

SSRO

Single Source
Regulations Office

Assuring value, building confidence

Consultation on the compliance and
review methodology

September 2016

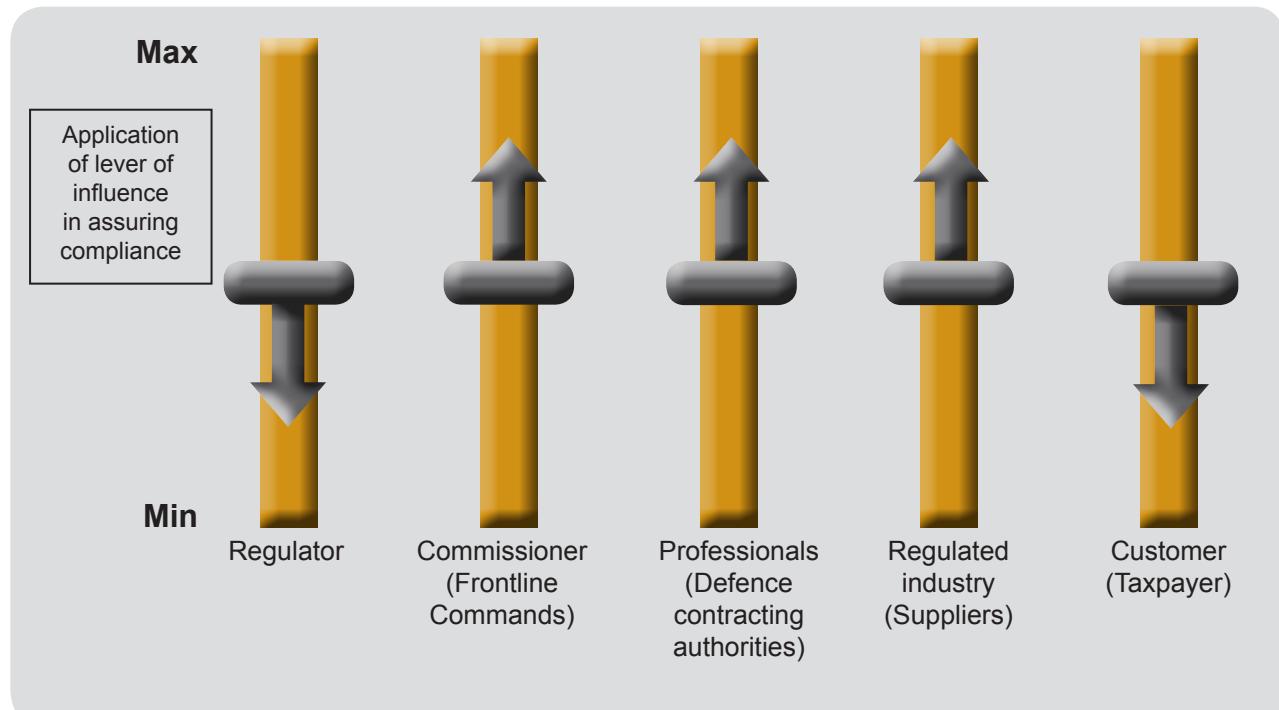
Contents

1. Introduction	1
The compliance and review methodology	5
2. Compliance with reporting requirements (Section 36(2))	5
3. The pricing of contracts	7
4. Ratings	9
5. Format of Annual Compliance Report	9
Format of publication	10

1. Introduction

- 1.1 The Defence Reform Act 2014 (the Act) places two review obligations on the SSRO. Firstly, the SSRO is required, in accordance with Section 36(2) of the Act, to keep under review the extent to which persons subject to reporting requirements are complying with them. Secondly, under Section 39(1) of the Act, the SSRO is required to keep under review the provision of the regulatory framework established by Part 2 of the Act and the Single Source Contract Regulations 2014 (the Regulations).
- 1.2 In addition, the Framework Document between the MOD and the SSRO provides that the SSRO, having monitored the application of the framework, will publish an annual report *“that summarises compliance by the MOD and single suppliers to the provisions of the DRA and SSPRs”*.
- 1.3 The SSRO has reviewed its model of regulation, in the light of:
 - its function to ensure that the government and taxpayers are assured that the Defence Reform Act and Single Source Contract Regulations are being implemented as Parliament intended;
 - current regulatory best practice, including the findings of the Regulatory Futures Review;
 - the SSRO’s experience to date, following publication of its first Compliance Report in January 2016 and interim Compliance Statement in June 2016; and
 - comments raised and responded to, for example through the SSRO’s Helpdesk.
- 1.4 Ensuring compliance within single source defence procurement is not however the sole responsibility of the SSRO, and other stakeholders have a significant role in doing so. We have assessed the roles and responsibilities of all participants in the regime and, as illustrated in Exhibit 1 below, whilst the SSRO has a duty to ensure compliance with the Act and the Regulations, it is our view that there is a greater role for self-assurance in compliance by stakeholders.

Exhibit 1: The SSRO’s view of the ideal Single Source regulatory position

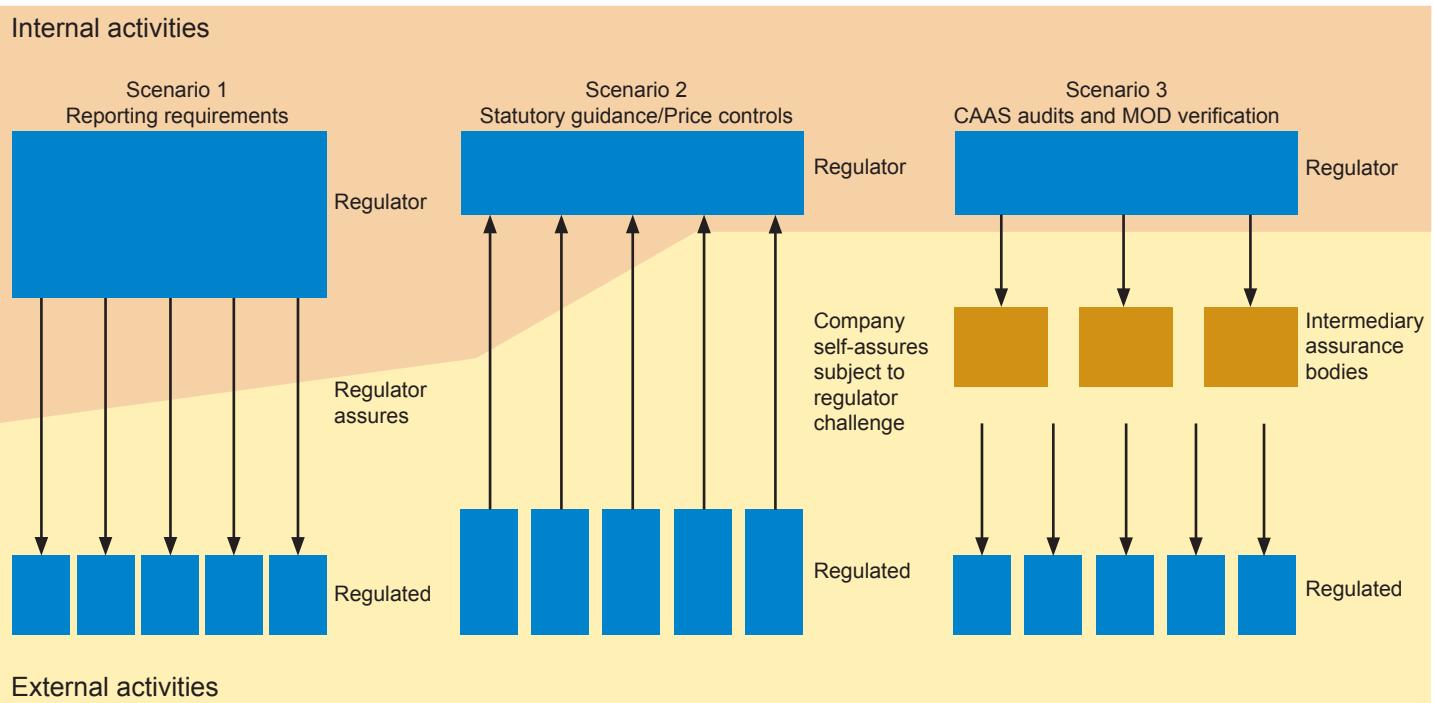


1.5 The SSRO's view of an ideal model for assuring compliance with the Defence Reform Act and the Single Source Contract Regulations involves:

- The front line commands, as commissioners, challenging the professionals to procure goods and services in line with the Act, Regulations and the SSRO's statutory guidance. As budget holders, front line commands should ensure they are getting the capability they need at the right price, quality and time. This entails holding the defence contracting authorities to account for delivering the correct pricing controls and managing the risk to the delivery of the programmes.
- The procurement agencies: the defence contracting authorities, as the professionals procuring the goods and services need to price single source contracts in line with the requirements of the Act and the Regulations, and ensuring that costs are Allowable and in line with the SSRO's statutory guidance, and that profit has been calculated in line with the published rates and guidance.
- Defence companies, as the regulated industry, having a statutory requirement to assure the professionals that all costs are Allowable and to report any deviations from the statutory guidance in the contract reports.
- The customer, or taxpayer, having an interest and influence in commenting on and monitoring the cost and delivery of defence programmes. However, the public does not have the information to receive assurance that those that are regulated are complying with the law.
- This leaves the role of the SSRO, which has the statutory role to review and report compliance to the commissioners and customers.

1.6 Each of these groups has an influence on ensuring compliance with the Act and Regulations in order to ensure value for money for the tax payer and a fair and reasonable return for industry in the procurement of single source military equipment and services. An external regulator can only ever deliver a baseline assessment of compliance, especially given the limited resources and enforcement powers that have been bestowed upon the SSRO.

Exhibit 2:



- 1.7 As illustrated in Exhibit 2, regulatory best practice suggests three relevant approaches to regulation. These are:
 - a. The regulator directly assures the activities of the regulated.
 - b. The regulator evaluates and challenges the self-assurance/compliance of industry.
 - c. The regulator relies on an intermediary assurance of those that are regulated.
- 1.8 Best practice suggests a move toward greater use of intermediary regulated self-assurance. Exhibit 2 details the three models showing the relative activities of each party.
- 1.9 In comparing our approach to assessing compliance with these models, we have concluded that our methodology must rely on all three scenarios. In particular, we have highlighted the limitation of the SSRO to provide full assurance on the implementation of price controls in the absence of a referral for a determination.
- 1.10 In scenario 1, the SSRO directly assures that contractors have submitted the required reports and that they are completed in line with the Regulations and statutory guidance.
- 1.11 In scenario 2, the Act places an obligation on the contractors to report to the MOD and the SSRO that all costs are Allowable and that they comply with the Regulations and the statutory guidance. Where they have agreed a deviation from the statutory guidance, the contractor is obliged to report this to the SSRO. This allows the SSRO to rely on industry's reported self-assurance of compliance with the Regulations and statutory guidance.
- 1.12 In scenario 3, it is the role of the MOD and CAAS to audit the contract information and to verify that the reported information complies with the contract conditions and price controls. It is also their role to provide assurance to the SSRO that industry has complied with the requirements. This will therefore enable the SSRO to take assurance directly from the MOD rather than duplicating or re-performing this role.
- 1.13 We believe our proposed new compliance methodology works well within the resources that we currently have available and ensures there is no duplication with the work of the MOD or unnecessary burden on industry.
- 1.14 As a result, the SSRO has updated its published [compliance rating methodology](#) to propose an approach that:
 - makes the compliance methodology more closely aligned with best practice models of regulation;
 - makes clearer the distinction between the work / roles of the SSRO and the Cost Assurance and Analysis Service (CAAS);
 - makes clearer the legislative roles and responsibilities of the SSRO, the MOD and industry;
 - improves collaboration and understanding between the SSRO, the MOD and industry, whilst still maintaining the SSRO's independence;
 - reduces the overall 'compliance burden' on industry and the MOD; and
 - focuses on the actions taken by industry and the MOD, as the intermediary assurance authority, as a result of issues that are identified by the SSRO.

1.15 Under its updated approach, the SSRO will focus on the two obligations within the Defence Reform Act with a view to keeping the Regulations under review, by:

- considering if contractors are meeting their reporting obligations under the Act and Regulations (link to scenario 1 in Exhibit 2); and
- understanding the operation of the provision of the Act and Regulations with respect to the pricing of contracts and raising matters with the MOD on issues which suggest a deviation from the Act, Regulations or statutory guidance (link to scenarios 2 and 3 in Exhibit 2).

The compliance and review methodology

2. Compliance with reporting requirements (Section 36(2))

- 2.1. The SSRO will monitor whether contractors are meeting their reporting obligations under section 36(2) of the Act by considering if the required submissions:
 - are delivered on time; and
 - contain the information, including relevant explanations, prescribed in the Regulations and any relevant statutory guidance issued by the SSRO.
- 2.2. The SSRO's compliance approach will include querying obvious errors (for example internal reporting inconsistencies or arithmetical errors) as well as raising any matter if completed reports seem to be erroneous (for example containing incomplete or limited information on output metrics).
- 2.3. To establish whether the information is accurately reported and can be relied upon, the SSRO will:
 - ask the MOD to notify it, within an agreed period, of all Qualifying Defence Contracts (QDC) that have been entered into;
 - raise queries with contractors if there are errors or omissions apparent in a report; and
 - agree with the MOD that they will verify and confirm either: that the information from contractor submissions concerning the Allowable Costs and the contract profit rate is in accordance with the contract; or any variances identified.
- 2.4. Where contractors adhere to the reporting requirements the reports should provide an insight into the operation of the regulatory framework with respect to the pricing of contracts. Sufficient, good quality information will support the SSRO's understanding of:
 - the facts, assumptions and calculations relevant to each element of the Allowable Costs used to determine the contract price;
 - the calculation that was made under Regulation 11 of the Regulations, including all adjustments under the six steps, to determine the contract price;
 - any known deviation from statutory guidance; and
 - any other information material to the pricing of the contract.

Keeping the regulatory framework under review (Section 39(1))

- 2.5. The duty under Section 39(1) of the Act requires the SSRO to keep the provision of the regulatory framework under review. The pricing of contracts is a key aspect of the regulatory framework. The Act requires that:
 - contract prices are determined according to the formula “Contract Price = Allowable Costs + (Contract Profit Rate x Allowable Costs)” and in accordance with one of the six regulated pricing methods;
 - costs are only determined to be Allowable Costs where they satisfy the test of being Appropriate, Attributable to the contract and Reasonable in the circumstances (the AAR test); and
 - the contract profit rate for each contract is determined by a six step process that starts with the baseline profit rate set annually by the Secretary of State (the six steps).
- 2.6. If reports are submitted that comply fully with the requirements of the Regulations and the SSRO’s statutory guidance, then these will provide the SSRO with a range of information needed to carry out its review function. Accordingly, a high degree of compliance with reporting requirements should reduce the need for the SSRO to raise queries with the MOD or contractors in order to understand the operation of the pricing of the contract.
- 2.7. However, the SSRO may ask questions arising from submitted reports if that facilitates the discharge of its duty to review the provision of the Act and the Regulations and to develop a proper understanding of how the system of pricing of contracts is being applied. Further enquiry may well be prompted in cases where there are items that *prima facie* appear out of line with statutory guidance, with no clear explanation provided by the contractor.

Contractor reporting requirements

- 2.8. The SSRO will monitor compliance by contractors against statutory reporting requirements by using two specific indicators:
 - 1a) “all required reports have been submitted within the relevant deadlines”;** and
 - 1b) “reporting obligations have been met for all reports submitted in accordance with the Regulations and relevant statutory guidance”.**
- 2.9. The SSRO will detail, by contractor, in its annual Compliance Report the number of reports that were not submitted within the relevant deadline and the number of reports where reporting obligations, in accordance with the Regulations and relevant statutory guidance had not been met.

2.10. Where specific issues are raised by the SSRO with a contractor and are then resolved within the reporting period, either through resubmission of the report being queried or through submission of further information in the next relevant report (e.g. the next quarterly contract report), the SSRO will also note the resolution of the issue in the Compliance Report. Where specific issues are raised by the SSRO with a contractor and are then not resolved within the reporting period, the SSRO will inform the MOD and ask the MOD to issue a Compliance Notice in accordance with Section 31 of the Act. The SSRO will detail in the Compliance Report:

- the issue, by contractor, reported to the MOD;
- whether a Compliance Notice was issued by the MOD; and
- whether a Penalty Notice was issued by the MOD under Section 32 of the Act.

Consultation question

What is your view on the SSRO's compliance approach to reporting?

3. The pricing of contracts

- 3.1. The SSRO will review the reports submitted by contractors to assess the operation of the provision of the Act and Regulations with respect to the pricing of contracts. The SSRO's reviews will be based on the information that is required to be submitted by contractors in line with the Regulations and statutory guidance, but the SSRO will take into account other relevant information of which it becomes aware.
- 3.2. Under the Act, the parties to qualifying contracts may only agree a contract price based on Allowable Costs and a contract profit rate calculated in accordance with the prescribed steps and SSRO statutory guidance. Both parties must be satisfied that the contract costs are Allowable and the contractor must evidence this in its contract reports.
- 3.3. While the SSRO will assess the operation of the pricing provisions of the regulatory framework by reference to information reported on individual contracts, it is not the SSRO's role to audit reported costs or profit rates on a contract by contract basis. The SSRO may positively determine a matter of price (such as whether a cost is Allowable), but only if such a question is referred to it under the framework. In the absence of such a referral, the SSRO will not provide assurance that individual contracts have been priced in accordance with statutory requirements and it remains for the MOD to ensure that the contracts it enters into comply with the framework.
- 3.4. The SSRO will raise concerns with the MOD as the responsible party to validate the pricing controls, by asking for a response within an agreed time period as to how the price control provisions of the Act and the Regulations are being applied. Information reported about a particular contract may give rise to concerns in the following circumstances:
- the facts, assumptions and calculations relevant to an element of the Allowable Costs suggest a deviation from the Act, the Regulations or statutory guidance which has neither been reported nor explained;
 - the calculation made under Regulation 11 of the Regulations, including any adjustment under the six steps, to determine the contract price of a QDC appears to deviate from the Act, the Regulations or statutory guidance but has neither been reported nor explained;
 - a deviation from the statutory guidance has been reported by a contractor or an unsatisfactory explanation has been provided of a departure from the Act or the Regulations; and

- other information material to the pricing of the contract has been reported and this appears to suggest a deviation from the Act, the Regulations or statutory guidance.
- 3.5. The SSRO considers that it is preferable to promptly raise with the MOD any concerns or queries that it has identified after reviewing the information reported on a contract. This provides an early opportunity for an explanation to be provided that informs the SSRO's understanding of how the pricing provisions have been applied, or for appropriate action to be taken to act on well-founded concerns.
- 3.6. Subject to the MOD's response, the SSRO will categorise these issues into two groups where either the deviation has already been notified by the contractor as a known deviation, or where it has been identified by the SSRO separately. These will then be categorised into those in which the MOD:
- advises that the contract will be amended to address a deviation from the Act, the Regulations or statutory guidance [category 1];
 - refers the matter to the SSRO for determination [category 2];
 - confirms that deviation from the Act, the Regulations or statutory guidance has taken place but provides an explanation and indicates that no action is to be taken [category 3];
 - has not yet responded to the SSRO [category 4]; or
 - advises that no deviation from the Regulations or statutory guidance has taken place and provides an explanation [category 5].
- 3.7. In its Compliance Report the SSRO will detail the issues, by category, which it has raised with the MOD during the reporting period. If the pricing of individual contracts gives rise to broader concerns, the SSRO will address these in its annual Compliance Report. This will inform consideration by the SSRO of whether to amend its statutory guidance or to recommend changes to the Act or Regulations to the Secretary of State.
- 3.8. Where the MOD confirms that no deviation from the Regulations and statutory guidance has taken place, the SSRO will note the resolution of the issue and not detail the matter in its Compliance Report. The SSRO will also consider naming contractors under specific categories and commenting on the range and extent of deviation from the statutory guidance.

Consultation question

What is your view on the SSRO's compliance approach to pricing controls?

4. Ratings

- 4.1. The SSRO is proposing not to include a RAG (Red, Amber, Green) rating or indicator of compliance, but instead to provide a factual summary of the compliance activity. Ratings can add value, as they provide a simple indicator that can be understood and conveyed quickly. However, they do not provide the full picture, and require agreement between the parties responsible for regulation, which can unduly divert resources from other valuable functions.

Consultation question

What is your view on ratings?

Do ratings have a value to Parliament and the public that should be retained?

5. Format of Annual Compliance Report

- 5.1. The format of publication is detailed in the section below.
- 5.2. The SSRO intends for the Annual Compliance report, which will be issued in January 2017, to provide stakeholders with a detailed understanding of whether parties have taken meaningful steps towards implementing the provisions of the legislation and where parties have failed to act in accordance with the requirements.
- 5.3. The report will therefore also comprise: facts and figures about the single source regime as a whole such as the number and value of QDCs reported to the SSRO; an overview of compliance with the Act and Regulations; trends with respect to the submissions received by the SSRO; other observations about the regime since its introduction, for instance known exemptions; and other content that stems from the updated compliance regime.

Consultation question

What is your view of the format of the report?

Format of publication

Reporting requirements

Indicator 1a: all required reports have been submitted within the relevant deadlines

Contractor	Number of QDCs	Number of reports expected	Number of reports submitted within the relevant deadline	Percentage of reports submitted within the relevant deadline
[A]	[5]	[25]	[20]	[80%]
[B]	[1]	[3]	[2]	[66%]
etc	etc	etc	etc	etc

Indicator 1b: all reports have been completed in accordance with the Regulations and relevant statutory guidance

Contractor	No. of initial submissions where reporting obligations have been met in accordance with Regulations and statutory guidance	%	No. where resubmissions/ the next submission correctly reflect reporting obligations in accordance with Regulations and statutory guidance	%
[A]	[15]	[60]	[22]	[88]
[B]	[0]	[0]	[2]	[66]
etc	etc	etc	etc	etc

Compliance Notices

Contractor	Issue raised with MOD	Compliance Notice issued by MOD? (Y/N)	Penalty Notice issued for failure to act on Compliance Notice? (Y/N/NA)
[A]	[Missing CPS submission]	Y	N
[B]	[Missing CNR submission]	Y	N/A
[C]	[Incomplete CPS submission]	N	N/A
etc	etc	etc	etc

The pricing of contracts

Category 1

Issue identified	Outcome
[Detail]	[Contract amended- detail of amendment]
etc	Etc

Category 2

Issue identified	Outcome
[Detail]	Matter considered in line with SSROs referrals procedures. Determination can be seen here [hyperlink]
etc	Etc

Category 3

Issue identified	Outcome
[Detail]	No further action taken by MOD
etc	Etc

Category 4

Issue identified	Outcome
[Detail]	SSRO awaiting response*
etc	Etc

*To be followed up in next Compliance Report

