Guidance note

Update to the Single Source Contract Regulations 2014: Changes to the rules for pricing amendments to QDCs

The Defence Reform Act 2014 and the Single Source Contract Regulations 2014 set out a regulatory framework governing the pricing and transparency of single source defence contracts. This article is the second in our series tracking amendments to the regulations, looking at changes to the rules for pricing amendments to QDCs that came into effect on 1 April 2019.

Quick read

The Defence Reform Act 2014 (the "**Act**") and the Single Source Contract Regulations 2014 (the "**SSCR**") set out a regulatory framework for pricing, recordkeeping and reporting in contracts for goods, works and services above £5M in value that are placed by the Ministry of Defence without competition (known as "**Qualifying Defence Contracts**" or "**QDCs**").

Central to the regulatory framework is a requirement that the price payable under a QDC, and any amendments to the price made during the contract term, are determined using a prescribed formula – *(CPR x AC) + AC* – in which *AC* means the contractor's allowable costs under the contract and *CPR* means a contract profit rate calculated using six steps set out in the regulations.

On 1 April 2019, the Single Source Contract (Amendment) (No. 2) Regulations 2018 (the "**2018 Amendment No. 2 Regulations**") came into effect[1], which significantly changed the way in which the MoD and contractors are required under the SSCR to re-determine the price payable under a QDC when it is amended. The parties must still use the same *(CPR x AC) + AC* formula, but the way in which it applies now depends on which one of six categories the amendment falls into:

- Changes to the pricing method for the contract
- Changes to the pricing method for a defined component of the contract
- Changes to a defined element of allowable costs
- Changes to the contractual requirement (for non cost-plus contracts)
- Changes to the contractual requirement (for cost-plus contracts where the allowable costs resulting from the amendment are distinguishable from original costs)
- Changes to the contractual requirement (for cost-plus contracts where the allowable costs resulting from the amendment are not distinguishable).

The new rules on pricing of amendments are now set out in a Schedule to the SSCR, which replaces the problematic mechanism for pricing amendments that was previously set out in Regulation 14. Most importantly, they limit the circumstances in which the pricing formula must be re-applied to the whole of the contract price (rather than the amendment itself). But they leave a number of questions unanswered, and in their complexity are likely to introduce new challenges for MoD and contractors when applying the six categories to the multitude of commercial scenarios they face in practice.

[1]Part of the 2019 Amendment No. 2 Regulations which is unrelated to the subject of this article came into effect on 31 January 2019.

Background to the changes

How QDCs are priced

The cornerstone of the SSCR is the requirement in Regulation 10 that the price payable under a QDC must be determined in accordance with the formula:

(CPR x AC) + AC

in which "*AC*" means the contractor's allowable costs under the contract and "*CPR*" means the contract profit rate, calculated in accordance with a six-step method set out in Regulation 11. The meaning of "*costs under the contract*" depends on which of six permitted pricing methods is used. For example, if the QDC has a firm price, the costs are estimated at the outset of the contract to calculate the firm price. If the QDC has a cost-plus price, the costs are actual costs incurred by the contractor in performing the contract. Whether estimated or actual, both the MoD and the contractor must be satisfied that costs are "*appropriate, attributable to the contract and reasonable in the circumstances*" for them to be allowable.

Pricing of amendments

The same formula must be used when the parties to a QDC propose to amend it in a way that would affect the contract price. The logic is straightforward: if the price at the outset of a contract is regulated, for the regime to be effective the price must also be regulated in a similar way throughout the contract life.

Interpreting and applying the rules on pricing of contract amendments in practice is more difficult.

The first difficulty is ascertaining when those rules apply. Prior to the 2018 Amendment No. 2 Regulations coming into force, Regulation 14 of the SSCR set out rules for re-pricing QDCs that applied where the MoD and a contractor "*propose to amend a qualifying defence contract…in a way that would affect the price determined under regulation 10.*" This clearly applies where, for example, the amendment in question is a change to the contractual requirement requested by the MoD, such as an extension of services or a variation to the specification of equipment to be supplied. But it is not so clear where the price is adjusted by way of a pre-agreed mechanism in the contract, such as an indexation clause or a provision granting cost relief on an agreed basis to the contractor on the occurrence of specified events (which may or may not take effect by way of a contract amendment). Equally, the parties might amend a provision of the contract that has only a *potential* effect on the price, or affects it only indirectly (say, by amending a term that will alter the allowable costs incurred under a cost-plus contract if some future condition comes to pass).

This ambiguity matters, as the application of the pricing rules affects the freedom of the parties to a QDC to agree the terms of their commercial deal and manage the contract accordingly. The rules can deter parties from agreeing amendments or produce price adjustments with unintended consequences.

The second difficulty is ascertaining how to apply the pricing formula correctly. The Act requires the formula to be applied in one of two ways when parties are amending a QDC: either it is used to re-determine the whole of the contract price, or it is used to determine a price payable in respect of the amendment, which by implication is then added to or subtracted from the original contract price.

Regulation 14 implemented this requirement by providing that if the costs relating to an amendment were "*severable*" from the costs under the contract before the amendment, the formula would be used to calculate a price payable in respect of the amendment, and if the costs were not "*severable*" the formula would be used to re-determine the whole contract price.

The concept of severability has been a headache for MoD and contractors. Neither the Act nor the SSCR provided any guidance on what it meant. It was not always easy in practice to determine which costs were or were not severable, for example where the scope of a QDC was reduced on amendment with a decrease in direct costs but an increase in indirect costs, or where parties were switching from provisional to agreed labour or overhead rates. The implications were far-reaching: the result of being unable to "sever" the costs of an amendment was that the whole contract had to be re-priced with a new contract profit rate calculated under Regulation 11. Since the first step in Regulation 11 is to take the Baseline Profit Rate published annually by the Secretary of State that is in force at the date of the amendment, the outcome of even a relatively minor amendment could be a major shift in the commercial deal originally struck by the parties. Unsurprisingly, in practice parties have for the vast majority of amendments sought ways of ensuring that costs are treated as severable.

The SSRO recognised this difficulty in its recommendations on changes to the regulatory regime published in January 2018 after an industry-wide consultation. It recommended a modification to Regulation 14 to replace the severability test with a general requirement that the costs attributable to an amendment should be priced and the amended contract price should be the sum of the price payable before the amendment and the increase or decrease resulting from the pricing of the amendment.

The changes and what they mean for MoD and contractors

A new approach to pricing amendments

The 2018 Amendment No. 2 Regulations take a radically different approach to the SSRO's recommendation. They delete Regulation 14 in its entirety and replace it with a new Schedule to the SSCR, which sets out six categories of amendment, each with its own methodology for calculating the amended contract price. Three of these categories involve scenarios where there is a change to the contractual requirement (i.e. the specification, quantity or time or place for delivery of the goods, works or services being procured) and three involve scenarios where the contractual requirement is unchanged.

The first point of interest is that the gateway for applying the new rules on re-pricing remains the same as under Regulation 14: they apply where the parties to a QDC "*propose to amend the contract in a way that would affect the price*". In that sense the 2018 Amendment No. 2 Regulations resolve none of the ambiguity of when the provisions governing amendments to prices should or should not apply (although their ability to do so was limited as this wording appears in the Act).

The second point of interest is that for all six categories of amendment the parties are required to use the *(CPR x AC) + AC* formula to calculate a price payable in respect of the amendment, which is then added to or subtracted from a pre-amendment value to produce an amended contract price. The key variables are the meanings of the AC value and the pre-amendment value in each case. This means the circumstances in which the parties are required to re-apply the pricing formula to the whole contract are, in principle, more limited than under Regulation 14; the amendment being made would have to fall outside all six categories for this to arise.

In the remainder of this article we take a look at the six categories of amendment, and offer some observations on how they might apply in practice.

Categories 1 and 2: Changes to the pricing method

The first category of amendment is where a proposed amendment will change the pricing method used for the contract (for example a change from cost-plus to a target price).

How is the amended contract price calculated?

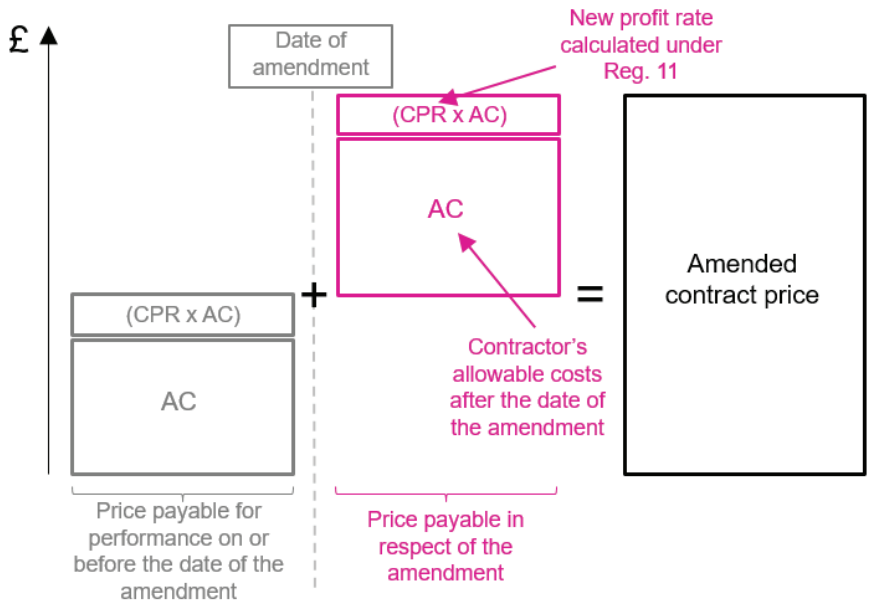
For this category of amendment, the price payable under the amended contract is the total of (1) "*the price payable in respect of performance under the contract on or before the time of agreement*" (i.e. the date of the amendment) and (2) "*the price payable in respect of the amendment*" calculated using the usual formula. When determining the price payable in respect of the amendment, the "*AC*" value in the formula is the "*allowable costs after the time of agreement*" (i.e. the date of the amendment). **This calculation is shown in figure 1.**

What does this mean?

The most significant effect of this provision is to clarify that when the pricing method for a QDC is changed, the change does not retrospectively alter the price payable in respect of past performance. In particular, the newly calculated profit rate applies only to costs after the date of the amendment (i.e. the part of the contract that remains unperformed). In this respect it should be welcomed by contracting parties who are anxious to avoid circumstances that require them to re-price the whole contract.

However, it does leave some questions unanswered. It is not certain what is meant by "*the price payable for performance under the contract on or before the time of agreement*". This term seems clearly to include allowable costs (and the associated profit) actually incurred by a contractor up to the date of the amendment under a cost-plus QDC, but it is less clear how it applies to costs that have been *committed* to be paid in performing the contract but not yet incurred. Likewise, if a QDC has a target, fixed or firm price, it may not

Figure 1: Changes to the pricing method



be straightforward to determine exactly what the price payable in respect of the performed part of the contract is, since by definition the original price is a price for the whole based on an estimate of costs and the contractor is taking risk on variance between that estimate and actual costs incurred. From a practical perspective, the new provision also assumes that the date of the amendment will align perfectly with an accounting date on which allowable costs of past and future performance can be clearly differentiated.

The second category of amendment is where a proposed amendment will change the pricing method used for a "*defined component*" of a QDC, for example if there is a Schedule of Requirements with multiple individually priced items. The methodology is largely the same as for the first category, save that the "*price payable for performance*" and "*the price payable in respect of the amendment*" refer only to the defined component for which the pricing method is being changed. The amended price is then the total of those elements and the price payable for performance under the remaining part of the contract that is unchanged.

Category 3: Change to an element of allowable costs

The third category of amendment is where a proposed amendment will "*change a defined element of allowable costs*" and the pricing method used is the firm, fixed, volume-based or target pricing method. It deals with scenarios where only the costs are changing, without a corresponding change to the requirement for goods, works or services and with no change to the pricing method. These scenarios might include, for example: (1) where the parties to a QDC agree that following review a particular cost included in the price is disallowable (or vice versa), (2) where the parties change the labour rates used to determine the price (for example by substituting provisional rates with agreed rates), or (3) where the parties have agreed to amend the price following agreement of a firm sub-contract price that was provisional at the time it was originally determined.

There is no definition in the 2018 Amendment No. 2 Regulations of a "*defined element*" of allowable costs. All it seems to require is that the parties are able to distinguish or separate one part of the costs included within the price from another. In principle, this might be anything from a single sub-contracted material price to the entirety of, say, the labour costs under the contract.

How is the amended contract price calculated?

For this category of amendment, the price payable under the amended contract is the total of (1) "*the original contract price less the adjustment amount*" and (2) "*the price payable in respect of the amendment*" calculated using the usual formula. For this purpose the "*adjustment amount*" means "*the amount of the original contract price which can be attributed to the defined element of allowable costs that is being changed*". When determining the price payable in respect of the amendment, the "*AC*" value is the "*defined element of allowable costs after it is changed*". **This calculation is shown in figure 2.**

What does this mean?

In essence this methodology amounts to a substitution out of the contract price of a particular cost element and a substitution in of a new, changed cost element.

Although not stated explicitly, the "*adjustment amount*" to be deducted from the original contract price logically includes the amount for profit that attaches to the cost element, calculated at the original contract profit rate. The profit rate attaching to the new cost element is the new profit rate calculated at the time of the amendment.

On one hand this provision provides more certainty to contracting parties that where a defined element of cost is being changed the new profit rate applies only to the changed element of cost and not the contract price as a whole. On the other hand, the intention seems to be that the new profit rate attaches to the entirety of the cost element that is being changed, rather than the delta between the original cost and the changed cost, so if the cost element in question is substantial (say a change from provisional to agreed labour rates) the application of a new profit rate could significantly benefit one party or the other.

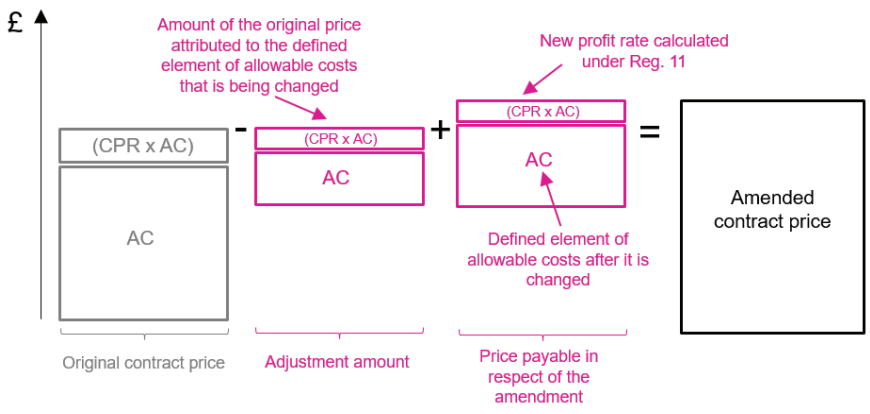
Category 4: Change to a contractual requirement (non cost-plus QDC)

The fourth category of amendment is where a proposed amendment will change a "*contractual requirement*" and the pricing method is not cost-plus. For this purpose "*contractual requirement*" means the specification, quantity or time or place for delivery of the goods, works or services being procured. In essence it is a change to scope of work to be performed.

How is the amended contract price calculated?

For this category of amendment, the price payable under the amended contract is the total of (1) "*the original contract price*" and (2) "*the price payable in respect of the amendment*" calculated

Figure 2: Change to an element of allowable costs



using the usual formula. The "*AC*" value in the formula is the "*amount…by which the amendment will change the original allowable costs*" – which can be a positive or negative amount – and "*original allowable costs*" means "*the allowable costs under the contract…as determined for the purposes of calculating the original contract price*". **This calculation is shown in figure 3.**

What does this mean?

In practice this category of amendment is likely to be more common than any other. Most amendments to QDCs that affect the contract price arise because of a change in the goods, works or services that are being procured. Of those, most also involve an increase in costs associated with a requirement for additional work to be performed.

In these cases the calculation of the amended contract price is straightforward. It is simply the total of the original price and a price payable in respect of the additional work, under which the new profit rate attaches only to the costs associated with the additional work (and not any original costs). In keeping with common practice, all pricing amendments involving changes to contract requirements in non cost-plus QDCs are effectively treated in the same way as if the costs relating to the amendment were "*severable*" under Regulation 14.

Less intuitively, where an amendment involves a *reduction* in costs (say, as a result of a change to simplify the specification for a product or reduce the quantity of goods to be delivered), the associated reduction in profit is calculated at a new profit rate, and not the profit rate that those costs attracted when they were originally included in the contract price. This makes for a relatively simple calculation in practice, but to a greater or lesser extent alters the overall rate of return that the contractor may expect to make on the remainder of the contract.

In either case the new profit rate attaches to the *net increase or decrease* in allowable costs, and in this sense may be contrasted with the methodology for changes to defined elements of costs under the third category above.

Categories 5 and 6: Change to a contractual requirement (cost-plus QDC)

The fifth and sixth categories of amendment are where a proposed amendment will change a "*contractual requirement*" and the pricing method is cost-plus. These are split into two scenarios: the first is where the allowable costs resulting from the amendment "*can be distinguished*" from the allowable costs under the contract before the contract is amended, and the second is where they cannot.

How is the amended contract price calculated?

Where the costs can be distinguished, the price payable under the amended contract is the total of (1) "*the original contract price*" and (2) "*the price payable in respect of the amendment*" calculated using the usual formula, and the "*AC*" value used to determine the price payable in respect of the amendment is the contractor's "*allowable costs resulting from the amendment*". **This calculation is shown in figure 4.**

Where the costs cannot be distinguished, the price payable under the amended contract is also the total of (1) "*the original contract price*" and (2) "*the price payable in respect of the amendment*", but in this case the "*AC*" value used to determine the price payable in respect of the amendment is the contractor's

Figure 3: Change to a contractual requirement (non cost-plus QDC)

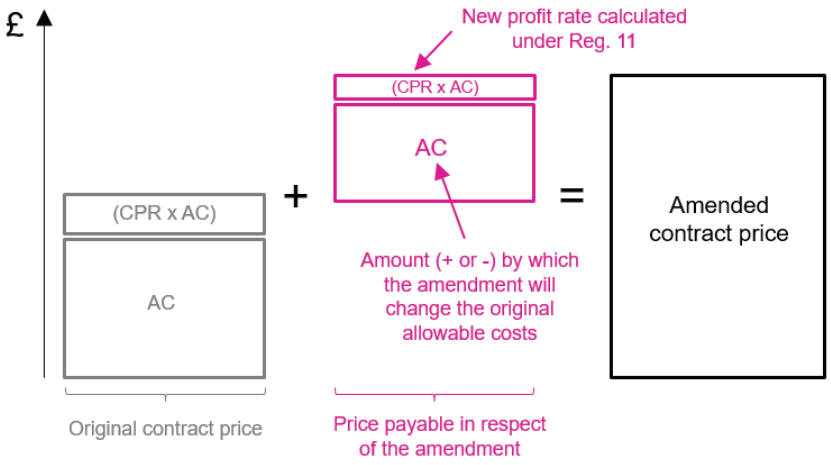
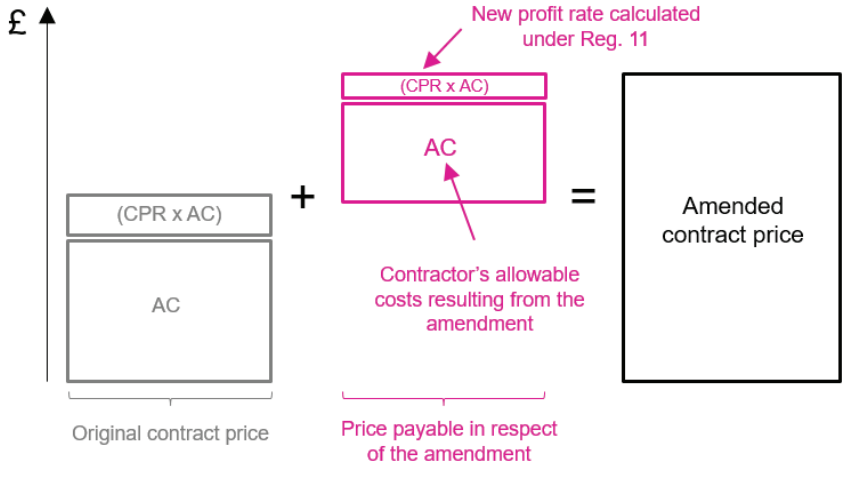


Figure 4: Change to a contractual requirement (cost-plus QDC with distinguishable costs)



"*allowable costs under the contract…after the time of agreement*" (i.e. the date of the amendment). **This calculation is shown in figure 5.**

What does this mean?

As with the old severability test under Regulation 14, there is no guidance on what it means for costs to be "*distinguishable*". In a cost-plus context the allowable costs "*resulting from the amendment*" will be actual costs incurred rather than costs estimated at the time of the amendment, so parties will need to consider whether they are able to distinguish costs resulting from the amendment on an ongoing basis.

For example, in the early stages of a large project parties might make successive amendments to a contract to incorporate additional batches of long-lead items to be procured by the contractor. In such case it might be very simple to distinguish the additional *scope of work* resulting from the amendment (namely the additional materials). However, if the procurement of those materials is added to an existing ongoing requirement, the parties must also be able to clearly distinguish the actual costs incurred in procuring each batch of materials in order to successfully operate a mixed economy in which costs incurred during the same period and under the same cost-plus price attract different profit rates.

Where the parties are unable to distinguish costs in this way, the alternative method of calculating the amended contract price seeks to provide a simple solution that differentiates between costs before the date of the amendment and costs after the date of the amendment. This is simple in theory, but in practice may present challenges where costs have been committed but not yet incurred at the date of the amendment.

Other amendments

Lastly, the 2018 Amendment No. 2 Regulations include a catch-all which applies if an amendment proposed does not fall within any of the categories above.

In this case the price payable under the amended contract must be re-determined in accordance with the formula in Regulation 10, and the parties may agree which pricing method to use and may agree that defined components of the contract will be priced by different pricing methods. Unlike the categories above, the catch-all does not make any provision for determining a price payable solely in respect of the amendment; the formula is applied to re-determine the contract price as a whole.

Multiple pricing amendments

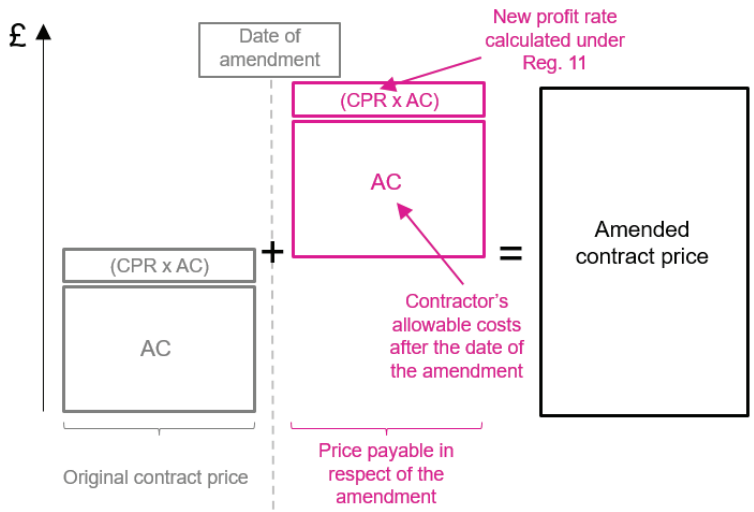
The final part of the 2018 Amendment No. 2 Regulations deals with scenarios where two or more pricing amendments are to be made to a QDC at the same time.

In such cases the amendments are to be treated separately and dealt with in turn, so that the categories above apply to each such amendment as they do to a single amendment. The only qualifications to this principle are that if the parties propose an amendment that changes the pricing method this must be dealt with first, and if they propose a pricing amendment that does not fall within any category (so the catch-all applies) this must be dealt with last.

This might be easier said than done. In reality, contract amendments in complex procurements usually make multiple changes to the terms of a contract at once, in ways that are interlinked, and that are negotiated as a package. Unravelling individual changes to align with the categories identified by the SSCR will not always be a simple exercise.

Ultimately, 2018 Amendment No. 2 Regulations go a long way to addressing the concerns of MoD and industry about their ability to price contract amendments without repricing the whole contract. However, they do so at the cost of additional complexity in an area that is already legalistic. Time will tell what issues this complexity presents, as the new provisions are tested against the multitude of commercial scenarios that parties face in practice.

Figure 5: Change to a contractual requirement (cost-plus QDC with non-distinguishable costs)



Please get in touch if you would like to discuss any of these changes or what they mean for your contracts.

Who to contact:

Chris Chesterman
Director

T +44 (0) 117 307 6865
M +44 (0) 7968 227 275
E chris.chesterman@burges-salmon.com

Melissa Walford
Associate

T +44 (0) 117 902 7780
M +44 (0) 7812 321 752
E melissa.walford@burges-salmon.com