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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

OPEN-ENDED CONTRACTS

Note by the Secretary of the Cabinet

On 21 February, following the invasion of Afghanistan, OD accepted a recommendation by the Secretary of State for Energy that a contract by the CEGB for the supply of enriched uranium from the Soviet Union should be allowed to continue. They agreed that to do otherwise would have involved substantial extra costs in obtaining the supplies from elsewhere (OD(80) 5th Meeting, Minute 3, conclusion 2).

2. The Committee instructed me, however, to consider how guidance should be given to Government Departments and nationalised industries about the undesirability of entering into open-ended contracts with no provision for termination. I attach a fuller memorandum which has been prepared in consultation with the Departments mainly concerned. The Prime Minister has agreed ~~but~~ THAT this memorandum could most appropriately be considered by the Ministerial Committee on Economic Strategy.

3. As far as Government Departments are concerned, it appears that standard break clauses are commonly used, though practice varies to some extent, depending on the circumstances of the contract in question. In the case of nationalised industries it seems that the practice varies, but that the use of break or termination clauses is less common. This is the sort of issue which Governments have usually left to the commercial judgement of each industry. One very relevant point is that to impose a break clause in cases where this does not exist at present could often involve additional costs to the public authority concerned, to pay for the benefits it would get. It follows that a decision whether to introduce such a clause is not alwaysclear cut, and has to be considered case by case.

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4. The implication of the note is that circumstances in which contracts are made vary so greatly that guidance from the centre cannot usefully go beyond making sure (as the consultations upon which the memorandum is based and its circulation herewith will have served to do) that departments are alerted to the problems and potential risks of open-ended contracts. The conclusions would leave to departmental Ministers decisons as to the extent to which open-ended contracts should be permitted or presented.

5. The Committee will wish to consider -

1. whether they are content with the conclusions in paragraph 12 of the memorandum;

2. whether those conclusions should be reinforced by a Ministerial decision that it should be an instruction in all departments that no open-ended contracts (that is, no contract which does not contain provision for break or termination at the department's initiative) should be concluded without the express agreement of a Minister;

3. whether a direction or instruction to similar effect should be given to nationalised industries;

4. whether such an instruction could and should be enforced by advising nationalised industries that losses arising from open-ended contracts concluded without Ministerial agreement will not be taken into account in determining their external financing limits.

Signed ROBERT ARMSTRONG

Cabinet Office
21 May 1980

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OPEN-ENDED CONTRACTS

Memorandum by the Cabinet Office

On 21 February, when Ministers discussed possible sanctions against the Soviet Union following the invasion of Afghanistan (OD(80) 5th Meeting, Minute 3, conclusion 2) they considered a contract placed by the Central Electricity Generating Board (CEGB) for the provision of enriched uranium for British nuclear power stations. Although Ministers agreed that the contract should be allowed to continue, they were unhappy about the open-ended nature of this contract, which made it difficult to discontinue it, even in the circumstances of the Afghanistan invasion. The Secretary of the Cabinet was instructed 'to consider how guidance should be given to Departments and nationalised industries about the undesirability of entering into open-ended contracts with no provision for termination'. This memorandum has been prepared as a basis for a response to that instruction.

2. All the main purchasing and sponsor Departments and the Treasury have been consulted. The Treasury is in the lead on procurement policy.

3. The CEGB contract was described in OD(80) 12, which was before Ministers in February. The main reason for entering into the contract, apart from diversifying the sources of enriched uranium, was that the Soviet Union offered the cheapest supply. Other countries, including West Germany, have similar contracts which are being continued. The CEGB's contract is not totally open-ended; it is for a period of ten years. It did not include a break clause, because in their view their interests were adequately protected by the contract's force majeure clause. Moreover the inclusion of such a clause could have increased the risk to the security of their uranium supplies from the Soviet Union, since the latter might then have insisted that the break clause should be reciprocal. It is perhaps fair to say that this was a particular and rather special kind of international contract which gave rise to particular problems; but there are of course other such contracts which could in certain circumstances give rise to similar problems.

4. What seems to be at issue in this instance is a contract with no provision for unilateral termination by the United Kingdom public authority concerned. The Ministerial instruction has been interpreted as relating to contracts of this kind.

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GOVERNMENT DEPARTMENTS

5. The Standard Conditions of Government Contracts for Stores Purchases (GC/Stores/1) contain a break clause (SC 56) for use in supplies contracts other than those of minor value or relatively brief duration where its inclusion is unnecessary. Similar powers of termination are included in works contracts, vis Condition 44 of the General Conditions of Government Contracts for Building and Civil Engineering Works (CG/Works/1). The use of these standard conditions is not mandatory. Each contracting Department must decide, and be prepared to defend, the precise terms which it incorporates in any contract. Departmental Accounting Officers are open to examination by the Public Accounts Committee in the event of something going wrong.

6. A copy of SC 56 is annexed. It will be seen that termination is at some cost to the Government as it necessarily provides for at least some compensation to be payable to the contractor. Each case must be considered on its merits; there are situations in which it would be inappropriate to include break clauses. The most obvious arises from the fact that it takes two to make a contract: if the other party will not accept such a provision, and there is no alternative source of supply, the Government has no option. Should the Government insist on a break clause in contracts where such a clause is not normally used, the contractor may seek to insure himself against premature termination by increasing his price.

7. Departmental practice varies, as does the nature of contracts placed. Most contain the relevant standard condition. Civil engineering and related contracts, for example roads, usually follow the standard commercial forms, which do not have break clauses because the contract is for specified work. Some other Departments, such as HMSO, have special arrangements appropriate to the type of contract placed by them. The Central Computer and Telecommunications Agency makes little use of a break clause because the nature of the business, often the acquisition of standard propritary equipment makes it unnecessary. Northern Ireland Departments in general do not use break clauses because their contracts are for specified periods or quantities.

Scottish Departments use a simplified version in many cases. All Departments are fully aware of the need to avoid any risk to public money through inadequate contracting provisions. There is a long history of scrutiny and comment by the Public Accounts Committee on Government contract procedures and conditions.

8. International collaborative procurement is a special case, and invariably calls for Ministerial consideration. When making such arrangements MOD customarily makes provision to enable withdrawal for reasons of national convenience (as do other parties).

NATIONALISED INDUSTRIES

9. We do not have full information about the practice of nationalised industries, but it is clear that practice varies. For example, the Departments of Trade and Industry have reported that break clauses are unlikely to be included as a general rule by the nationalised industries they sponsor. The British Steel Corporation does not have a break clause in its conditions of sale, although there is provision for termination on the buyer's default or insolvency; nor (normally) do British Airways in their aircraft orders, the Civil Aviation Authority or the British Airports Authority. The nationalised transport industries normally require break clauses for longer contracts or have special arrangements for examining those with unusual features. The nationalised energy industries do not generally include break clauses, though the National Coal Board includes a break clause in its standard conditions for mining works and the CEGB has, rarely, included break clauses in contracts under pressure from contractors for a review mechanism covering circumstances of severe hardship. The British Gas Corporation can be expected to include a break clause in any future contract for imported liquefied natural gas, if the seller reserves the right to periodic price review. A standard condition in the British National Oil Corporation's sale contracts is that they are interruptible at the Secretary of State's direction.

10. Departments do not think that it would be right to issue a general direction (which has legal force) to a nationalised industry, and doubt indeed whether their existing statutory powers would permit this. There would be less difficulty about giving informal guidance to the industries, whether through

a Ministerial letter or in some less formal manner at a meeting with the Chairman. In giving such guidance, the Government will have to be careful not to contradict its own policy of non-interference in management decisions. The use of unilateral rights to terminate a contract, other than for reasons of the other party's default or insolvency, is rare in commercial practice. In many cases the break clause would have to be reciprocal, which might well be disadvantageous. There are of course special considerations applying to some Government contracts, particularly in the defence field, which justify the special powers but it is questionable whether such considerations necessarily apply to public sector contracts generally. Indeed, to include such powers in every public sector contract could, as mentioned above, lead to contractors including additional provision in their prices against what would, in a very large part of public contracting, be regarded as a new and unquantified risk. If Ministers still feel, having considered this report, that some guidance should be given, that guidance could take the form of a letter from the appropriate Minister to each of the Chairmen seeking an assurance that his contractual procedures contain adequate safeguards, including arrangements to ensure that consideration is given to incorporating on contracts, where appropriate, provision for break or termination by the nationalised industry concerned.

LOCAL AUTHORITIES AND THE NATIONAL HEALTH SERVICE AUTHORITIES

11. We have not inquired closely into the contracting practices of local authorities. In general, it appears that local authorities do not include break clauses, except on contractor's default. Most of the National Health Service Authorities purchases of goods are made under so-called running contracts which effectively provide an opportunity for discontinuance with the completion of each order placed. The Authorities are thought likely to include provisions for mutual termination by notice in their contracts for services.

CONCLUSIONS

12. Our consultations with Departments suggest that the following conclusions would command a wide measure of acceptance -

a. It will not always be appropriate to include break clauses in Government contracts, and there should not be an invariable rule requiring their use in all contracts.

b. Existing practice, which allows for the inclusion of break clauses at the discretion of Departments, should continue.

c. It should be for each departmental Minister to consider whether there are specific categories of contracts entered into by his Department on which he needs to be consulted, and to approve whatever contractual arrangements best suit his own departmental activities.

d. No statutory 'general direction' should be given to the nationalised industries, but each Minister responsible for a nationalised industry should consider whether to give guidance to the Chairman by letter in the form suggested at the end of paragraph 10 above, and should take the opportunity to mention the problem, and explain the special circumstances of international contracts, at his next convenient meeting with the Chairman.

21 May 1980

56. Break.—(1) The Authority shall in addition to his power under any other of these Conditions, have power to determine the Contract at any time by giving to the Contractor written notice, to expire at the end of such period as may be specified in the Contract as the appropriate period for a notice to determine the Contract under this Condition or, if no period be specified, at the end of two weeks, and upon the expiration of the notice the Contract shall be determined without prejudice to the rights of the parties accrued to the date of determination but subject to the operation of the following provisions of this Condition.

(2) In the event of such notice being given the Authority shall at any time before the expiration of the notice be entitled to exercise and shall as soon as may be reasonably practicable within that period exercise such of the following powers as he considers expedient:—

(*a*) to direct the Contractor, where production has not been commenced, to refrain from commencing production;

(*b*) to direct the Contractor to complete in accordance with the Contract all or any of the Articles, or any part or component thereof in course of manufacture at the expiration of the notice and to deliver the same at such time or times as may be mutually agreed on, or, in default of agreement, at the time or times provided by the Contract. All Articles delivered by the Contractor in accordance with such directions and accepted shall be paid for at a fair and reasonable price;

(*c*) to direct that the Contractor shall as soon as may be reasonably practicable after the receipt of such notice:—

(i) take such steps as will ensure that the production rate of the Articles and parts and components thereof is reduced as rapidly as possible;

(ii) as far as possible consistent with sub-paragraph (i) of this paragraph concentrate work on the completion of parts and components already in a partly manufactured state;

(iii) determine on the best possible terms such sub-contracts and orders for materials and parts and components bought out in a partly manufactured or wholly manufactured state as have not been completed, observing in this connection any direction given under paragraph (*b*) and sub-paragraphs (i) and (ii) of this paragraph as far as may be possible.

(3) In the event of such notice being given:—

(*a*) the Authority shall take over from the Contractor at a fair and reasonable price all unused and undamaged materials, bought-out parts and components and articles in course of manufacture in the possession of the Contractor at the expiration of the notice and properly provided by or supplied to the Contractor for the performance of the Contract except such materials, bought-out parts and components and articles in course of manufacture as the Contractor shall, with the concurrence of the Authority, elect to retain;

(*b*) the Contractor shall prepare and deliver to the Authority within an agreed period, or in default of agreement within such period as the Authority may specify, a list of all such unused and undamaged materials, bought-out parts and components and articles in course of manufacture liable to be taken over by or previously belonging to the Authority and shall deliver such materials and things in accordance with the directions of the Authority who shall pay to the Contractor fair and reasonable handling and delivery charges incurred in complying with such directions;

(*c*) the Authority shall indemnify the Contractor against any commitments, liabilities or expenditure which are reasonably and properly chargeable by the Contractor in connection with the Contract to the extent to which the said commitments, liabilities or expenditure would otherwise represent an unavoidable loss by the Contractor by reason of the determination of the Contract:

Provided that in the event of the Contractor not having observed any direction given to him under Clause (2) of this Condition the Authority shall not under this Clause pay any sums in excess of those which the Authority would have paid had the Contractor observed that direction.

(4) If in any particular case hardship to the Contractor should arise from the operation of this Condition it shall be open to the Contractor to refer

the circumstances to the Authority who, on being satisfied that such hardship exists shall make such allowance, if any, as in his opinion is reasonable and the decision of the Authority on any matter or thing arising out of this Clause shall be final and conclusive.

(5) The Authority shall not in any case be liable to pay under the provisions of the Condition any sum which, when taken together with any sums paid or due or becoming due to the Contractor under the Contract, shall exceed the total price of the Articles payable under the Contract.

(6) The Contractor shall in any sub-contract or order the value of which is £10,000 or over made or placed by him with any one sub-contractor or supplier in connection with or for the purpose of the Contract take power to determine such sub-contract or order in the event of the determination of the Contract by the Authority under this Condition upon the terms of Clauses (1) to (5) of this Condition save only that:—

(*a*) the name of the Contractor shall be substituted for the Authority throughout except in Clause (3) paragraph (*a*) where it last occurs and in Clause (4); and

(*b*) the period of the notice of determination shall be such period as may be specified in the Contract as the appropriate period for a notice to determine a sub-contract or order under this Condition, or, if no period be specified, two weeks.