Guidance note

Update to the Single Source Contract Regulations 2014: Changes to the reporting requirements for contractors

he 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 third in our series tracking amendments to the regulations, looking at changes to the reporting requirements, final price adjustments and QSC assessments that will come into effect on 1 September 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**"). They also apply to single-source sub-contracts to QDCs above £25M in value (known as "**Qualifying Sub-Contracts**" or "**QSCs**").

The Single Source Contract (Amendment) Regulations 2019 (the "**2019 Amendment Regulations**") will come into force on 1 September 2019, making some significant changes to the obligations of parties under QDCs and QSCs[1]:

- Additional information in relation to sub-contracts to be provided in the reports submitted under QDCs
- A new obligation on contractors to notify the MoD and the Single Source Regulations Office (SSRO) every time they carry out an assessment of whether a proposed sub-contract would be a QSC
- Amendments to the data to be provided to the MoD in supplier reports in relation to cost variance, budgeting, and the sites at which activities relating to QDCs are undertaken
- Clarification of how final price adjustments are calculated and a change to the way in which final price adjustments for QSCs are implemented
- Simplification of the way in which the values of related contracts are aggregated when determining whether they exceed the £5M threshold to be a QDC

This article summarises the key changes and offers some observations on what they mean in practice for the MoD and contractors.

The key changes and what they mean for the MoD and contractors

Additional reporting requirements in QDC reports

Regulations 24 to 28 of the SSCR set out reports that contractors are required by law to provide to the MoD under QDCs: a Contract Reporting Plan, a Contract Notification Report, Quarterly Contract Reports, Interim Contract Reports and a Contract Completion Report.

The 2019 Amendment Regulations amend the required content of these reports in three ways:

- In the Contract Notification Report, Quarterly Contract Reports, Interim Contract Reports and Contract Completion Report, the requirement to provide specified details in relation to sub-contracts (such as pricing and scope, association with the prime contractor, and SME status) now applies to all sub-contracts valued at £1M or more, rather than being limited to the 20 highest-value sub-contracts above that value.
- In the Contract Notification Report, Quarterly Contract Reports, Interim Contract Reports, and Contract Completion Report, for all sub-contracts valued at £15M or above contractors must report whether they have assessed that the sub-contract would be a qualifying sub-contract and the outcome of that assessment, confirm whether the sub-contract was or will not be competitively tendered, and confirm whether the sub-contract enables the performance of any other contracts.
- The obligations to report information relating to the "*value*" of a QDC have been amended to refer to the "*contract price*". This means that reports should refer to the contract price determined in accordance with Regulation 10, rather than a more subjective assessment of the "*consideration…which the contracting authority expects will be payable*" at the date the contract is entered into.

[1]The amendments also make a number of clarifications and corrections to the drafting of the SSCR

For QDCs with large numbers of high-value sub-contracts, the change in sub-contract reporting will increase the burden on contractors, but most of the additional required information should be readily available in contractors' procurement plans. The change in terminology from "*value*" to "*contract price*" appears to be intended to provide greater clarity as to the reference value to be used (particularly where the contract price has been amended), but it will remain at least partly subjective for target price, estimate-base fee and cost-plus contracts, where the price is not known until the contract has been performed.

New recordkeeping and reporting obligations on assessment of sub-contracts

Regulation 61 of the SSCR requires contractors to assess whether any sub-contract that they propose to enter into for the purposes of a QDC (or a proposed QDC) would be a QSC if it was entered into. They must keep records of those assessments.

The 2019 Amendment Regulations insert two new obligations on contractors in relation to these assessments:

- Where the value of a proposed sub-contract is £15M or more, the contractor must include in the records an assessment of whether the proposed contract would be the result of a competitive process, and any other reason relied upon to justify a negative assessment.
- Where the contractor makes a record of its assessment, it must notify the MoD and the Single Source Regulations Office (SSRO) that an assessment has been made.

The new recordkeeping obligation may not significantly change what contractors do in practice. A proper assessment and record of whether or not a sub-contract would be a QSC must include an assessment of whether the sub-contract would be the result of a competitive process, since this relates to the legal criteria for a sub-contract to be a QSC, and the basis on which the decision was made that the sub-contract was not a QSC. However, it might be inferred that this obligation has been included to remedy some failure (or perception of failure) by contractors to keep satisfactory records.

On the face of it, the new notification obligation is a significant one for contractors with large supply chains. It applies to all sub-contract assessments (not only those where the value of the proposed sub-contract is £15M or more), and effectively extends the existing notification obligations under Regulation 61, which previously required notifications only of positive assessments and did not require direct notification to the SSRO. Contractors can expect the SSRO to take a keen interest in these notifications, not least because the SSRO has previously published its view that contractors should carry out assessments under Regulation 61 for material amendments to *existing* sub-contracts – as well as new sub-contracts – an interpretation that is not shared by all.

Amendments to supplier reports

In addition to contract reports under QDCs, Part 6 of the SSCR requires companies to submit supplier reports to the MoD in relation "Qualifying Business Units" that are providing deliverables under QDCs or QSCs with a total value of at least £10M.

The 2019 Amendment Regulations make a number of changes intended to refine the data provided to the MoD and ensure the associated reporting burden is proportionate. In particular:

- In the QBU Actual Cost Analysis Reports provided under Regulation 35 and the QBU Estimated Cost Analysis Reports provided under Regulation 37, a threshold of materiality now applies to the requirements to provide explanations of cost variance.
- In the Estimated Rates Claim Reports provided under Regulation 36, suppliers must now include "*budgeted volume data*" in addition to the budgeted cost for the QBU, which is intended to enable the MoD to better understand the drivers of future contractor rates.
- In the Strategic Industry Capacity Reports: Activities People and Infrastructure provided under Regulation 42, the requirement to include a description of physical sites at which activities relating to QDCs have been undertaken now applies only to sites at which £10M or more of costs have been attributed, rather than £1M.

Changes to final price adjustments

Regulations 16 and 17 of the SSCR set out a procedure for making a final price adjustment under a QDC priced using the firm, fixed or volume-driven pricing method, which is designed to protect against excessive profits and losses being made by the contractor. The SSCR allow the Secretary of State to direct that a QDC valued under £50M is exempted from this procedure.

The 2019 Amendment Regulations clarify that, where a QDC includes any elements that are priced on another basis (such as cost-plus or target price elements), those elements are excluded both when

determining the value of the QDC for the purposes of an exemption and when calculating the adjustment itself.

These clarifications reflect the only logical way of applying Regulations 16 and 17 in practice, but some ambiguities remain as to how final price adjustments apply to QDCs with multiple firm, fixed or volume-based prices.

Final price adjustments for QSCs

The 2019 Amendment Regulations also change the way in which final price adjustments under QSCs are dealt with. Under a new Regulation 66, if a final price adjustment is calculated under a QSC, the price of the QSC itself will not be adjusted, but instead a reconciliation payment is made directly to or from the MoD and the sub-contractor.

The rationale for this change is straightforward: the purpose of any such adjustment is solely to protect against the sub-contractor making excess profit or loss, which should not interfere with the cost risk taken or profit made by the prime contractor. However, there may be accounting or other financial implications of giving effect to this provision in practice, as the payment in either direction is between parties with no contractual relationship and it is not in consideration for the delivery of any goods, works or services.

Calculating the value of contracts

Regulation 5 of the SSCR sets out how to determine the value of a contract for the purposes of the SSCR. The value is relevant to a number of other provisions, most importantly to determine whether a contract meets the £5M threshold to qualify as a QDC or the £25M threshold to qualify as a QSC.

Regulation 5 requires the values of related contracts entered into with the same supplier to be aggregated to produce an overall value, to protect against avoidance of the regulatory framework by fulfilling requirements for goods, works or services under multiple lower-value lots or a series of contracts.

The 2019 Amendment Regulations amend Regulation 5 in four ways:

- One of the methods for aggregating the values of related contracts has been removed, leaving a single method under which the values of contracts with the same supplier must be aggregated where they are entered into to fulfil the same requirement.
- When aggregating the value of contracts, the MoD must disregard contracts with values of £250k or less where it is reasonably satisfied that the procurement has not been subdivided to avoid the regulatory framework.
- Competitively let contracts are excluded from the aggregation exercise.
- Even if an aggregated value exceeds the £5M threshold to qualify as a QDC, the MoD can only treat an individual contract with a value of £1M or less as a QDC if it is reasonably satisfied that the procurement has been subdivided to avoid the requirements of the regulatory framework.

A single method of aggregating the values of related contracts is welcome, as it maintains the overall policy objective of anti-avoidance in a simpler way. The exclusion of competitively let contracts from the aggregation exercise is logical as the competitive process serves the same purpose of assuring value for money that the regulations are designed to achieve.

Perhaps most importantly, the exclusion of contracts below £250k from aggregation altogether, and the introduction of a default position that contracts below £1M are not QDCs, should avoid placing a disproportionate administrative burden on large numbers of low-value contracts. It also creates a neater parallel with MoD Commercial Policy on single-source non-qualifying contracts, under which SSCR principles on pricing and transparency are generally applied to contracts above £1M in value.

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

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