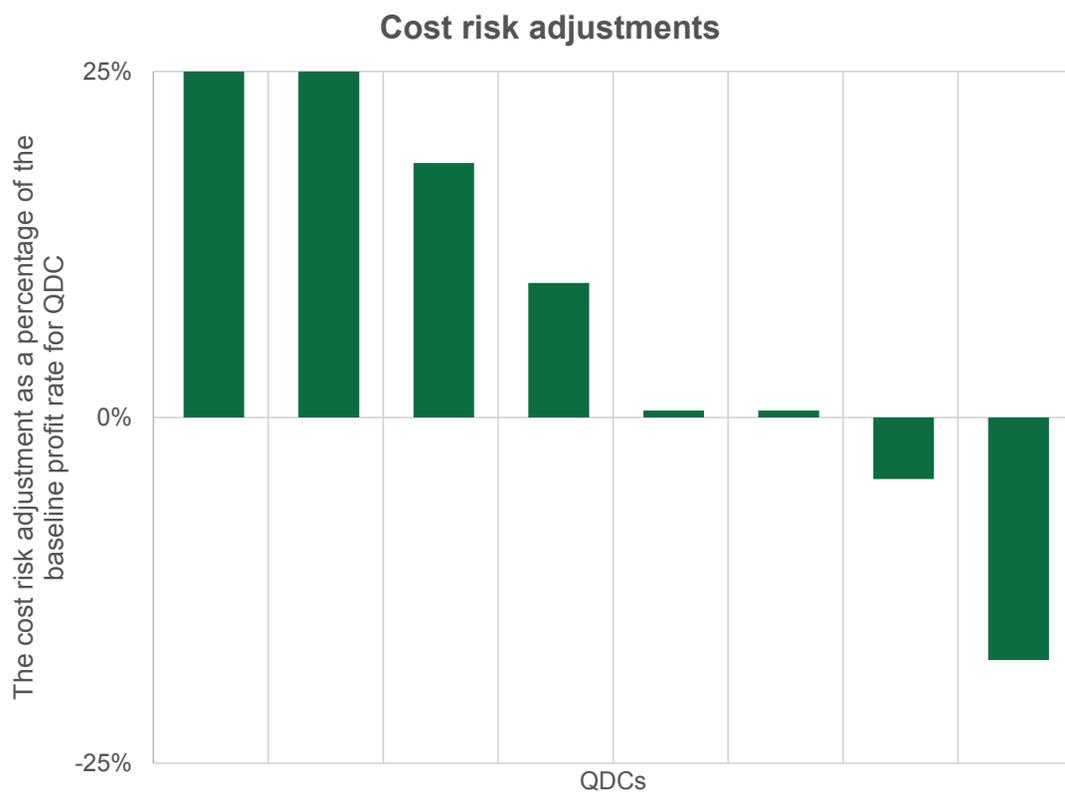
“Adjust the baseline profit rate by an agreed amount which is within a range of plus or minus 25 per cent of the baseline profit rate, so as to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs”.

- 4.38 The cost risk adjustment guidance is principles, rather than rules, based and as such does not set out any specific format to follow in evidencing the assessment of risk involved in a QDC such as through the use of risk registers.
- 4.39 Risk registers are provided to support risk assessment on firm/ fixed price contracts that detail all contract risks.
- 4.40 The SSRO notes that the extent of the positive risk adjustment to the profit rate appears high on some fixed/ firm price QDCs given the nature of the risks detailed in the accompanying risk registers.
- 4.41 It is also apparent that some risk adjustments are not well supported by evidence provided of the risk borne by the contractor, or the likelihood of these risks occurring.

4.42 The SSRO has also identified QDCs where the contract price included costing for a level of risk. As insufficient evidence and justification was provided by the contractor it was unclear whether the inclusion of this cost should have resulted in a corresponding reduction in the level of risk adjustment made to the profit rate adjustment.

4.43 Prior to the signing or award of a QDC, the contractor and the MOD should have agreed the extent of any risk adjustment and then the contract profit rate. However, the SSRO has received QDC reports in which the MOD has not yet agreed to the risk adjustment and so the contract profit rate is provisional and not yet agreed even though the QDC was signed and commenced.

4.44 The cost risk adjustment is within a range of positive or negative 25 per cent of the baseline profit rate. The graph below details the cost risk adjustment as a percentage of the baseline profit rate on the first QDCs that have been notified to the SSRO and illustrates the wide range of adjustments that have been applied to different QDCs. While it is encouraging to see that there is a differentiation in the level of adjustment, the SSRO has not always received sufficient evidence or justification to support the specific adjustment made in calculating the contract profit rate for a specific QDC.



Contracting methods

4.45 There are six regulated pricing methods that the parties to a QDC may decide to use, as set out in Regulation 10 (4)-10(11).

4.46 The six regulated pricing methods are:



4.47 While it is not a requirement to evidence this, it is not always clear to the SSRO why a particular regulated pricing method has been adopted for a particular contract. Although the SSRO has no role in assessing the decisions the MOD makes as to the contracting method adopted, we make the observation as the independent expert on MOD single source procurement⁴ and in the spirit of seeking good value for money for the taxpayer.

4.48 In the past repetitive short-term cost-plus contracts, that limit liability and may lack rigour as they are output rather than outcome focused, have been employed in complex lengthy contracts in lieu of a more appropriate contract method. It is encouraging to see that these short-term limit of liability contracts are starting to be replaced by QDCs with an appropriate contracting or regulated pricing method, which represent better value for money.

4.49 A short term approach to contracting lacks rigour, and is output rather than outcome focused. This type of agreement prevents rather than incentivises best practice; is unlikely to pass the value for money test; and may not withstand public scrutiny.

4.50 The SSRO would encourage the MOD to undertake more pre-contract award activity. An investment in time during the pre-contract award phase would ensure measurement of the benefits that could be achieved by establishing appropriately constructed risk based contracts from the outset.

4.51 This approach would enable outcomes and risks to be properly articulated in the terms of the contract and best practice to be appropriately measured and rewarded.

Stakeholder support and SSRO Answers

4.52 The SSRO has received and responded to 105 enquiries from stakeholders who have requested support on aspects of the Framework. These have been received and responded to through our dedicated helpdesk email, telephone enquiries and our **SSRO Answers** publication.

- 4.53 SSRO Answers is intended to supplement SSRO issued statutory guidance by providing informal clarification on questions asked by stakeholders about aspects of the Framework. It is updated monthly and currently includes 65 questions and answers.
- 4.54 The answers provided do not constitute a formal opinion or determination under the Act and the Regulations, and are not designed to replace a party's need to make a formal referral on specific areas.

MOD compliance

- 4.55 The SSRO measures compliance by the MOD with its obligations and commitments through three indicators:
- its adherence to the Single Source Cost Standards;
 - its adherence to the contract profit rate guidance in the QDCs that it agrees with contractors; and
 - its notification and verification of QDCs and QDC reports ("reports") to the SSRO.

QDC notification

- 4.56 The SSRO monitors and records the MOD's performance against its commitment to provide the SSRO with accurate notification of a new QDC within five working days of contract award or signature.
- 4.57 The timely and accurate notification of QDCs facilitates the SSRO's ability to plan and allocate resources for inducting new contractors into the process for completing and submitting reports, and for assessing QDC reports for compliance. Crucially, prompt notification of QDCs allows the SSRO to provide contractors with access to the secure report submission portal in sufficient time before the first reports are due (one month after QDC award or signature).

- 4.58 Prompt notification also allows the SSRO to support contractors and resolve any issues or queries they may have about the reports or the nature of any supporting information required. This is a particularly important issue in the first year of the operation of the Framework, when procedures are unfamiliar. Contractors typically have a number of queries about what is required and seek discussions with the SSRO for clarity. This is discussed at length in Section 5 'First QDC: Lessons Learnt'.

- 4.59 The MOD has generally not met the five day notification commitment during this first year of operation. In some instances this has hampered the ability of the SSRO to make early contact with contractors, and has contributed to contractors failing to meet the requirement in the Regulations to submit the first QDC reports within one month of contract award or signature.

"A key part of the [single source procurement] reform lies in the creation of the SSRO as an independent, arm's length mediator between MOD and industry on single source contracts. The SSRO was set up in late 2014 and has been active in producing a range of statutory guidance for industry and MOD on how the reforms will work in practice. The SSRO is able to give opinions and make legally binding judgements on issues referred to it by either the MOD or industry. The MOD is committed to making full use of the SSRO's expertise and has already referred the Astute Boat 5 contract to the SSRO for an opinion on pricing."
MOD Equipment Plan, 22 October 2015

- 4.60 However, the SSRO has observed a welcome improvement in the MOD's adherence to the five day notification commitment towards the end of 2015.

4.61 In most instances the MOD has provided an accurate notification of new QDCs. However, the MOD has on occasion failed to provide sufficient explanation in instances when information in the notification was incorrect. Examples of inaccurate notification have included incorrect contract values and start dates.

4.62 We would expect the current improvements for this compliance metric to continue in 2016 as the MOD's Single Source Advisory Team⁵ establishes itself and its processes and awareness of compliance requirements increases across the MOD and its project teams.

Report verification

4.63 In developing our working arrangements the MOD committed to notifying the SSRO that it had verified QDC reports within 30 days of the MOD receiving such reports. In verifying QDC reports the MOD confirms that the information contained within the reports accords with the documentation for the contract the MOD has entered into and is as the MOD had expected. Any discrepancies or issues, including costs that the MOD considers may not meet the SSRO's Single Source Cost Standards, will be taken up by the MOD with the contractor. The 30 day metric was designed to ensure the efficient processing of QDC reports, whereby any non-compliance identified within the reports can be communicated to the contractor and the MOD and addressed as soon as possible.

4.64 For the majority of QDC reports submitted, the SSRO has not received formal notification by the MOD of verification within 30 days. Notification in most cases has been provided well beyond

the 30 day period. The MOD has now advised that it will not be able to provide verification within 30 days and the SSRO will seek to agree an appropriate timescale and amend its published compliance methodology.

Allowable Costs

4.65 The SSRO assesses the MOD on whether the costs in QDCs, and detailed in the QDC reports, adhere to the SSRO's Single Source Cost Standards. This is because the costs are agreed by both the contractor and the MOD.

4.66 The SSRO formally notifies contractors and the MOD in instances where it identifies costs it considers to be non-Allowable in a QDC. Where such costs are subsequently removed the SSRO may decide to increase the MOD's (and contractor's) compliance rating for Allowable Costs.

4.67 The requirements for providing information on Allowable Costs in contracts are set out in Regulation 23 of the Regulations.

4.68 The SSRO has been unable to provide assurance on Allowable Costs for a number of QDCs due to the limited data that it has received. The SSRO has requested data to support and justify the inclusion of costs in a QDC where it considers the costs may be non-Allowable. The SSRO will then rate contracts for compliance based on any further evidence or lack of evidence provided. The SSRO would expect the MOD as an intelligent customer to impress upon its suppliers the need to provide both the SSRO and the MOD with all necessary evidence and information to support and justify costs and to comply with the spirit as well as the letter of the Framework.

4.69 Over the compliance monitoring period the SSRO has increased the compliance rating for the MOD where it agreed with the contractor that non-Allowable Costs identified would subsequently be removed.

⁵ The Single Source Advisory Team (SSAT) is the section of the MOD that oversees the Framework and of the MOD's obligations under it.

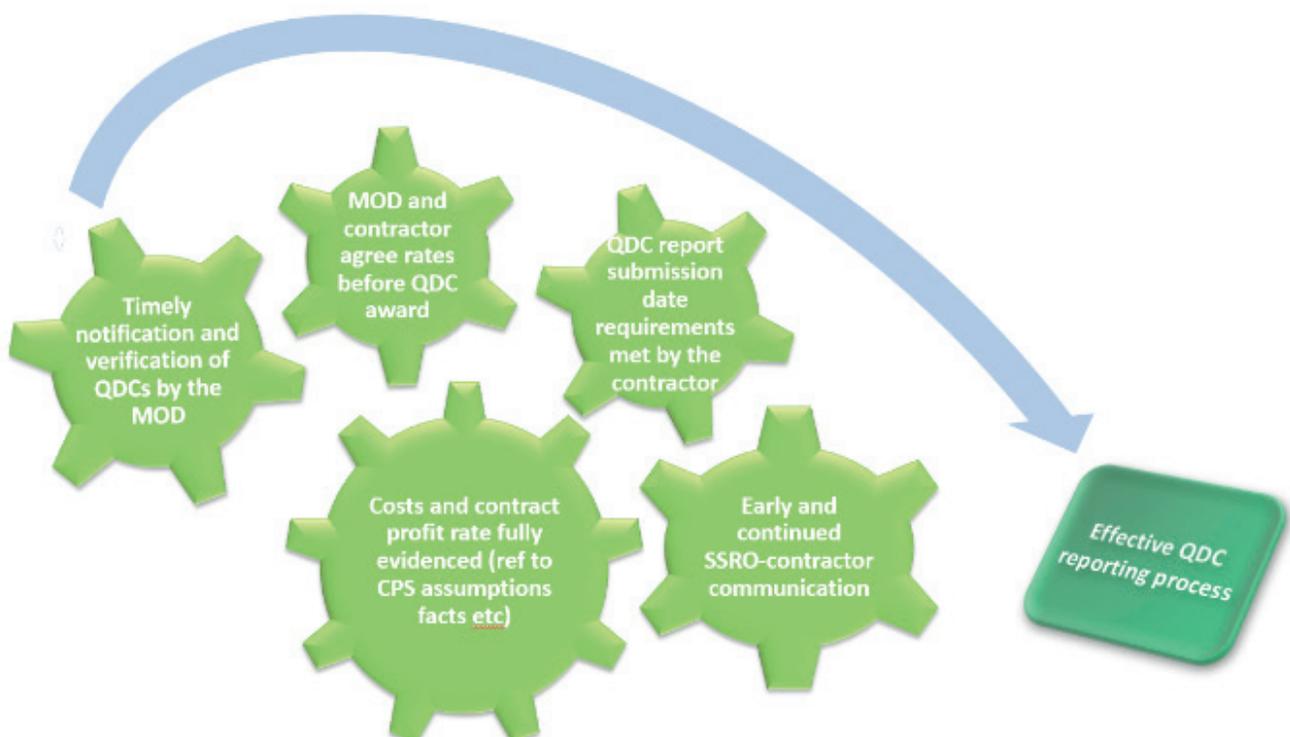
However, such decisions will be dependent upon the nature of the costs involved and the frequency with which the same non-Allowable Costs are identified as having been included with QDCs that the MOD has entered into.

Contract profit rate

- 4.70 The SSRO assesses the MOD for compliance on whether the contract profit rate in QDCs, as detailed in the Contract Pricing Statement QDC report, adheres to the SSRO's contract profit rate guidance. This is because the MOD agrees the contract profit rate with the contractor. The requirements for providing information on the contract profit rate used in contracts are set out in Regulation 23 of the Single Source Contract Regulations 2014.
- 4.71 The SSRO has been unable to properly assess compliance on this for some QDCs due to the limited data that it has received. The SSRO has requested evidence and documentation in order to substantiate QDC contract profit rate calculations where necessary.

Use of provisional rates

- 4.72 The SSRO's assessment of reports received over the compliance monitoring period has revealed the extensive inclusion of provisional rather than final agreed rates in QDCs that have already commenced, including on QDCs that use a Firm or Fixed pricing method.
- 4.73 The use of provisional rates by contractors which have not been agreed by the MOD compromises the SSRO's ability to assess whether the QDC complies with the Act and the Regulations as contractors are reluctant to provide the SSRO with supporting evidence and assumptions to justify rates that have yet to be negotiated and agreed by the MOD. We acknowledge the MOD may, in the interest of delivering Defence capability quickly, on occasion need to agree contracts before all of the costs are settled. This is poor contracting and procurement practice as it may result in a lack of clarity for MOD as to its expenditure on a QDC and a corresponding lack of certainty for the contractor as to what it will be paid.



Knowledge of the Act and Regulations

4.74 The SSRO has observed that there are widely varying degrees of knowledge and understanding of the Act and Regulations within the MOD's project teams and is aware of instances where MOD staff have issued inconsistent and/or incorrect advice and guidance to defence contractors. The SSRO would expect, with the establishment of the MOD's Single Source Advisory Team, that knowledge and understanding across the MOD should increase significantly over 2016.

4.75 Planned amendments to the SSRO's statutory guidance documents such as the Single Source Costs Standards and the Contract Profit Rate to provide further clarity on some aspects of the Regulations should also help to increase understanding among defence contractors and MOD staff.

Qualifying Subcontracts

4.76 Sections 28 to 30 of the Act cover the application of the legislation to subcontracts. The purpose of these sections is to ensure that if subcontracts are awarded on a non-competitive basis, they will be subjected to the regulatory framework created by the Act in the same way as primary contracts are, with appropriate modifications as set out in Part 11 of the Regulations. The obligations to which a QDC is subject are intended to "flow down" to its subcontracts if those subcontracts are themselves not competed. Subcontracts that are subject to the Act are called "qualifying subcontracts" (QSC).

4.77 Regulation 61 typically makes it the responsibility of the primary contractor to assess whether a subcontract is a qualifying subcontract and to keep a record of this assessment. In the event that the primary contractor makes a positive assessment (that the subcontract meets the conditions of section 28 of the Act) they must notify the Secretary of State of that assessment. Once a positive assessment has been made the contract in question becomes a QSC and is treated as such by the SSRO.

4.78 QDCs are often large and complex and it is common for elements to be subcontracted. These subcontracts may themselves be of very substantial value. For this reason it is essential that primary contractors make timely and correct assessments when determining whether subcontracts are QSCs. Any failure to do so could prevent the legislation from "flowing down", resulting in large portions of single source government defence expenditure falling outside of the single source regulatory framework.

4.79 Over the past year the SSRO has advised prime contractors on how to reasonably assess whether subcontracts are QSCs. By advising in this manner the SSRO has had the opportunity to see first-hand how prime contractors are interpreting the legislation when assessing whether subcontracts fall under the Act. There have been instances where, in the SSRO's opinion, the legislation may not have been interpreted correctly by prime contractors. Examples include:

4.80 **Contractual amendments.** A prime contractor has made the case that there is a distinction between ‘entering into’ a contract and ‘amending a contract’, and that the test to determine whether a subcontract is a QSC should only be undertaken at the time a subcontract is initially entered into.

4.81 In the SSRO’s opinion, supported by leading counsel, this interpretation of the legislation is incorrect. In our view, the effect of agreeing to significantly amend the terms of an existing contract is to enter into a new contract on the amended terms. As such an assessment as to whether a subcontract is a QSC should be undertaken if a subcontract is amended – providing that the amendments are material.

4.82 **Timing of entry into the contract.** A prime contractor has stated that as the definition of a QSC hinges on whether a subcontract involves the provision of anything “for the purposes of a QDC”, a subcontract cannot be a QSC if it was entered into prior to the QDC being signed. The logic being that if a QDC technically did not exist at the time the subcontract was entered into, the subcontract could not be for the purposes of a QDC and could not therefore be deemed to be a QSC.

4.83 In the SSRO’s opinion, supported by leading counsel, this interpretation of the legislation is incorrect. In our view the fact that a subcontract was signed before the QDC does not remove the obligation to carry out an assessment under Regulation 61 and does not have the effect that the contract fails to satisfy the definition of a QSC. Any other approach would expose the framework to avoidance. The explanatory notes to Section 29 of

the Act (which covers determining whether a contract is a qualifying subcontract) identifies the risk of avoidance and points to the provisions of the Act which aim to mediate against this risk. The passage in question states:

“One possible way a contractor could deliberately avoid flowing down the obligations to a subcontractor that would otherwise be subject to them would be to enter into conditional subcontract or similar arrangement prior to the signing of the primary QDC. Subsections (3) and (4) are designed to address this possibility, and provide equivalent provision to subsections (1) and (2)”.

5. Case study: ‘Lessons learnt from the first QDC’

- 5.1 The SSRO is committed to improving and developing the process of assessing QDCs. As part of this commitment, the SSRO held a discussion with the MOD’s Single Source Advisory Team and the defence contractor party to the first QDC, to produce a document on “lessons learnt” from the first QDC to come under the Framework.
- 5.2 The SSRO was notified in April 2015 of the first QDC to be signed under the Framework, and consulted with the parties to the contract on any lessons that could be drawn from the first QDC in September 2015. The “lessons learnt” document agrees a series of actions that would support the effective and transparent functioning of the Framework.
- Communication**
- 5.3 It was agreed that early communication between the SSRO and defence contractors party to a QDC is beneficial and essential. This is to allow for sufficient time before the first QDC reports are due for the SSRO to assist and guide contractors through reporting requirements and to resolve any technical issues with uploading reports to the secure portal. The need for early communication is particularly necessary where it is the first occasion that a defence contractor is party to a QDC.
- 5.4 The SSRO was only notified by the MOD that the contract had been signed one day before the first reports were due to be submitted. This gave the SSRO little time to provide the contractor with access rights to the secure online portal for report submission or to address any queries the contractor might have had about the reports they were required to submit. Consequently, it was agreed that in future the MOD would inform the SSRO of future QDCs within five days of it being awarded or signed.
- 5.5 The contractor found it useful to work together with both Landmark, the SSRO’s expert managed service provider for the secure reporting portal, and the SSRO for uploading reports. A formal procedure is now in place and is managed by the SSRO’s Reporting Helpdesk, who will involve Landmark Technical Support where necessary, to provide help to contractors requiring access to the portal for the first time or assistance with uploading reports.
- 5.6 The MOD agreed to share its own verification analysis of the QDC reports for compliance with the Single Source Costs Standards.
- Supplementary information**
- 5.7 The contractor submitted a copy of the contract document and a slide pack that explained how the contract operated and what it was intended should be delivered, which the SSRO found extremely helpful in aiding our understanding of the QDC.

- 5.8 The SSRO welcomes any supplementary documentation that may assist us in assessing whether a QDC adheres to the Single Source Cost Standards and our guidance on the contract profit rate. Other useful documentation could include:
- a description and overview of costs included;
 - a mapping of the contractor's work breakdown structure to the Defined Pricing Structure; and
 - a paper explaining the nature of amendments to the contract that have resulted in a change to the value reported in a Quarterly or Interim Contract Report.
- 5.9 The contractor had not initially provided sufficient information with the first Quarterly Contract Report (QCR). When submitting QCRs, any changes in contract values should be fully explained and supporting information or descriptions provided. In addition, the SSRO requested supporting information on how indirect cost had been calculated as this was not initially provided.
- 5.11 The SSRO agreed to publicise this issue in 'SSRO Answers'. The answer reiterated that the QMAC has no relevance in determining if a cost is Allowable. Although the QMAC is completed by the contractor and describes how they will allocate and apportion costs, this does not mean that costs included in the QMAC are automatically Allowable. Indirect costs included in the QMAC will only be Allowable if they meet the principle of being 'appropriate, attributable and reasonable' and are agreed between the contractor and the MOD, who will have regard to the Single Source Cost Standards. The contractor has since agreed to remove all non-Allowable Costs.

Allowable costs and QMACs

- 5.10 The contractor was not aware that the QMAC, which was agreed with the MOD some time before the QDC was entered into, could now contain items which were not compliant with the Single Source Cost Standards and therefore not Allowable under the Regulations.

6. Referrals

Background

- 6.1 The SSRO provides opinions and legally binding determinations in response to valid referrals from the MOD, contractors and subcontractors. To date the SSRO has issued one opinion and received one request for a determination.
- 6.2 The SSRO's issued opinion was in respect of a proposed QDC. The referral sought the SSRO's opinion on the extent to which specified costs were Allowable Costs, as well as additional guidance to that contained in the SSRO's Single Source Cost Standards⁶. The referral was made under Section 35(1) the Act and Regulation 51(1) (d) of the Single Source Contract Regulations 2014.
- 6.3 In accordance with the procedures published in the SSRO's referrals guidance, the SSRO produced an anonymised summary of the SSRO's opinion⁷, which provides an overview of the key principles which emerge from the opinion and can be found on the SSRO homepage. The account below is based on the published anonymised summary and aims to share with stakeholders the opinion of the SSRO on the matters referred.
- 6.4 The matters referred to the SSRO for an opinion were:
- the extent to which the price risk for direct labour, materials and technical risks included within the proposed Target Cost was an Allowable Cost, and a view on an appropriate confidence percentile range to contract at for future contracts;
 - the extent to which the cost for rework and defects and deficiencies included within the proposed Target Cost were Allowable Costs; and
 - the extent to which the price risk for indirect costs included within the proposed Target Cost was an Allowable Cost.
- 6.5 In addition, the SSRO was asked for general observations or points of principle that might be applicable to other contracts. Consequently the SSRO expressed some principles that we believe may be more generally applicable and are therefore important for the consideration of Allowable Cost and price risk in future QDCs.

⁶ Single Source Cost Standards: Statutory Guidance on Allowable Costs January 2015

⁷ SSRO Opinion 1

Question 1

- 6.6 *An opinion on the extent to which the price risk for direct labour, materials, and technical risks included within the proposed Target Cost is an Allowable cost.*
- 6.7 In response to this question the SSRO considered whether it was appropriate, in principle, to include an adjustment for price risk in a Target Cost estimate.
- 6.8 Using the SSRO's Single Source Cost Standards (paragraph 11.1, bullet point 12) the SSRO came to the view that for a contract that uses a regulated pricing method that transfers most or all cost risks to the MOD, such as the cost plus method, the cost contingencies or cost risks are not Allowable Costs. By contrast, appropriate provision for risk can be an Allowable Cost in contracts that use a regulated pricing method where the contractor bears a substantial element of cost risk.
- 6.9 For the referral in question, the proposed contract uses the Target Cost method, and both parties agreed on the inclusion of price risks in the contract. The SSRO therefore concluded that this contract can include a provision for risk in the Target Cost, where risk is borne by the contractor and where it is adequately quantified.

Consideration of whether the contractor will be bearing risk

- 6.10 When considering whether the contractor would be bearing risk in relation to direct labour, materials, and technical risks under the proposed contract, the SSRO concluded that, since the contractor would be bearing risk in relation to direct labour hours, materials and technical risks under the proposed contract, it was reasonable for the Target Cost to include an amount that reflects the quantum of those risks.

Consideration of methods used for assessing a value for risk

- 6.11 Thirdly the SSRO considered the methods used for assessing a value for risk to include in the Target Cost. In order to estimate a value for price risk, the parties used a Monte Carlo analysis. This is a simulation technique that contributes to an assessment of the combined impact of uncertainty about the estimates of individual cost items on variation in the estimate of Target Cost.
- 6.12 The SSRO's view was that, while Monte Carlo analysis was an appropriate technique to use, it might be appropriate in large and complex projects to use more than one technique for the purpose of cross-validation.

Consideration of learning curve benefits

- 6.13 The SSRO's research identified that, given the nature of manufacturing production units concerned in this referral, the taxpayer should benefit from learning curve improvements. A specified percentage improvement would be appropriate, while properly recognising the manufacturing challenges involved. The application of this learning curve would indicate that a share of the direct labour costs in the price risk would not be an Allowable Cost.

Consideration of wage inflation uprating

- 6.14 The referral noted that an adjustment to the Target Cost in 2014 Economic Conditions (ECs) was agreed between the parties in order to reflect that value in 2015 ECs. The adjustment involved inflating labour-related cost elements by a specified percentage. We understood that the final Target Cost in the contract would be in 2015 ECs.

6.15 Having reviewed the evidence the SSRO reached the view that calculating labour costs at 2015 ECs using a relevant and current inflation index would be a more suitable method for calculating Allowable labour costs than using a pre-determined per cent uplift factor. Should this lower uplift rate be applied, there would be a reduction in both the labour and price risk cost included in the Target Cost. The SSRO's opinion was that an amount equal to the price risk cost corresponding to the higher percentage was not an Allowable Cost.

6.16 *A view on an appropriate confidence percentile range to contract at for future contracts.*

6.17 The SSRO was asked for its view on the appropriate confidence percentile at which to contract on future projects. The SSRO did not consider it appropriate to provide an opinion on the confidence percentile range to apply to future contracts for a similar product. Each contract must be considered in the light of its particular circumstances and any percentile derives from its own specific input assumptions.

Question 2

6.18 *An opinion on the extent to which the costs for re-work and defects and deficiencies included within the proposed Target Cost are Allowable Costs.*

6.19 The referral asked the SSRO's opinion on the extent to which the cost for re-work and defects and deficiencies included within the proposed Target Cost were Allowable Costs. The SSRO's Single Source Cost Standards States that: "costs that are generally unallowable" include those "for the remedy of faulty workmanship or the consequences that result". In addition we recently issued the following as an SSRO answer on rework:

"The cost of rework will similarly be *allowable if it meets the principle of being appropriate, attributable and reasonable and is agreed between the contractor and the MOD, who will have regard to our guidance on allowable costs. For example:*

1. First in Class - rework which occurs during the process of manufacturing an item for the first time would generally be considered allowable.

2. Re-specification - rework which occurs due to a change in design specification from the MOD would generally be considered allowable.

3. Faulty Workmanship - the costs of rework due to faulty workmanship or the consequences that result from faulty workmanship are generally non-allowable. Similarly, rework that is a result of a contractor not delivering a specification would generally be non-allowable.

To demonstrate that re-work is appropriate, attributable and reasonable the contractor will clearly need to be able to measure reliably how much re-work falls into the various categories outlined above."

6.20 Making the cost of rework and defects and deficiencies Allowable under the Act, and reflecting this in the Single Source Cost Standards, would by definition enable these costs to attract profit based on the formula for determining contract price specified in Regulation 10 of the Regulations (i.e. price = AC + (CPR x AC)). Changing the definition in this manner would theoretically reward inefficiency, which was not the intent of the Currie report and the resultant legislation, Regulations and published SSRO Single Source Cost Standards. Any production inefficiency should represent a concomitant reduction to the bottom line, and in Target Cost contracts should constitute an impact to the share-line.

- 6.21 The SSRO's opinion was that cost disallowed by the parties for faulty workmanship and defects and deficiencies was within the bounds of reasonableness. However, the SSRO would have expected the contractor to have collated historic rework data from which to make an accurate estimate of the costs that should be allowed. We recommend that new and accurate measurement processes are put in place.

Question 3

- 6.22 *An opinion on the extent to which the price risk for indirect costs included within a proposed Target Cost is an Allowable Cost.*
- 6.23 The referral asked the SSRO's opinion on the extent to which the price risk for indirect costs included with the proposed Target Cost is an Allowable Cost. The Single Source Cost Standards states that:
- “overhead and indirect costs which cannot be directly attributed are defined as those costs which, though necessarily having been incurred during the performance of the qualifying defence contract and qualifying subcontract for the conduct of the contractor's business in general, cannot be identified and measured as directly applicable to the performance of that contract”.*
- 6.24 The SSRO's opinion was that fixed indirect costs should be treated as fixed, and only the proportion of the indirect costs that are variable should be identified, proven and uplifted for direct hour uncertainty.

General observations

- 6.25 *Application of the SSRO's Single Source Cost Standards.*
- 6.26 The SSRO was asked to clarify, based upon the information provided to us, whether the approach taken by the parties in negotiating the proposed QDC was consistent with the SSRO's Single Source Cost Standards.
- 6.27 The SSRO noted that it is not straightforward to verify the price risk components presented to it in the referral. Both parties were unable to explain their own view of the relevant inputs and how they were at variance with the other party's perspective, and placed undue reliance on their view that they had reached a satisfactory outcome. The negotiation of a settlement that is believed to be beneficial to both parties does not release either from their obligation to comply with Section 20(4) of the Act and paragraph 7.4 of the Single Source Cost Standards.
- 6.28 Referrals must contain sufficient, relevant and detailed evidence to support matters on which parties seek a referral. Parties that are unable to supply sufficient evidence to justify that costs are AAR are not compliant with the Act.

7. Outlook

7.1 The SSRO is committed to improving and developing the process for assessing QDCs. It is a legal requirement that contractors have regard to this guidance and the burden of proof remains with the contractor to communicate how they have had regard to the guidance to the SSRO, in order that the SSRO is able to make informed compliance assessments.

7.2 The SSRO expects that understanding of the Regulations, and therefore compliance, will improve in the future. We will continue to: assess and report on compliance by contractors and the MOD with the Act and Regulations; work to increase appropriate transparency of UK single source defence procurement; drive and encourage compliance and 'good' behaviour; and demonstrate that the SSRO is fulfilling its obligations to keep the extent of compliance under review.

“The SSRO will deliver a more effective and efficient way of procuring the essential equipment our armed forces need to keep the United Kingdom secure, and at the right price.” **Minister for Defence Equipment, Support and Technology, 25 July 2014**

7.3 The SSRO will collect data from the QDC reports submitted to conduct a range of analytical work. This data will be used to produce, for example, comparative management information and defence benchmarks and parametrics

that could support the MOD and industry to deliver good value for money from single source defence contracts. The SSRO is currently considering its programme of value for money studies, on which we have recently concluded a public consultation.

7.4 In order to ensure continued efficiency and efficacy, the SSRO will conduct its statutory review of the Act and the Regime with a public consultation later in 2016. We would invite all interested parties to respond to the consultation.

External events

7.5 The government has committed to meeting the NATO 2 per cent target in every year of this Parliament, an additional £3.5 billion is available from the Joint Security Fund over the next 5 years to fund new defence and security capabilities (of which £2.1 billion of the Fund will go to the MOD), the MOD's Equipment Plan is in place and the SDSR commitments are due to be implemented.

7.6 The SDSR contains many initiatives that suggest single source procurement of equipment and services will remain a large proportion of MOD spend in the coming years, and it has been widely reported that the implementation of the SDSR will result in some significant single source contracts. The SSRO therefore expects that the volume of QDCs will increase as more new single source contracts are signed.

- 7.7 The SSRO believes that an obvious route to the efficiency savings required of the MOD would be to ensure that all future single source procurement is subject to the Regulations.

“The Successor submarine and Type 26 Global Combat Ship programmes will be the first major projects delivered through single-source contracts overseen by the SSRO.” SDSR, Page 76 point 6.53

- 7.8 The SSRO was pleased to note that the SDSR made explicit reference to its work and stated that the Successor submarine and Type 26 Global Combat Ship programmes will be the first major projects delivered through single source contracts overseen by the SSRO. We look forward to engaging with all parties to these contracts to ensure compliance with the Regulations, and to securing both good value for money for the taxpayer and a fair price for contractors.

8. Appendix 1: Compliance Rating Methodology

- 8.1 The SSRO has created a methodology to measure defence contractor and MOD compliance with their duties and obligations under the Act and Regulations, from which data and rating scores will be produced.
- 8.2 The methodology requires the SSRO to scrutinise the reports provided on each QDC, but does not require the SSRO to give full assurance that contracts comply in full with all the Regulations.
- 8.5 The SSRO had developed robust internal guidance for conducting compliance assessments to ensure that assessments are objective and consistent. Compliance data is stored in a secure database.
- 8.6 The SSRO has committed to formally notifying a contractor where it considers it to be non-compliant. The SSRO is also currently providing additional assistance and guidance to contractors who have entered into QDCs to ensure there is no disadvantage to those who are the first suppliers to be party to QDCs.

Compliance assessments

- 8.3 Compliance assessments are conducted using the SSRO's compliance rating methodology. The methodology facilitates the recording of data available to the SSRO on the MOD's and suppliers' adherence to the Regulations. The compliance rating methodology will be used to allocate the MOD, suppliers and each QDC a red, amber or green (RAG) rating.
- 8.7 The Secretary of State for Defence may take any necessary compliance action by the issuing of Compliance and Penalty notices, under Sections 31 and 32 of the Act.

Allowable costs and contract profit rate assessments

- 8.4 The development of the methodology was supported by extensive research into methodologies by other regulators, credit rating agencies and independent organisations, as well as a six-week public consultation which ran from 29 June 2015 to 25 August 2015. The SSRO was pleased that the feedback broadly endorsed the principles behind the methodology. A consultation response document is available on the SSRO's website. An overview of the methodology is provided below.
- 8.8 The SSRO will independently assess, through reports submitted by contractors, whether a contract is in line with the contract profit rate guidance, and whether there are any clearly non-allowable costs in the contract. Contractors' scores will be determined by the SSRO's assessment of whether reports comply with the SSRO's guidance. The MOD will be deemed to have not complied where it has agreed to or failed to identify breaches in the Regulations or SSRO guidance.

- 8.9 Compliance ratings reflect assessments made on information required to be submitted to the SSRO or that the SSRO has become aware of. Consequently, the SSRO will not provide full assurance on compliance, as it is for the MOD to ensure that contracts it enters into comply with the framework. For example, whether costs are allowable is often a matter for judgement, and the SSRO will only provide a full judgement when asked to do so when the matter is referred to it for an opinion or determination. However, if there are any costs that are clearly not allowable, and the SSRO becomes aware of these, then that will inform the assessment of compliance.

Communication with MOD and contract

- 8.10 Where the SSRO has found that the MOD or a contractor is not compliant, the SSRO will write formally to ensure the affected party is fully aware of the SSRO's view, and that this will be reflected in the annual Compliance Report.
- 8.11 If an issue is resolved (for example a non-allowable cost is removed) via a referral, the issuing of a compliance notice or negotiations, the SSRO would note the resolution in the Compliance Report, and the matter would not affect the compliance rating. Opinions and determinations that result in a change to compliance assessments that have already been included in a published Compliance Report will be amended in the following report.

9. Appendix 2: Compliance and Penalty notices issued

9.1 The Secretary of State for Defence may issue Compliance and Penalty notices, under Sections 31 and 32 of the Act.

Compliance notices

9.2 A Compliance notice can be issued to a contractor if they contravene Section 31, and if there are “steps that can be taken by the person to remedy” the contravention in question (Section 31(1)).

9.3 A Compliance notice will specify the steps necessary to remedy the contravention, and direct the contractor to take such steps (Section 31(2)). It must also “give details of the contravention”, “specify the period within which the steps specified in the notice must be taken”, and state that if the contractor “fails” to take those steps, the Secretary of State for Defence may issue a compliance notice (Section 31(6)).

9.4 Section 31(3) states the contraventions for which a Compliance Notice can be issued.

Penalty notices

9.5 A Penalty notice can be issued to a contractor in two circumstances. The first is where the Secretary of State for Defence considers the contractor to have “failed to take the steps specified in a compliance notice” and “does not have a reasonable excuse for the failure” (Section 32(2)). The second is where the contractor has contravened Section 31 and the Secretary of State does not think that there are “steps that can be taken by the person to remedy the contravention” (Section 32(3)).

9.6 A Penalty notice is a notice that requires the contractor to “pay a penalty to the Secretary of State before the end of the period of six months beginning with the date on which the notice is given” (Section 32(4)).

9.7 A Penalty notice must specify the contravention to which the notice relates, state the amount of the penalty (as to which, see section 33), specify the date by which the penalty must be paid (subject to subsection (8)), specify how the penalty may be paid, give details of the interest that would be payable by virtue of section 34(2) in relation to any part of the penalty that is unpaid after the date specified under paragraph (c), and explain how the person may apply to the SSRO, before the end of the period mentioned in subsection (4), for a determination of any of the matters mentioned in subsection (7) (Section 32(6)).

Notices issued in 2015

9.8 As stipulated by the statutory guidance on Penalty notices (Paragraph 9), a list of contractors issued with Penalty notices will be given. Compliance notices will also be listed.

9.9 Penalty notices which have been referred for a determination will not be listed in future Compliance Reports where the decision is outstanding, as stipulated by the Penalties Guidance document.

9.10 No Compliance or Penalty notices were issued in the period from 18 December 2014 to 31 December 2015.

