

Single Source Contract Regulations 2014 Guidance

Chapter 3 Pricing a Qualifying Defence Contract: The Cost Element

Purpose

1. The guidance in this chapter relates to a Qualifying Defence Contract (QDC) and applies equally to a Qualifying Sub-contract (QSC), unless stated otherwise. To assess whether you are dealing with a prospective or actual QDC or QSC you must read [Chapter 2 Qualifying Defence Contracts](#).
2. The guidance does not apply to other single source contracts (Non-qualifying contracts). If you assess that your contract is a Non-qualifying contract then you must read the [Pricing of Single Source Non-qualifying contracts](#) Commercial Policy Statement, and also Commercial Cascade 06/2017.
3. If you are dealing with a prospective or actual QDC or QSC then you must read this chapter to understand:
 - a. the **statutory obligation** on the contractor to provide MOD with transparency of their price proposal in the periods before and immediately after contract award, including the requirement to submit a Contract Pricing Statement;
 - b. the **statutory obligation** on MOD to assess and be satisfied that the contractor's proposed costs are Allowable Costs;
 - c. how costs can be either direct or indirect and how indirect costs are often priced in contracts using labour & overhead 'recovery rates', sometimes called 'MOD Agreed Rates' (usually following a CAAS investigation);
 - d. the steps you can take to seek pricing assistance from CAAS;
 - e. why you may sometimes have to agree a 'provisional price' and the problems that may cause when pricing a QDC;
 - f. the different 'regulated pricing methods' permitted by the Defence Reform Act (DRA) and the use of Maximum Price / Limit of Liability clauses when placing a QDC;
 - g. that in some circumstances the contract price you agree may be subject to a Final Price Adjustment (FPA), if there has been an excess profit or loss on the contract, as defined in the DRA / SSCR;
 - h. that subcontractors with a Qualifying Sub-contract have the same obligations to show that their proposed costs are Allowable Costs;
 - i. how both parties are able to refer pricing matters to the external Single Source Regulations Office (SSRO) for an opinion (non-binding) or determination (binding).

4. This chapter has been created as definitive guidance for MOD commercial officers so 'you' indicates an action on the commercial officer.

What is the Legal Framework?

5. The primary legislation is the [Defence Reform Act 2014 \(DRA\)](#). Sections 15 – 21 of the DRA set out the principles for agreeing the contract price and Section 24 refers to contract reports.

6. The secondary legislation is the [Single Source Contract Regulations 2014 \(SSCR\)](#). Part 3 of the SSCR sets out the principles for agreeing the contract price and Part 5 covers reports on QDCs.

Confidentiality – Criminal Offence of Unauthorised Disclosure

7. The DRA requires contractors with QDCs to keep relevant records which the MOD may access. Contractors must also provide a range of standardised reports to the MOD and the Single Source Regulations Office (SSRO). Much of the information received will be commercially sensitive and you must handle it accordingly. Schedule 5 of the DRA explains 'permitted disclosures' of information received under the DRA / SSCR. You can find detailed guidance on your confidentiality obligations in relation to Schedule 5 protected information at [Chapter 9 Confidentiality](#).

The Contract Price Formula

8. The DRA states the price payable for a QDC must be determined in accordance with the pricing formula:

$$\text{Allowable Costs} + (\text{Allowable Costs} \times \text{Contract Profit Rate}) = \text{Contract Price}$$

9. The pricing formula applies regardless of which pricing method you have used. For example, the Allowable Costs for a firm priced QDC are based on the agreed estimated costs at the time of pricing. For a cost plus contract the Allowable Costs are the actual costs incurred on the contract.

10. This chapter does not provide guidance on calculating the Contract Profit Rate; you can find information on that in [Chapter 4 Pricing a Qualifying Defence Contract: The Profit Element](#).

No Acceptable Price, No Contract (NAPNOC)

11. MOD policy is that you should approach the price negotiation on the basis of the No Acceptable Price, No Contract (NAPNOC) principle. This long established principle is not changed by the DRA. A NAPNOC compliant contract is where a price is agreed at the time of contract award, based on a negotiated estimate of the contract costs. A contract is not NAPNOC compliant if the price is agreed after contract award, for example a contract placed on an ascertained cost or provisional price basis. See paragraphs 32 – 36 below for guidance on provisional pricing.

12. Although contracts priced on the basis of ascertained costs are permitted under the DRA (e.g. cost-plus or Target Cost Incentive Fee (TCIF)), you should only use these non-NAPNOC approaches when authorised to do so by your commercial line management.

Allowable Costs

13. There are three principles set out at the DRA Section 20(2) which determine whether a cost is allowable. These are explained further in the 'Single Source Cost Standards: Statutory Guidance on Allowable Costs' (SSCS or SGAC) published by the [SSRO](#). To be allowable, the contractor must provide evidence that their costs are:

- a. appropriate – the type of cost is appropriate to be recovered through a QDC;
- b. attributable – the cost relates to the activities being undertaken for the QDC; and
- c. reasonable – the amount of the costs are reasonable in the circumstances.

14. Section 20(4) of the DRA enables the MOD to require a contractor to show that their proposed costs are allowable by submitting sufficient supporting evidence to the MOD. It is not your responsibility to specify in detail what constitutes adequate supporting evidence. Although you may provide broad clarification, it is for the contractor to make their own judgement about the level of evidence required to show that all their costs are allowable.

15. It is your responsibility on behalf of the MOD to assess whether the contractor has shown their costs are allowable, and that you understand the basis of their proposal. This is a statutory obligation on the MOD so if you are not satisfied that a contractor has justified their costs you should challenge their proposal and seek further clarification.

16. To verify that the contractor's proposed costs are allowable, you must also follow the SGAC. Costs must pass each of the AAR principles – if they fail any one of these principles there is no need to continue with your assessment. For example, if a cost is not appropriate it is not allowable so there is no need to review whether the cost is attributable or reasonable.

17. Your contractor might request that you provide them with a statement that the MOD agrees their costs are allowable. You should not provide this statement – it is your role to be satisfied that costs are allowable, but only from the MOD's perspective. It is important that each party recognise their separate obligation in relation to Allowable Costs and make their own independent judgement as to whether costs are allowable.

18. You must comply with the SGAC to determine whether costs are allowable unless you have clear and convincing reasons to deviate from them. You must follow the SGAC in force at the time the contract is entered into (or in the case of estimated cost recovery rates pre-agreed by the MOD, when those rates are agreed). There is more information about cost recovery rates at paragraphs 22 – 31.

19. If you believe any deviation from the SGAC is appropriate you must confer via email to [DESComrcl-SSAT-1\(Multiuser\)](mailto:DESComrcl-SSAT-1(Multiuser)) before reaching any agreement with your contractor.

20. If you require CAAS support to scrutinise a QDC price proposal, you must complete a [DEFFORM 122](#). If you are unable to secure CAAS or other expert support then you will have to undertake the task using your own and your team's resources.

21. If you have to sign a contract before you have received satisfactory assurance from the contractor that their costs are AAR (e.g. you need to sign for reasons of operational necessity), you must put this in writing to your contractor. If you are satisfied with some elements of the contractor's costs but not others, then you should specify which costs cause you concern and why (i.e. the costs are not adequately shown to be allowable).

Direct Costs, Indirect Costs and MOD Agreed Rates

22. A contractor's proposal will be made up of both direct and indirect costs. Regardless of whether their costs are direct or indirect they have a statutory obligation to show you that all their costs are allowable, and you have a statutory obligation to be satisfied that this is the case.

23. Direct Costs arise as a direct result of the contractor performing the contract and are attributable to that contract alone. For example direct labour, raw materials and sub-contracted elements.

24. Indirect costs (e.g. lighting and heating) do not relate directly to a single contract but may be reasonable costs of doing business which the contractor seeks to recover from the MOD and other customers. There are two methods that apply to the recovery of indirect costs: Direct Recovery¹ or Absorption Recovery². Either method is permitted under the SGAC although the common approach in MOD single source pricing is the latter, the prior agreement of contractor cost absorption recovery rates.

25. These recovery rates are typically investigated by CAAS as part of an annual, formalised 'Rates Programme'. After completing their investigation CAAS will make a recommendation to the senior commercial officer allocated as the lead for a named contractor and, if accepted, the rates become 'MOD Agreed Rates' for use in pricing.

26. Agreed Rates can either be Agreed Estimates or Agreed Actuals. Agreed Estimates are forward looking and usually relate to the contractor's current financial year, ideally agreed with MOD at or near the start of that financial year. Agreed Estimates are used in firm and fixed pricing, or to agree the Target Cost in a TCIF contract. Agreed Actuals relate to the contractor's previous financial year and are required for any contract to be priced on the basis of actual costs (also called ascertained costs).

27. You can check whether your contractor has current MOD Agreed Rates by

¹ When using a Direct Recovery method the overhead costs are priced as an identifiable set of line items within a contract. Under the DRA and SSCR, direct recovery of overheads is treated in the same way as Direct Costs.

² Absorption costs are priced across the outputs of the contractor and added at an agreed rate across the quantities ordered.

contacting [DES CAAS-Acct-DepHoP4](#), copied to [DES CAAS-Acct-DepHoP-SL](#). 'Current' normally means the contractor's current or previous financial year; any rates that are older must be treated with caution because they are unlikely to comply with the relevant statutory guidance on allowable costs. Where there are current Agreed Rates in place you must not negotiate the use of other rates unless the rates have become materially inaccurate since they were agreed.

28. Rates must be in accordance with the SGAC i.e. the costs recovered through the use of Agreed Rates must be appropriate, acceptable and reasonable costs. Rates that were agreed prior to the SSCR coming into force (Dec 2014) will almost certainly not be in accordance with the SGAC and should not be used for pricing new work.

29. The SSCR permits Allowable Costs to be estimated at the time of agreement (i.e. when the contract is entered into or amended) for some pricing methods (see paragraph 39 below), using the SGAC in force at that time. However, in reality some costs may be estimated before the contract is entered into or amended. Likewise, the MOD Agreed Rates process is typically an annual, cyclical process, and rates may have been agreed between the parties before being used in the pricing of a QDC.

30. This does not mean that the use of such cost estimates in pricing including those within MOD Agreed Rates, would necessarily contravene the SSCR as long as it was reasonable to do so, taking into account the commercial realities of pricing a contract. Things you might consider when questioning whether it is reasonable to do so, include; the justification for estimating the costs at an earlier time; how long before contract award / amendment date the costs were estimated; and whether anything had come to the parties' attention in the period between cost estimating and contract award / amendment which would make it unreasonable to use those cost estimates.

31. You must challenge assumptions which have been made by the contractor that impact the contract price if you believe their assumptions to be questionable. You must document these challenges and the contractor's responses in your contract file minutes. The SSRO may need to take these records into account in any future referral (if a referral is made by either party to the contract – see paragraphs 70 - 74).

Provisional Pricing

32. A provisional price (also called a 'pegged price') is a price that neither party intends to be the final contract price. It is a temporary price, pending agreement between the parties of the final contract price (although noting that if no agreement is ever reached then the provisional price would be the contract price). A provisional price might be used because there is an outstanding pricing matter which the parties are unable to settle prior to contract award.

33. A QDC placed on the basis of a provisional price is not compliant with the DRA / SSCR because provisional pricing is not one of the 'regulated pricing methods' specified at clause 10 of the SSCR 2014. For this reason (and others below) you should avoid provisional pricing as far as possible.

34. The most common reason for entering into a QDC on a provisional price basis is that MOD Agreed Rates for the contractor are not available. In this situation it is likely to be difficult for the contractor to show that their proposed costs are compliant with SSRO Statutory Guidance on Allowable Costs, so you may have to contract on the basis of provisional rates until such time that Agreed Rates are available.

35. A problem with provisional pricing is the agreement of an SSCR compliant Contract Profit Rate (CPR), the calculation of which must begin with the published Baseline Profit Rate (BPR). The BPR that must be applied to finally agree the price of the QDC must, under Regulation 14 of the SSCR 2014, be the BPR in force at the time when you amend the contract (to replace the provisional rates with agreed rates). The BPR at the time of amendment may be higher or lower than the BPR in force at the time you let the contract, consequently this change in the profit rate is likely to cause issues for one party or the other. Other adjustments within the CPR calculation may also be affected (e.g. 'step 6' Capital Servicing Adjustments). To further understand how contract amendments must be priced, see paragraphs 61 - 67 below.

36. For all these reasons provisional pricing should be avoided as far as possible. If used then the contractor must record the provisional status of the price at contract award, in the Contract Pricing Statement (CPS) - see paragraphs 49 - 54 below. You must include a clause in the contract which states the intention of both parties to agree a DRA/SSCR compliant price at a later date. You should seek Commercial Legal Services (CLS) assistance in drafting a suitably worded clause.

Failure to Agree on Pricing Matters

37. There may be cases where you are unable to reach agreement with the contractor on whether all or part of a cost is 'Allowable'. Where attempts to resolve such an issue fail, the SSCR allow for certain matters to be referred by either party to the SSRO. You may only make a referral to the SSRO via the MOD SSAT.

38. A referral made prior to contract award may lead to an SSRO opinion which the parties must consider carefully, even though as an opinion it is not binding on them. However, once on contract either party has the right to request an SSRO determination which is legally binding on the parties. You can find details of the pricing matters subject to SSRO opinions and determinations in the Disputes and Remedies section at paragraphs 70 - 74.

Pricing Method

39. Regulation 10 of the SSCR states that at the time of entering into a QDC both parties must agree the regulated pricing method to be used as described below. You may agree to price components of a QDC using a combination of different pricing methods. If you have a QDC which has a tasking element, the contract should state how those future tasks will be priced, and when in the future they come to be priced, they must be SSCR compliant. The regulated pricing methods are:

- a. Firm pricing – the contract price is calculated using an agreed value

for the estimated Allowable Costs, at the date the contract is entered into. Where a firm price is agreed it can only be amended through a contract amendment agreed by both parties. The exception is that under SSCR Regulations 16 and 17, a firm price may be subject to a Final Price Adjustment, if an excess profit or loss has occurred – see paragraphs 42 - 43 below.

b. Fixed pricing - the contract price is calculated using an agreed value for the estimated Allowable Costs, at the date the contract is entered into. However, the price may subsequently be adjusted in accordance with changes in specified indices or rates, between the time of agreement and a specified time. As with a firm price, a fixed price may also be subject to a Final Price Adjustment if an excess profit or loss has occurred.

c. Cost Plus – the contract price is calculated using the total actual Allowable Costs incurred by the contractor at the completion of the contract. Interim calculations may occur through the life of the contract, if appropriate.

d. Estimate Based Fee – this is a hybrid type of pricing partly based on an estimate of costs and partly based on actual costs. An estimated value of Allowable Costs is agreed at the date the contract is entered into but this is only used to establish the contract fee (i.e. profit) by applying the agreed Contract Profit Rate to those estimated costs. The contract price is determined later by adding the actual Allowable Costs incurred by the contractor to the calculated fee.

e. TCIF – a target cost is calculated using a value for the estimated Allowable Costs agreed at the date the contract is entered into. The final contract price is then determined at the end of the contract by reference to the actual Allowable Costs incurred by the contractor. The final price is subject to an adjustment by contract terms governing the sharing between the parties of any cost overrun or under-run against the target cost. In the event of a dispute concerning the Allowable Costs claimed, either party may refer the matter to the SSRO for determination.

f. Volume driven pricing – this is another hybrid type of pricing also partly based on an estimate of costs and partly based on actuals. The cost or rate (e.g. cost per widget; or cost per hour) is agreed between the MOD and the contractor, on the basis of cost estimates. The actual contract price is subsequently agreed on the basis of applying those agreed cost or rate estimates to the actual number of items, or hours, required by the MOD. For example, the agreed firm price of £75 per widget (based on estimates) is applied to the actual number of widgets used. So at £75 per widget if MOD used 100,000 widgets the volume driven contract price would be £7.5M, whereas if MOD used 80,000 widgets the contract price would be £6M. Under the SSCR, the estimated cost element of a volume-driven price may be subject to a Final Price Adjustment, if an excess profit or loss has been made - see paragraphs 42 - 43.

Use of Maximum Price (MP)/Limit of Liability (LoL)

Clauses

40. The MOD sometimes uses MP / LoL clauses when placing contracts on an ascertained cost basis (e.g. TCIF, cost-plus contracts). Legal opinion is that on a QDC this has potential to conflict with the DRA / SSCR which states that for a cost-plus contract the Allowable Costs are the actual Allowable Costs incurred by the contractor. So if a contractor incurs costs that would in all other respects be Allowable Costs but which the MOD seeks to disallow because they exceed a MP / LoL, the contractor might have a case that to be compliant with the DRA / SSCR, such costs should in fact be allowed in the contract price.

41. For this reason you must recognise the MP / LoL for what it is – a budgetary control device and not necessarily a legal cap on the contract price. If you set a MP / LoL you must also include an obligation on the contractor to give notice of their actual incurred costs, in relation to the MP / LoL. There must be a sufficient period of notice to give you enough time to decide on an appropriate course of action before the MP / LoL is actually breached (e.g. stop the work, raise the LoL, reduce the requirement).

Final Price Adjustment (FPA) - Protection against Excess Profit and Losses (PEPL)

42. The DRA Section 21 and SSCR Regulations 16 and 17 provide for a statutory Final Price Adjustment (FPA) which may result in either an increase or decrease to the contract price. The MOD refers to this mechanism as Protection against Excessive Profit and Loss (PEPL). PEPL applies to all QDCs (or components of a QDC) priced using either firm, fixed and /or volume driven pricing methods. You can find more detailed information about how PEPL operates in [Chapter 7 End of Contract Activities and Reports](#).

43. The existence of an FPA provision in the legislation does not mean that a contingent liability is created for the MOD at the point of contract award. You must not report a contingent liability simply because you have placed a QDC. However, the contract reporting regime for a QDC requires the contractor to provide the MOD with a forecast of the price impact, if and when they believe an FPA will be required. It is at this point that a contingent liability for the MOD may be created and you must share this information with your finance team.

Dis-application of PEPL

44. The DRA Section 21 (5) allows the MOD to 'switch off' the PEPL FPA prior to QDC award, so it will not apply in the event of an excess profit or loss on the contract. This option is only available for QDCs valued between £5m and £50m; QDCs above the £50M threshold will always be subject to the PEPL mechanism.

45. The MOD's default policy is not to disapply PEPL. However there may be circumstances under which you may consider taking this step, for example:

- a. where there are follow-on contracts and you want to incentivise the contractor to reduce their costs as much as possible in the current contract; or

- b. to incentivise the contractor to manage the risk.

46. If you wish to disapply PEPL you must consult the MOD SSAT and seek approval from your 1* Commercial.

47. You must include DEFCON 803 in your contract to disapply PEPL where you have obtained 1* Commercial approval. If you do not wish to disapply PEPL then you must not include DEFCON 803 in your contract.

PEPL and Qualifying Sub-contracts

48. PEPL applies to all QSCs priced using either firm, fixed and /or volume driven pricing methods with a value equal to or greater than £50M. For QSCs where components have been priced using firm, fixed and / or volume driven pricing, PEPL applies where the total value of the component(s) is equal to or greater than £50M. You are not permitted to dis-apply PEPL on any QSCs.

The Contract Pricing Statement

49. The DRA sets a minimum legal requirement for QDC reports which have to be produced by the contractor and submitted to the external SSRO and the MOD. Once a QDC has been placed, the contractor must access the on-line web forms on the Defence Contract Analysis and Reporting System (DefCARS), accessed via the SSRO. Once registered with the SSRO for access to DefCARS, the contractor should also have access to training and guidance documents provided by the SSRO. See Commercial Cascade 07/2017 for more information about the DefCARS reporting system.

50. The first report required is the Contract Initiation Report, which must be submitted within one month of contract award. The Contract Initiation Report comprises of three separate statutory QDC reports, including the Contract Pricing Statement (CPS). The CPS is similar in purpose to the Equality of Information Pricing Statement previously used by the MOD when pricing single source contracts. The purpose of the CPS is described below; other reporting requirements are explained in the following chapters:

- a. 'on contract' reporting in [Chapter 5 Contract Reporting](#);
- b. end of contract reporting in [Chapter 7 End of Contract Activities and Reports](#); and
- c. reports on overheads and forward planning, etc. (supplier level reporting) in [Chapter 8 Supplier Reporting](#).

51. The CPS is a critical report, providing an audit trail for all material pricing facts, assumptions and calculations agreed by the parties at the time of entering into a QDC. The CPS must:

- a. set out any Allowable Costs and the Contract Profit Rate used to determine the contract price;
- b. set out the date and version of the SGAC (described in paragraphs 13 - 21) in force at the time of contract agreement;
- c. describe any known deviation from the SGAC made in pricing the contract;

- d. describe the calculation that has been made to determine the profit rate for the contract, including all adjustments (as described in [Chapter 4 Pricing a Qualifying Defence Contract: The Profit Element](#));
- e. provide a description of facts, assumptions and calculations relevant to the Allowable Costs under the contract, including assumptions and calculations relevant to any risk or contingency included in those Allowable Costs. The calculations and assumptions must:
 - (1) cover each element of the Allowable Costs; and
 - (2) identify any facts or assumptions provided by the MOD and used in the calculation of the Allowable Costs;
- f. describe any other information which is materially relevant to the pricing of the contract.

52. The CPS does not need to duplicate each and every document which contains a fact, assumption or calculation relevant to the contract price, if it is accessible elsewhere. For example, there may be a separate pricing model which explains the price build in detail; in which case it is important that the CPS references that detailed pricing model, including the version number and date, as the basis of the agreed contract price.

53. You must challenge the data and assumptions in the contractor's CPS (or in any of the documents referenced by the CPS), if you do not understand or you disagree with them and the impact of those disagreements is material to the price, and record all correspondence in the contract file. To leave them unchallenged might undermine any future referral to the SSRO for a determination of the contract price (see paragraphs 73 - 74) as the MOD might be seen to have made inadequate efforts to verify the Allowable Costs. While this would not alter the contractor's obligation to use fit-for-purpose pricing assumptions and to submit only Allowable Costs, the SSRO might take it into account when reaching a decision.

54. You may access the CPS and all other ODC reports submitted in connection with your contract, by accessing the DefCARS online reporting system after contract award. You must contact the MOD SSAT [DESComrcl-SSAT-1\(Multiuser\)](#) to register for access to DefCARS, and to receive User Guidance documents. Once you have accessed DefCARS you should check that the CPS submitted by your contractor reflects the agreed price at contract award and ensure there are no inaccuracies or unexpected changes. If the contractor provides a late or misleading CPS or if there is a complete failure by the contractor to provide a CPS, they will be considered to have committed an Actionable Contravention under the DRA / SSCR. This is explained under the compliance and penalty notice regime described in paragraphs 75 - 76.

Sub-contract Pricing

55. A sub-contract of £25m or above may be a qualifying contract under the DRA / SSCR, if placed on a single source basis, predominantly for the purposes of delivering a QDC or group of QDCs, or prospective QDCs. If a sub-contract meets the criteria of a qualifying contract it is called a Qualifying Sub-contract (QSC). You can find further information on QSCs in [Chapter 2 Qualifying](#)

Defence Contracts.

56. A QSC must be priced in accordance with the provisions of the DRA / SSCR. It is the responsibility of the prime contractor to obtain reasonable and accurate quotes for any sub-contracted work, and to agree a price that is appropriate, attributable and reasonable. It is not the MOD's responsibility to assure these costs, only to carry out due diligence that the prime contractor has fulfilled their obligation in pricing the QSC. The contract pricing method for a QSC must be one, or a combination of, the methods described in paragraph 39, and it is for the prime contractor and the sub-contractor to agree the approach.

57. A qualifying sub-contractor must understand they have a legal obligation under Section 20 of the DRA to only propose costs that are allowable in accordance with the SSCS / SGAC. The prime contractor should always seek assurance from sub-contractors, that the QSC is priced in accordance with the SGAC. A sub-contractor who proposes costs that are not allowable in accordance with the SSCS / SGAC may be subject to a referral by the MOD to the SSRO, to determine a contract price adjustment.

58. The normal relationship in a supply chain is between the MOD and the prime, and the prime and the sub-contractor. However, a QSC sub-contractor may be unwilling to share certain information with the prime. This should only apply to some aspects of the price where the sub-contractor and prime may be in direct competition in other areas of their business. Where the sub-contractor needs to protect information some elements of pricing may require agreement between the MOD and the sub-contractor, without the prime's direct involvement.

59. Although the QSC sub-contractor may have provided costs directly to the MOD, the prime still has a duty to ensure all its costs, including any sub-contract costs, are compliant with the legislation. The prime is likely to want to seek assurance from the sub-contractor that any costs agreed directly with the MOD comply with the SGAC. You need to be aware of the confidentiality regime which must operate if you deal direct with the sub-contractor; you can find further information on confidentiality in [Chapter 9 Confidentiality](#).

60. A QDC price proposal may contain significant elements of single source sub-contracting all of which are under £25m and therefore not QSCs. The prime contractor still has an obligation to demonstrate to the MOD that these sub-contract costs are Allowable Costs (since they make up elements of the QDC costs) but there is no legal obligation on the non-QSC subcontractors to provide pricing information, or cost reports once on contract. You should include DEFCON 802 in all QDCs, in order that the MOD has some transparency of these potentially significant value sub-contracts. DEFCON 802 requires the QDC prime contractor to use reasonable endeavours to obtain transparency rights for the MOD, on single source sub-contracts of £1m and over, that are not QSCs.

Pricing an Amendment to an Existing QDC

61. If you amend a contract that is already a QDC, you must price the amendment using the SGAC in force at the time of the amendment to

negotiate and agree the Allowable Costs. You must also calculate the Contract Profit Rate using the Baseline Profit Rate and adjustments in force at the time of the amendment. The amendment must be priced using one or a combination of the pricing methods described in paragraph 39. If a new contract item is added on amendment both parties must agree an appropriate pricing method.

62. Pricing of QDC contract amendments is governed by Regulation 14 of the SSCR, this does present some difficulties which the MOD, Industry and the SSRO are currently discussing as part of the first statutory review of the SSCR, due to complete in December 2017, with any changes to the SSCR likely to be actioned in 2018.

63. Regulation 14 classifies contract amendments as 'severable' or 'non-severable' but does not define these terms. Where the costs of the original contract price and the amendment cannot be separated out, the amendment is 'non-severable' in SSCR terms. This gives rise to difficulties concerning the extent to which the price for the entire contract needs to be re-determined and what profit rate should be applied. The SGAC has some guidance on pricing non-severable contract amendments, in particular how sunk costs may be treated.

64. Where the amendment can be priced separately from the original contract price it is defined in Regulation 14 of the SSCR as a 'severable amendment' and is more straight forward to price. In this case, the amended total contract price will be:

- a. the total of the original contract price; plus
- b. any price increase or price reduction payable under the contract which is attributable to the amendment.

65. MOD policy, following the provision of CLS advice on the interpretation of Regulation 14, is that until such time as the SSCR 2017 Statutory review is complete, most amendments are likely to be classified as 'severable' and will be priced using the 'delta approach'.

66. The 'delta approach' means that the profit rate in force at the time of the amendment should only be applied to the £ delta (i.e. difference) between the total Allowable Costs before the amendment, and the total Allowable Costs after the amendment. This £ delta in the Allowable Costs is effectively the value of the 'severable' element. The worked examples at Annex A make it easier to understand this approach.

67. If you require an updated CPS as part of the contract amendment process, you must request one using the on-demand reporting process. You can find further information in [Chapter 5 Contract Reporting](#).

Converting a non-QDC into a QDC

68. If you are amending a single source contract after 18 December 2014 and the contract was originally placed before this date; or if you are placing a single source amendment to a contract originally placed through competition (whether before or after this date), the DRA Section 14 allows you to make the

entire amended contract a QDC, if both parties agree (see [Chapter 2 Qualifying Defence Contracts](#)).

69. Under either circumstance the DRA/SSCR imply that the whole of the contract price will need to be redetermined. However, the SSRO Statutory Guidance on Allowable Costs has clarified this point, and allow that when both parties agree to convert an existing contract to a QDC on amendment, then 'sunk costs' may be left undisturbed, and not repriced. You may contact the MOD SSAT for advice when seeking to convert a non-QDC into a QDC on amendment.

Disputes and Remedies

SSRO Opinions

70. If you have a dispute with your contractor that is preventing the agreement of a contract price you must attempt to resolve the matter through local negotiations and escalate as necessary, including to the MOD SSAT. If you cannot resolve the matter through negotiation, you may wish to seek an opinion from the SSRO. You must not approach the SSRO directly; any MOD referral must be made through the MOD [SSAT](#).

71. During the pre-contract phase the SSRO may give an opinion on any matter if both parties agree to make a joint referral. Certain other matters may be unilaterally referred to the SSRO for an opinion, by either the MOD or the contractor. These unilateral referrals relating to a proposed QDC or proposed amendment to a QDC are set out at SSCR Regulation 51 (1), and are:

- a. the appropriateness of Contract Profit Rate adjustments (see [Chapter 4 Pricing a Qualifying Defence Contract: The Profit Element](#));
- b. the appropriate amount of group cost risk adjustment, group Profit On Cost Once (POCO) adjustment or group capital servicing adjustment (see Chapter 4 Pricing a Qualifying Defence Contract: The Profit Element);
- c. the appropriateness of the cost recovery rates used by the contractor to estimate likely Allowable Costs; and
- d. the extent to which a particular cost would be an Allowable Cost.

72. An SSRO opinion made before contract let is not legally binding but will provide a clear indication of how the SSRO believe the pricing dispute should be resolved. This is important because under SSCR Regulation 51 (2), either party can refer any of the above matters for an SSRO determination once on contract (see SSRO determinations below). In this scenario the SSRO is very likely to maintain their original position unless there has been a significant change of circumstance.

SSRO Determinations

73. Once on contract the MOD or the contractor may seek a legally binding determination on certain matters relating to contract pricing. Under the SSCR,

either party may ask the SSRO to make a binding determination on any of the matters referred to at Regulation 51 (2) summarised at paragraph 71 above. The SSRO could make a legally binding order that the contract price be adjusted to what it would have been had the pricing principles been followed. You can find examples of previous SSRO determinations and opinions on the [SSRO](#) website.

74. If you require a determination from the SSRO about Allowable Costs, you must give at least 20 working days written notice to the contractor requesting evidence of how the principles of the costs being allowable were met. If you have not received a response within 20 working days, or you have received a response which you consider to be unsatisfactory, you may still proceed with your request for an SSRO determination without the contractor's evidence. You can find more information on the SSRO referrals process in [Chapter 12 The Single Source Advisory Team](#).

Compliance and Penalty Notices

75. The SSAT will monitor the contractor's performance, including compliance with the prescribed timescale for submitting a CPS, and other matters such as the timely submission of recovery rates claims (see [Chapter 8 Supplier Reporting](#)). If the contractor fails to submit or submits a late CPS, or submits a misleading or inaccurate CPS, the SSAT may, depending on the circumstances, issue a compliance notice and / or penalty notice.

76. The SSAT has sole responsibility for managing the compliance regime and issuing compliance notices. You can find further information about the compliance and remedies regime in [Chapter 10 Compliance and Remedies](#).

Contacts, Training and Further Information

77. The [Web Access Page](#) for the DRA and SSCR contains a summary of the legislation, details of who you can speak to for advice, and what training is available. It also contains links to other chapters in the SSCR guidance and other relevant topics and information.

What are the Key Points to Remember

1. Costs must meet the three principles of being Allowable Costs – they must be appropriate, attributable and reasonable.
2. The contractor has a responsibility under Section 20 of the DRA, to only propose costs they believe are allowable and in accordance with the 'Single Source Costs Standards: Statutory Guidance on Allowable Costs' (SSCS, or SGAC). The contractor has an obligation to show how their costs are allowable, when requested to do so by the MOD. Therefore, you should always ask a contractor to show you how their proposed costs are allowable.
3. You have a statutory obligation on behalf of MOD, to be satisfied that contractor's costs are Allowable Costs.
4. You should not make any statement to a contractor that you agree that their costs are allowable. You are making a judgment only on behalf of the MOD; the contractor must make their own judgement as to whether they believe their costs are allowable.
5. You must not negotiate away from MOD Agreed Rates unless there is good evidence why they should not be used (e.g. material events have occurred which make them inappropriate). Disregarding pre-agreed rates without good reason will undermine the MOD's position and leave it exposed to a challenge from the contractor.
6. You must ensure you use the current version of the SGAC at the date of agreeing a contract price, or a contract amendment.
7. You must ensure you keep an auditable record of all assumptions, agreements and challenges to the Allowable Costs and pricing of the contract.
8. In exceptional circumstances you may award a QDC on the basis of a provisional price. You must include a contract clause stating what elements of the price are provisional and making explicit the intention of the parties to amend the contract at a later date to agree an SSCR compliant price. You must be aware that using provisional costs or rates may also make at least part of the profit rate agreed at contract a provisional rate, to be amended in accordance with SSCR Regulation 14.
9. If you use a Maximum Price or Limit of Liability on a QDC or QSC you must recognise that it is not necessarily a cap on the price MOD may have to pay – it is essentially a budgetary device and you must ensure the contractor has an obligation to give you good warning of any potential breach of the MP / LoL, in order that you can take appropriate action.
10. PEPL applies to all Qualifying Sub-contracts priced using either firm, fixed and / or volume driven pricing methods, or components of, with a value equal to or greater than £50M and cannot be dis-applied. It also applies to similarly priced QDCs but can be dis-applied for contracts with a value below £50M by use of DEFCON 803.
11. Contract amendment of QDCs can sometimes produce difficult pricing issues - you should understand the approach set out in this guidance and seek

further advice from the MOD SSAT if you are uncertain how to proceed.

12. You must be aware Schedule 5 of the DRA sets out provisions relating to the permitted disclosure of SSCR information received from contractors, and of unauthorised disclosures. There are penalties which apply to you personally, which may include a fine or imprisonment. You should read [Chapter 9 - Confidentiality](#) to understand these provisions.

13. You must not contact the external SSRO. If there are issues which you wish to raise with the SSRO, you must engage with the MOD SSAT.

Annex A: Pricing an Amendment to a QDC - the 'Delta' Approach

Background

1. Regulation 14 of the SSCR requires that the contract price must be re-determined when an existing QDC is amended. The contract price should be re-determined in different ways, depending on whether the amendment is 'non-severable' or 'severable'. Neither the DRA 2014 nor the SSCR 2014 explain what makes an amendment 'severable' or 'non-severable'.

2. MOD's policy, supported by Central Legal Services (CLS), is that if the parties agree to either an increase or decrease to the Allowable Costs, to perform the amended requirement, then that contract amendment may be considered 'severable'. The £ delta in Allowable Costs resulting from the amendment is the severable amendment cost and should be priced in accordance with SSCR Regulation 14(2):

14(2). Where the allowable costs relating to the amendment are severable from the allowable costs under the contract before the amendment, the amended contract price is the total of—

- (a) the price payable under the contract before the amendment; and
- (b) any increase or decrease in the price payable under the contract which is attributable to the amendment.

3. To comply with the SSCR, the contract profit rate applied to the Allowable Costs described at Regulation 14(2)(b) should be a contract profit rate calculated using the published rates in force at the time of the amendment.

Examples

Example 1 – A firm priced contract where there is an increase in the estimated costs of the contract arising from the amendment.

£	
Original estimated costs	10,000,000
Original contract profit rate @ 10%	1,000,000
Original firm price of QDC	11,000,000

£	
Revised estimated costs, to perform amended requirement	12,000,000
'Delta' the difference between Original and Revised estimated costs	+2,000,000
Revised contract profit rate at time of amendment	8%

£	
Original firm price of QDC	11,000,000
Price attributable to amendment: 2,000,000 + (2,000,000 x 8%)	2,160,000

Re-determined QDC price in accordance with SSCR Regulation 14(2)	13,160,000
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Example 2 – A firm priced contract where there is a decrease in the estimated costs of the contract arising from the amendment.

	£
Original estimated costs	10,000,000
Original contract profit rate @ 10%	1,000,000
Original firm price of QDC	11,000,000

	£
Revised estimated costs, to perform amended requirement	6,000,000
'Delta' the difference between Original and Revised estimated costs	-4,000,000
Revised contract profit rate at time of amendment	8%

	£
Original firm price of QDC	11,000,000
Price attributable to amendment: $-4,000,000 + (-4,000,000 \times 8\%)$	-4,320,000
Re-determined QDC price in accordance with SSCR Regulation 14(2)	6,680,000