Allowable cost guidance consultation

Consultation response form

Overview

This response form should be read in conjunction with the consultation document.

This is a public consultation, which is open to anyone with an interest in the SSRO's two statutory aims of ensuring that good value for money is obtained in government expenditure on qualifying contracts, and that parties to those contracts are paid a fair and reasonable price. We also welcome comments from people or organisations with a particular interest in non-competitive defence procurement. The consultation will close on 16 August 2022.

Please respond by 5.00pm on ~~Friday~~ 18th July 2022.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand. Completed response forms should be sent.

- by email to: **consultations@ssro.gov.uk** (preferred)
- by post to: Allowable cost consultation responses, SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB
- by telephone, including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Allowable cost guidance consultation

Consultation response form

Your details

Name:

James Schofield

Organisation (if you are responding on behalf of an organisation):

Leonardo UK Ltd

Position (if you are responding on behalf of an organisation):

VP Finance

Consultation questions

Consultees do not need to answer all the questions if they are only interested in some aspects of the consultation.

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail. This will help us to understand the basis for your answer and inform our finalisation of the guidance. As a minimum, please include the paragraph number(s) your comment refers to.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by marking one of the boxes below.

Yes [X] No [ ]

Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

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In addition to responding to the consultation questions we provide comment on the inputs and SSRO response included in this consultation. We hope this helps when considering proposed guidance. Our comments are in relation to:

2. Concepts and terms used in the consultation
3. Overview of Allowable Costs guidance
4. Overheads and indirect costs as allowable costs in qualifying contracts
5. Application of the AAR principles to indirect costs

Comments on inputs and SSRO responses

2.6, 2.7

In pricing, costs are either treated as a direct cost to contract or a cost that is indirectly allocated to the contract. We therefore think it would be simpler to keep with the terms direct and indirect costs as included in Regulation 29(5). Introducing another term "overheads" with its obliged explanation of meaning seems unnecessary.

3.1,3.2

As we have previously proposed, the overview to SACG should make clear Section 13 of the Act frames the purpose for allowable cost guidance and that Section 20 provides the methodology to discharge that purpose (the outcome of applying S20 methodology must always be tested against S13's requirements).

To explain our thinking:

Section 13 requires Value for Money on Government expenditure and that a Fair price is paid.

"Fairness", therefore, is a primary purpose to be achieved when applying Section 20.

Allowable costs guidance should help the user to continually test the application of Section 20 against Section 13 objectives. To support that we believe guidance should ask the user to consider costs, especially indirect costs, in the context of what is UK Government asking of the contractor? This goes beyond the specifics of the contract's deliverables which, for some users of guidance, might be their interpretation of what "enabling the performance of the contract" means.

SACG to Section 20 might explain AAR:

- **Appropriate** – what type of cost is appropriate to the nature of business being contracted?
  (In the context of Section 13 – Costs that enable the business to: be capable of contracting with Government, successfully execute contracts, successfully execute the contract in question, and to comply with Government policy, legislation and processes).
- **Attributable** – is the method of attribution fair*?
- **Reasonable** – what level of cost is reasonable?

* "Fair" Attribution may include:

- Costs solely caused by the contract - these will be direct costs and it is "fair" the contract has 100% of such costs.
- Costs that are not solely caused by the contract, but the contract could not be won, nor business operate to execute this and other contracts, without such costs and investments being incurred. Here a "fair" method of attribution is required to ensure a fair share of these costs are charged to the contract.

3.3, 3.4

If the SSRO are not persuaded by the above argument, then improved guidance at 3.8 and 3.9 is required:

SACG at 3.8 explains the term, introduced by the SSRO, "enabling the performance of the contract" may involve costs that are incurred on behalf of the contract in question or may be a cost that is incurred, by the business, in support of many contracts.

3.8 on its own can be read, by some, in narrow terms such as what is required to enable delivery of the specific contracted requirements and by others in a more inclusive way.

SACG 3.9 tries to encourage the user's to consider "enabling the performance of the contract" might involve broader consideration of allowable costs. It explains costs incurred sustaining capabilities that are essential OR desirable should be allowable.

We agree SACG should explain to the user they must consider all costs required to operate a business capable of contracting with Government, meeting Government policy and other regulatory requirements, however, we do not see the current wording of 3.9 achieves this.

We recommend guidance at 3.9 is expanded along the lines of that we suggest in response to question 2 below:

4.8

We believe fairness should frame consideration of "attribution" (direct or indirect cost). Causality may be one of a number of considerations when determining a Fair Attribution:

- It is fair that a cost, solely caused by the contract, has 100% of that cost attributed to it (direct cost).
- An indirect cost, that is distant from the specific contract (and other contracts), but necessary to the continued functioning of the business, is not easily considered in terms of causality (to a contract), but its costs must be "Fairly" shared across all the contracts (to achieve S13 requirements).

4.15

As our response at 4.8

4.28

We understand the MOD and SSRO believe including the term "the costs of maintaining a going concern" would be unhelpful. The reason we proposed its inclusion is because it is an explicit requirement when contracting with Government. As included in our prior submission:

*The MOD Commercial Toolkit explains the requirement of Government for a "**going concern**" capable of discharging the contract. Only suppliers with "good standing, capability and capacity to deliver the contract" should be invited to bid and they must "remove potential suppliers who are disqualified or have weaknesses that would make them unlikely to be able to deliver the contract." The tool kit explains how to discharge these requirements and instructs reference to the **Defence and Security Public Contracts Regulations (DSPCR) 2011 and in particular, regulations 23 to 26**, which explain criteria for rejection, requirements regards a contractors economic and financial standing and technical and professional abilities. The toolkit also covers the requirement to support UK prosperity and innovation.*

We would request the SSRO reconsider the above and their conclusions at 4.28.

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4.30
Could the SSRO please provide support to their conclusion at 4.30?

We do not see the response to Q17, of the Q&A's, as providing an answer to the points raised by industry. Q17 explains the CG costs are not adjusted when determining the PLI and explains the reasons for this.
Industry contention is that CG profits are net of costs that, under the SACG, would be disallowed. Therefore, the PLI used when calculating the BPR is a "lower" profit rate than if the PLI is restated for disallowed costs.

4.36
Whilst we agree with the discussion at 4.36, we think, if (say) Engineering is seen as essential or desirable capability and that research is an important activity towards its sustainment, then other tests (e.g. goods or services could not have been provided but for the research having been previously undertaken) are unnecessary.

Furthermore, any "tests" as included in the discussion at 4.36 should not be limited to just MOD single source contracts. MOD should be interested in all their current and future contracts and contracting types. Indeed, the context should be broad enough to consider Gov't policy being pursued: UK prosperity, innovation, levelling up, up skilling, etc.
An example of this is the recent MOD paper "The Defence Capability Framework" sets out the "what" defence is interested in developing and requests industry helps in developing the "How". It describes the exploring of the how will be "through focus of our collective resources and incentivise industry investment in R&D…"
https://www.gov.uk/government/publications/the-defence-capability-framework

4.36 bullet 2 might be improved by being changed to "win and deliver UK Defence contracts"

4.45
Regards sales and marketing costs, we agree with the conclusion reached and that current SACG is maintained.

4.46
We request the SSRO reconsider our prior input on the topic of indirect pricing rates as a tool for incentivising efficiency.
We explained why rates are not a mechanism for driving efficiency and provided two examples to help explain this point. In the simple examples provided, just the denominator (hours) changed. You may have a lower rate by being less efficient (it took more hours to produce given output), or conversely a higher rate from being more efficient (it took fewer hours).
Our position is that indirect rates are an outcome of moving numerators and denominators, they are not a vehicle to easily understand or drive efficiency without full understanding of context (impact on the rates itself and the impact on the charge to contracts). We believe other tools are better suited to drive and benchmark efficiency.

In previous input, we also explained, a fundamental requirement, of an indirect costing rate, is that it meets statutory accounting requirements. It also explained the necessary link between the costing rate structure, in a business' ERP system and that used in pricing rates in order that DeFCARS contract reporting and post costing can be conducted by the conversion of actual costing rates, recorded in the accounting system (against the contract), into pricing rates.

By means of example:
In a complex businesses with vertically integrated Bills of Material (BOM): A part is made in the machine shop (hours incurred and material) and issued into stock when complete. Then the part is issued as a material item, to a sub assembly, along with other parts, and work conducted to create the sub-assembly. When complete the sub assembly is issued to stock. The sub assembly is then issued, as a material item, from stock to the project/ contract for final assembly. Assembly hours are incurred at the project level, assembling together all the sub-assemblies. To convert all the hours incurred and any material uplifts from internal costing rates to pricing rates you need to identify all the hours and material uplifts throughout the BOM (not just those booked at the top level project). Consistency between costing and pricing rate denominator (recovery base) is vital, as is the classification of indirect costs allowable in "production" costs, if statutory requirements are to be met and DefCARS reporting achieved within required timescales.

Table 2 – Research and timing

As commented above, at 4.36: If Engineering is an essential or desirable capability and R&D is a key activity in sustaining this capability, why isn't that test, on its own, adequate?

5.13

We are confused by the statement that "the requirements of allowable costs can only be met to the extent that the parties understand the specific contract or contracts to which the rates will apply – a rate cannot meet the requirements of allowable costs in the absence of a contract…." and "it cannot be fully determined, however, that a particular cost is an allowable cost under a qualifying contract in accordance with the requirement of section 20(2) of the Act, until the contract under consideration is being priced."
We would observe that rates are agreed, at a business unit level, somewhat independently of any specific contract. For instance:

- Actual rates are agreed (at a BU level) looking at the total activity/recovery base as compared to the BU's actual allowable indirect costs; whilst,
- Forward (estimated) rates are agreed assuming estimated indirect costs and an estimate of the recovery base. This forward estimate of the recovery base will include assumptions regarding new contracts being won that may or may not be realised.

Rates being agreed as allowable, independent of a specific contract, is also discussed at 5.5 where it is explained the MOD are proposing the SSRO could make a determination on the rates independently of a specific contract so as only the rates are determined and not a contract's price.
We presume the SSRO mean a cost, including a rate, only becomes relevant to the DRA when used in pricing or post costing a qualifying contract?

5.15 Appropriate

We found the discussion here a little confusing. It is written as if rates are constructed with a contract in mind and how it enables its performance. Indirect rates are generally "process based" (e.g.: a rate for 5 axis machining, a rate for manufacture of composite blades), not contract based. A contract that requires that process/activity will be charged that common rate (for the common process) either as part of the material cost issued to the contract or as a booking of time against the contract (see earlier example at 4.46).
We also recommend language used in guidance needs to embrace all ways of working. Some businesses may have dedicated support functions such as HR and dedicated research, included in the BU. Other groups may have a "central services" approach where the activities are conducted as a division, or group, and relevant costs are recharged to the business unit (i.e. the same costs may sit in different places with different groups).

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Question 1: Please share your views on proposed guidance changes in the consultation document to Section 2 – Application of the guidance.

Section 2: Application of the guidance

Statutory Allowable Cost Guidance (SACG) 2.2
As the proposed guidance at 2.2 does not cover all the important topics that are covered in the existing SACG 2.2 we assume this is a new, additional, paragraph rather than a substitution.

Proposed SACG 2.6
The Act places the onus on the contractor to evidence AAR. Some of the suggested sources of information may not be available to the contractor (e.g. will MOD be willing to share information they hold? How will third party evidence be obtained, at what cost, and how will it be made relevant to the circumstances of the single source requirement?).

We recommend "2.6.a. the specific requirements and circumstances of the contract;" is reconsidered if it is to better facilitate consideration of indirect costs involved in meeting Government's broader requirements, distant from the contracts deliverables, but necessary to contracting with Government.
As stated previously, the agreement of rates is often conducted without reference to a specific contract.

Allowable cost guidance consultation

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Question 2: Please share your views on proposed guidance changes in the consultation document to Section 3 – the AAR principles.

Section 3: The AAR principles

Proposed SACG 3.5

Again, we do not fully appreciate how the SSRO statement "... allowable costs cannot be fully concluded until ...claimed.. under a contract" works in relation to the agreement of indirect pricing rates?

We presume it means an agreed rate is not relevant to the DRA until it is used on a qualifying contract?

Rates are agreed, at BU level, before their use in forward pricing, or post costing, of contracts. They are not re-agreed at the point each contract is priced, reported, or post costed.

In addition, the MOD are proposing changes to legislation to mean rates can be referred for a determination, independent of a contract. That being the case does that imply/explain pricing rates and their requirement to meet S13 and S20 is independent of their use on a qualifying contract?

Proposed SACG 3.8

We welcome the explanation of costs that enable the performance of the contract may be incurred: before, during, or after the specific contract.

We see 3.8 as explaining when costs may be seen as enabling a contract. It could be costs that support :

- the contract in question, or
- Multiple contracts

However, we see that proposed at 3.8c is not discussing when a cost is enabling the performance of a contract but covering reasonableness which is already adequately covered in 3.13.d “Reasonable in the circumstances”.

We recommend 3.8c is removed

If 3.8.c is not removed, we see it as being too narrow (referring to efficiency in qualifying contracts only - not in other MOD and non-MOD contracts (i.e. all contracts), and that the requirement to assess for "efficient and proper" as being too subjective.

Beyond the specific contract deliverables, we also would add Government policies and various types of necessary regulation can cause indirect (and direct) costs to be incurred. Policies such as: prosperity, levelling up, carbon zero, innovation and Gov't procurement requirements. If the contractor did not meet these requirements the contract could not be won and successfully executed.

Proposed SACG 3.9

The proposed change to 3.9 does not adequately facilitate consideration of capabilities and costs that Government require of contractors, through policy and process and compliance with various forms of regulation, if they are to be considered suitable for contracting.

Government policy and process (see our comment at 4.28 above) makes requirement of contractors beyond the specific contract deliverables. When considering if those requirements are met and if the contractor is suitable, Government conducts that assessment at the business unit level. We therefore recommend 3.9 discusses essential or desirable capabilities in a context that covers both the contractual deliverables and in the context of Government policy, suitable contractor requirements and the various regulatory requirements a contractor has to meet.

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We suggest wording such as:
"Delivering the contract in question may require sustaining an essential or desirable capability. These capabilities are those appropriate to: the contract in question, similar contracts, and those required by Government policy, defence requirements (including the suitable contractor requirements as set out by the Defence and Security Public Contracts Regulations (DSPCR) 2011), along with the various regulatory requirements associated with the market".

We believe if 3.9 embraces all the costs required of a compliant defence contractor, this would resolve many of the issues seen when agreeing indirect costs and remove the need for much of the proposed changes to SACG Section 4.

Allowable cost guidance consultation

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Question 3: Please share your views on proposed guidance changes in the consultation document to Section 4 – Cost accounting and financial reporting

Section 4: Cost accounting and financial reporting

Proposed SACG 4.1
As we commented in our section "comments on inputs and SSRO response" at 2.6 (above), we recommend proposed SACG 4.1 is removed. We believe guidance should keep to the terms: direct and indirect costs, consistent with Regulation 29(5) and not introduce the term "overheads".

Proposed SACG 4.2
We recommend proposed SACG 4.2 remains as current SACG 4.1.
A description of a cost accounting methodology or example is not required and choices of the appropriate methodology, as discussed at 4.46 ("comments on inputs and SSRO response" above) will need to meet the requirements of statutory audit.

Proposed SACG 4.4
We recognise proposal SACG 4.4 is very similar to current SACG 4.2.
We had questions regarding current guidance and reiterate them here.
We request the first sentence is removed. Firstly, we think the basis for any allocation should be fair (see comments at "comments on inputs and SSRO response" 3.1 and 3.2 above). Secondly, we also do not think it possible to achieve the objective set of no over or under recovery. By means of explanation:
When agreeing actual rates there is no residual over or under recovery other than the level of dis-allowance the MOD may seek to pursue. However, if the objective set relates to the difference in an actual agreed rate (for a given year) with the estimated rate used in the pricing of a QDC/QSC (possibly set many years previous) then it is likely, even with the best (most logical) estimates, there will be a variance as the business units recovery base and indirect costs may differ from that estimated 3 or 4 years previous.

We may not have fully understood the second sentence of 4.4 and as such think requires clarification. We think it is explaining a contractor may have different costing systems for MOD work and non-MOD work? As we explained (above) at "comments on inputs and SSRO response" 4.46 this is not our experience.
We recommend 4.4 is reconsidered and/or explained further.

Proposed SACG 4.6
The consultation refers to paragraphs 6.23 - 6.25. We have not found these in the guidance?

Proposed SACG 4.7
We recommend 4.7 is removed and guidance remains aligned with definitions included in Regulation 29(5).

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Proposed SACG 4.8, 4.9
We believe current SACG 4.6 would be preferable to proposed SACG4.8 and 4.9.
For the reasons discussed at proposed SACG 3.5, the proposed SACG 4.9 seems confusing.

Proposed SACG 4.10
We recommend 4.10 is removed and believe if SACG 3.8 and 3.9 are addressed, as recommended above, then current SACG 3.11 through to 3.14 adequately deals with AAR.

If proposed SACG 4.10 is not removed, but amended, we recommend that:

Proposed SACG at 4.10 "Appropriate" is amended to explain allowable costs may be incurred directly by the business unit or by its group on its behalf (as explained at "comments on inputs and SSRO response" 5.15 above) e.g.:
"Whether the cost is incurred by the business unit, or on its behalf by a group company, examples of costs which might be appropriate include: the HR costs relevant to the business unit's operation, research costs relevant to the business unit meeting Government policy and defence requirements to sustain essential or desirable capabilities; and other business enablers that exist for the benefit of the customer, or are required for the contracting company to function lawfully or efficiently."

Proposed SACG at 4.10 "attributable" is amended to align with, or simply reference to, current SACG 3.12.c. We don't think guidance should be suggesting methodologies that may or may not be in conflict with the accounting practice.

Proposed SACG 4.11
We are confused by the requirement to "consider the types of contracts to which the rates will be applied". For instance a manufacturing rate (made for stock) will be set in relation to the costs and activities of that process, based on MRP demand, and not with reference to the type of contract that may consume the component?
Proposed SACG 4.11 example
We find the example confusing.
Second paragraph:
Our experience is we do not propose contract specific General and Administrative (G&A) cost treatment. We agree Business Unit rates and use those rates when pricing contracts.
Fourth paragraph:
Is this example consistent with the treatment in SACG Part C.1.2 and C.1.3?
In the example is the MOD saying the costs being recharged from the centralised group function were simply incorrectly calculated (i.e. some of the central G&A costs were nothing to do with activities of the BU that is pricing the MOD contract and those costs ought to be excluded from the "shared" Group G&A costs and charged directly to the relevant BU(s)). Again, we don't agree that, at time of pricing each contract, a discussion should happen regarding the appropriate G&A recovery base to use. The methodology needs to be consistent for all contracts if S13 fair pricing is to be achieved.
Fifth paragraph:
We note MOD's proposal to remove the regulatory requirement for Rates Comparison Reports.

Allowable cost guidance consultation

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Question 4: Please share your views on proposed guidance changes in the consultation document to Section 5 – Guidance on specific cost type: Part D – Research and development costs.

Section 5: Guidance on specific cost types

Proposed SACG D.2.2

Why has the term "money spent" been introduced to guidance? There is a danger it could be read as obliging cash accounting rather that accruals accounting? Is that intended? If so this conflicts with accounting standards. We therefore recommend the term is removed from guidance.

As discussed at Table 2 – Research and timing and at "comments on inputs and SSRO response" 4.36 above:

If Engineering is an essential or desirable capability and R&D is a key activity in sustaining this capability, why isn't that test on its own adequate?

We recommend:

- Removal of the first bullet
- Changing the second bullet to better embrace that we suggest for SACG 3.9: "the research costs were incurred to sustain capabilities essential or desirable to: the contract in question, similar contracts, and those capabilities required by Government policy, or defence requirements, or the suitable contractor requirements as set out by the Defence and Security Public Contracts Regulations (DSPCR) 2011, or other regulatory requirements associated with the market"

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Question 5: Do you have any other views you wish share or feedback on the consultation document?

Current SACG A.3.1
Redundancy costs:
We recommend removing from guidance "…but only if approved by the Secretary of State" to better reflect the requirements of SACG Section 3 the AAR principles.
If the caveat is not removed it requires modification to explain the MOD's agreement is required only for settlements that are in excess of amounts payable based on contracts of employment and precedence operated by that company in relation to redundancy settlements.
The current inclusion of the caveat has led to MOD pursuing exclusion of any payments in excess of statutory minimum. We would contend a reasonable person informed of the facts (a judge) would conclude settlement, to an employee being made redundant, should be based upon contractual terms and precedence and as such these costs meet AAR.

With regard to indirect costs, we believe it would be of benefit if SACG included the examples and logic the SSRO explained in their consultation of 2018/2019 on "Pricing guidance summary of consultation responses" at 2.11 through 2.15.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/919774/Pricing_guidance_summary_of_consultation_responses_January_2019A.pdf

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- by telephone, including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767

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Allowable cost guidance consultation

Consultation response form

Your details

Name:

J B Ashley

Organisation (if you are responding on behalf of an organisation):

Computis Ltd

Position (if you are responding on behalf of an organisation):

Director

Consultation questions

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Question 1: Please share your views on proposed guidance changes in the consultation document to Section 2 – Application of the guidance.

New 2.2 paragraph
This paragraph adds nothing to the guidance and actually causes confusion. The current paragraph 2.2 lays out the legal position. The guidance is not intended to "assist" the determination of whether a cost is AAR. Both MOD and contractors have to adhere to the guidance unless they have good reason to differ. That cost recovery rates, whether they are used in costs as estimated at the time of agreement or used in actual costs determined during the contract or after the contract completion date, are subject to the AAR test is implicit, as they are an element of the cost charged to a contract and, therefore, must be subject to an allowability test as any cost. To state that the guidance may be applied to rates not yet applied to a contract is meaningless, regardless of the level in an entity at which they are calculated. The rates applied to a contract are subject to AAR testing as and when so applied.

New paragraph after new paragraph 2.2
Providing examples and then stating that they should not be applied rigidly is not helpful.

New paragraph after existing paragraph 2.4
Existing paragraph 4.8 should be deleted and not replaced. Information concerning DefCARS cannot be part of statutory guidance on allowable costs as it is outwith the subject, relating to Parts 5 and 6 of the Regulations.

Revised paragraph 2.6
The information available to evidence whether a cost is AAR will always include the contractor's records. HMRC define a record as "information created, received and maintained as evidence and information by an organisation, in pursuance of legal obligations or in the transaction of business". Given that definition and that the value being evidenced must be included in either an estimate or actual cost breakdown which would itself be a record, the SSRO should be definitive and state that the contractor's records will be required as part of evidence that a cost is AAR.

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Question 2: Please share your views on proposed guidance changes in the consultation document to Section 3 – the AAR principles.

Revised paragraph 3.1

I suggest that the final sentence be extended to include the definition of an indirect costs given in R29(5)(b)(ii), being that the costs "have been calculated using a cost recovery rate".

New paragraph after existing paragraph 3.4

This new paragraph implies that costs recovered via rates can only be considered AAR when applied to a contract and should be reviewed and adjusted from contract to contract. This may reflect the fact that agreed estimated recovery rates calculated by a contractor would be updated prior to contract agreement should it be the case that significant changes had occurred in the business unit costs or recovery bases between the time of agreement of the rates and contract signature.
If the SSRO is convinced that this should be the case, it should make that statement plainly. However, in so doing, the SSRO should be aware of the consequences for contractors, MOD and the impact on Part 6 reporting, as it would call into question the utility of agreeing estimated recovery rates and the requirement for the Estimated Rates Claim report.

Revised paragraph 3.8

I am not convinced that the inclusion of the phrase "before, at or after the time of agreement" adds anything. It would be unlikely that a cost would be incurred at the time of agreement.

Expanded existing paragraph 3.9

This section would appear to contain contradictions. If MOD wishes to maintain a capability, it will issue a contract containing that requirement. If a contract requirement can only be delivered by maintaining a capability, the costs of so doing should be allowable as part of the cost of the contract. However, if the capability is sustained in order to deliver similar contracts but not the contract under scrutiny, unless the contract specifically requires the capability sustainment, it would not be considered attributable. As written it could be construed that the SSRO is suggesting that costs incurred on a contract are allowable because a capability may be required to be maintained to provide an ongoing capability to perform future MOD qualifying contracts, although the contract contains no specific requirement. If the SSRO considers that the current legislation produces a result that is unfair to either MOD or contractors , then it should recommend a change to the legislation rather than attempt to generate compromises via guidance.

Allowable cost guidance consultation

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Question 3: Please share your views on proposed guidance changes in the consultation document to Section 4 – Cost accounting and financial reporting

Paragraphs 4.2 to 4.5
The SSRO has correctly stated that it is not and should not be prescriptive about the categorisation of costs. That is a matter for contractors and the MOD. However, given that an explanation of the methodology used for the allocation and apportionment of costs is essential if actual costs are to be compared with estimated costs, the SSRO guidance should be more specific is requiring contractors to maintain a QMAC or similar document that can be used to ensure that the allocation and apportionment of actual costs matches or can be reconciled readily to costs included in estimates.
The guidance may reflect contractors duties to keep records and provide reports but the duties are set out in the Act and Regulations and not Section 2 of the guidance as stated. The last sentence of para 4.5 is misleading.

Paragraph 4.9
The last sentence of this paragraph would appear to imply that rates should be calculated on a contract basis. This may reflect the fact that agreed estimated recovery rates calculated by a contractor would be updated prior to contract agreement should it be the case that significant changes had occurred in the business unit costs or recovery bases between the time of agreement of the rates and contract signature.
If the SSRO is convinced that this should be the case, it should make that statement plainly. However, in so doing, the SSRO should be aware of the consequences for contractors, MOD and the impact on Part 6 reporting, as it would call into question the utility of agreeing estimated recovery rates and the requirement for the Estimated Rates Claim report.

Paragraph 4.10
I do not think this paragraph adds anything of value to that already included in the guidance.

Paragraph 4.11
Illustrative example: Second paragraph

See note on Paragraph 4.9. re: calculation of recovery rates on a contract basis

Illustrative example: Final paragraph

I am not aware that MOD has requested any contractor to provide a Rates Comparison Report. The methodology suggested in this paragraph is, therefore, unlikely to be followed by MOD. If MOD did start to use this methodology, it would be extremely complex if the SSRO's apparent insistence on contract based recovery rates was also followed.

Allowable cost guidance consultation

Consultation response form

Question 4: Please share your views on proposed guidance changes in the consultation document to Section 5 – Guidance on specific cost type: Part D – Research and development costs.

Revised paragraph D 2.2

Given the requirement to show that any research undertaken enables the performance of the contract, for contracts other than those with research as a requirement, research costs will only ever be recoverable on an historic basis. This assumes that a contractor can show a causal link between the outcome of the research and the requirements of the contract and has the records to demonstrate what costs have been incurred. I have had experience of contracts that used technology developed by companies over extended periods. Contractors do not generally keep records for the time implied and MOD would probably object to paying the costs of retaining such data.

If a contractor pursues private venture research and, as a result, is able to develop a product or service of interest to MOD, the approach adopted fails to provide a methodology for recompensing the contractor for the costs and risks undertaken.

Allowable cost guidance consultation

Consultation response form

Question 5: Do you have any other views you wish share or feedback on the consultation document?

SSRO should delineate clearly between that which is to be considered ‘statutory guidance’ and that which is opinion in both published guidance and consultation documents.

Allowable cost guidance consultation

Consultation response form

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Allowable cost guidance consultation

Consultation response form

Your details

Name:

Alison Hexter

Organisation (if you are responding on behalf of an organisation):

Thales UK Ltd

Position (if you are responding on behalf of an organisation):

Finance Director, Government Finance

Consultation questions

Consultees do not need to answer all the questions if they are only interested in some aspects of the consultation.

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail. This will help us to understand the basis for your answer and inform our finalisation of the guidance. As a minimum, please include the paragraph number(s) your comment refers to.

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[x] Yes [ ]

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Allowable cost guidance consultation

Consultation response form

Question 1: Please share your views on proposed guidance changes in the consultation document to Section 2 – Application of the guidance.

2.6 • A contract must not only recover the direct costs involved but must also contribute fairly to the firms development , its overhead and its profitability – a FAIR price is also the key . Section 13 requires Value for Money on Government expenditure and that a Fair price is paid to the contractor and as such frames the purpose for allowable cost guidance.
We agree consider costs that are incurred by a Company are either Direct – where the costs is clearly solely incurred for the purpose of fulfilling that contract and is thus is allocated to a contract or an indirect cost which is recovered against all a firms customer funded contracts on an Indirectly recovered basis ie it is apportioned and assigned to a contract using a cost recovery rate.
One of the issues with the guidance is that not all Firms adopt the same principles to recover indirect cost (especially if there are several legal entities) For any given firm there are countless ways of calculating the production cost of a product , so what is really important is the method of cost collection applicable to the firm and the QMAC is understood.
It is confusing to include the term overhead. The costs of the Company, salaries, transport depreciation ,insurances, travel , subcontracts etc can be defines as overheads, the key being whether they are direct or indirect.
There is no mention in the guidance of Fixed or variable cost- Contractors with more customers offer better value to the Government , in that they have the ability to recover the fixed costs over a wider customer base. In the case say of a distribution firm a 10 to 20% increase in the volume sold will not increase a firm's fixed cost. So the point is the reasonableness of the amount of the cost must take this into consideration. Often a firms total cost is reviewed without the wider picture being understood,

So, we consider that included in the definition of a direct cost , could be a cost which is readily seen to be associated with a discrete package of goods and services, and without this expenditure it is not possible to complete the activity and thus this cost is directly allocated to a contract.
Indirect costs are common to several products or deliveries.

It should be confirmed that rates belong to a business unit and not a contract – simply the cost to the contract is determined by the rate of the employee doing the work , determined by his business unit .

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Allowable cost guidance consultation

Consultation response form

Question 2: Please share your views on proposed guidance changes in the consultation document to Section 3 – the AAR principles.

The issue with section 3 is the definition of a reasonable person – a reasonable person may not have a clue about finance! The characteristics of AAR have been debated for some time, but in my view the contract price must not only cover the direct cost involved but must also contribute to the firms development and its profitability, (sustain an essential or desirable capability) so my interpretation of this is linked with the ability to enable the performance of the contract by the Company being strong and in good financial condition. This means it must be able to recover the necessary cost it incurs and receive a fair profit rate .

Individuals that have had wider experience as say part of a group have more awareness of this and again it is common sense but the issue is often had with costs such as Selling and Marketing which do not benefit directly the contract in question, but do mean that Fixed cost can be recovered over a wider customer base so a broader approach is needed to rate agreement (and I think your guidance alludes to this).

There are also certain costs such as pensions that could vary from Company to Company – some Companies may offer more generous defined contribution benefits or employment benefits as they see this being a way to retain staff and thus save on recruitment fees – so it is important to consider costs incurred as part of a whole package and not isolate.

Companies that are part of a Group do incur necessary Group costs, and again if these costs were not incurred at Group level they would need to be incurred locally.

Costs solely caused by the contract - these will be direct costs and it is “fair” the contract has 100% of such costs. Costs that are not solely caused by the contract, but the contract could not be won, nor business operate to execute this and other contracts, without such costs and investments being incurred are indirect .

Here a “fair” method of attribution is required to ensure a fair share of these indirect costs are charged to the contract. Often Companies are compared without understanding completely the indirect cost recovery structure – in Thales we have harmonized our rate construct for this reason to assist understanding a comparability. – For example Material handling and G&A recovery over labour only. Labour cost tends to be less volatile than materials but if there is not an appreciation that Costs are recovered differently, one cannot just compare say a DIRECT labour & overhead rate.

The treatment of staff , whether they are direct or indirect again needs to be understood as obviously if there are more indirects , rates will be higher , but less hours on a project.

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Allowable cost guidance consultation

Consultation response form

Question 3: Please share your views on proposed guidance changes in the consultation document to Section 4 – Cost accounting and financial reporting

Thales does not agree totally there needs to be a link (4.8/4.15) between each cost and a contract. Overhead cost by its very nature, is just not contract specific. We do recognise the importance of demonstrating the value of the cost incurred and agree that different approaches may be necessary for businesses which solely deliver Single source contracts. However, we consider it is more important to concentrate on the fairness of the allocation of these overhead costs in diverse businesses. Enabling the performance of the contract" may involve costs that are incurred on behalf of the contract in question or may be a cost that is incurred, by the business, in support of many contracts this is the nature of overheads. An indirect cost, is necessary to the continued functioning of the business and is not easily considered in terms of causality (to a contract) so 4.29 comments supported

So the guidance as it stands is still open to interpretation and my worry (4.9) that Businesses that do have more diversity in their customer base (so more productive hours) will be adversely impacted when costs are disallowed or a proportion disallowed such as for example research and selling and marketing , We therefore welcomes focus on research cost 4.33 as this type of cost does benefit the health of the business, maintains our technical expertise and as a whole and the ability to offer expertise in solutions to all our customers – hence increase the volume of business .The services sold by the Thales group are seldom standard products and are a result of the expertise we have invested in PVRD.Developing new technology is a long term strategy and obviously the cost is not contract specific – that is why it is debated! There is complexity and we concentrate on optimal technical solutions. I can confirm, Industry does only recover cost once, there is a danger though that historic cost is not recovered as it may not be used for pricing and is reflected in contracts and only on post costing situations.

General and Administrative costs ensure the proper running of the firm and are totally necessary and facilitate the conduct of all operations as our Corporate head Office Group costs .

Thales will support further discussion on redundancy – we consider costs should be agreed as incurred and then spread so an not to distort a particular year (4.32) We also need to recover the cost we incur not statutory minimum .

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Allowable cost guidance consultation

Consultation response form

Question 4: Please share your views on proposed guidance changes in the consultation document to Section 5 – Guidance on specific cost type: Part D – Research and development costs.

5.8 Thales agree that the guidance should be more specific to recognise that rates promulgated **belong to a business unit** – they are agreed for the business unit and then used on a contract , and then the individual Pts should focus on the quantum of hours and any escalation needed to do activity per contract , rather than to try and use different rates

We also consider there should be some clarity for pricing using estimated or trend rates.

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Allowable cost guidance consultation

Consultation response form

Question 5: Do you have any other views you wish share or feedback on the consultation document?

Some of the topics have been debated for some time and we welcome the fact that consultations are run albeit recently in smaller forums. We generally support the DSAG submissions. We welcome the clarification in the guidance on agreement of the cost recovery rate and have indeed over recent years since 2016 have harmonised the rate construct for all our business units – we recover our overhead over direct customer funded hours and have 2 levels of material handling , and G&A again over labour only . Obviously if a contractor has a lower material burden the labour and overhead rates may be higher and also any deltas to Direct .Indirect staff mix does cause variation so comparison across Companies in rates themselves is dangerous .
.It is the total cost of acquisition that is the key and not the rates per se.

Thales has worked with the ICPT and SSPS , also split Labour and Overhead in the labour rate construct to enable different escalation to be applied to each element of the rate. The overhead is recovered as a Value per hour and not as a % so it does not vary with seniority. Thales support the comments in sec 5.15 and are willing to share what we have achieved to demonstrate AAR.
One issue is the time taken for submission and agreement of rates – We acknowledge that there are statutory guidelines for submission but there is no recommendation of time line for agreement

BUCARS need to be understood too as business units often receive cost – (IT HR etc.) but the heads are central, so any analysis of cost per head may be incorrect. This is important when comparing rates across Companies that the cost is understood
At times it is disappointing that the process of rate agreement is lengthy and so many costs are challenged when the Company has stringent management control processes with action plans before cost is incurred. Cost is incurred in line with Company policy and not at statutory minimum.

The agreement of actual rates should be easier as we have evidence of cost incurred but it is estimated rates in reality we should be using for pricing as this reflects the position over the life of the contract. Thales was in a position of trying to agree formalised trend rates for future pricing for all contracts within a `business unit but this has stalled, post Covid with the recent uncertainty on external escalation.

In all Companies, planning and budgeting are essential. The problem with estimated rates is that they are often a matter of judgement, the number of disrupting events is high, such as timeliness of order intake and the ability to recruit the necessary staff and external constraints.

The whole landscape becomes understandable only through a combined analysis of the data supplements by a series of additional details and information and consistency across PTS would be good and this is helped today by the SSPS function. We recognise the issues that one size may not fit all (Different legal entities) .

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Consultation response form

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Allowable cost guidance consultation

Consultation response form

Your details

Name:

Scott Cattaneo

Organisation (if you are responding on behalf of an organisation):

ADS (DSAG)

Position (if you are responding on behalf of an organisation):

Head of Defence Commercial

Consultation questions

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Allowable cost guidance consultation

Consultation response form

This section also includes comments on the SSRO paper before the Section 2 response.

1. DSAG is not content with the SSRO definition of attributable to the contract in 3.3 and 3.4. The requirement of 'attributable to the contract' is made in S20(2)(b) of the DRA, and that is all that is specified. The SSRO have expanded on this to require costs to be incurred to 'deliver the contract in question', or 'deliver multiple contracts including the contract in question and equitably apportioned to those contracts'.
2. **3.1,3.2**
   As we have previously proposed, the overview to SACG should make clear Section 13 of the Act frames the purpose for allowable cost guidance and that Section 20 provides the methodology to discharge that purpose (the outcome of applying S20 methodology must always be tested against S13's requirements).
   To explain our thinking:
   Section 13 requires Value for Money on Government expenditure and that a Fair price is paid. "Fairness", therefore, is a primary purpose to be achieved when applying Section 20.
   Allowable costs guidance should help the user to continually test the application of Section 20 against Section 13 objectives. To support that we believe guidance should ask the user to consider costs, especially indirect costs, in the context of what the UK Government is asking of the contractor? This goes beyond the specifics of the contract's deliverables which, for some users of guidance, might be their interpretation of what "enabling the performance of the contract" means.
   SACG to Section 20 might explain AAR:

   Appropriate – what type of cost is appropriate to the nature of business being contracted? *(In the context of Section 13 – Costs that enable the business to: be capable of contracting with Government, successfully execute contracts, successfully execute the contract in question, and to comply with Government policy, legislation and processes).*
   Attributable – is the method of attribution fair*?
   Reasonable – what level of cost is reasonable?

   * "Fair" Attribution may include:
   Costs solely caused by the contract - these will be direct costs and it is "fair" the contract has 100% of such costs.
   Costs that are not solely caused by the contract, but the contract could not be won, nor business operate to execute this and other contracts, without such costs and investments being incurred. Here a "fair" method of attribution is required to ensure a fair share of these costs are charged to the contract.

3. This definition (3.3 and 3.4) and the SSRO widening to '*delivering the contract in question may require sustaining an essential or desirable capability'* is unreasonably restrictive, for cost types that benefit the whole business. The SSRO have used convoluted arguments to try to achieve an acceptable treatment of research costs, and, at best a confusing position on sales & marketing costs. This could be avoided if, as the US FAR 31.201-4 (Determining allocability) permits costs (c) '*necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown'*. This FAR is tried and tested, and is proportionate, if this were adopted, complex SSRO arguments would be avoided and clarity would be brought to the MoD and industry negotiations.
4. If the SSRO do not recognise this can they set out why they believe that FAR31.201-4 (c) is not appropriate?
5. Section 4.8 states the SSRO requirement, that a cost must 'enable the performance of the contract', and that this means there is 'a link between the costs and the contract'. The SSRO state that industry has not identified anything which contradicts this statement, however, it is for the SSRO to state why the legislation imposes this requirement. S20(2)(b) is the only legislative requirement, and this does not require 'enabling' or a 'link'. As Industry cannot prove a negative is it for the SSRO to prove their requirement.
6. The QMAC is not completed for a contract (4.18), it is completed for a business unit. It is a record of the method of attribution of cost to the end cost objectives, it is a disclosure to the MoD, reviewed and accepted by the MoD. It often underpins the assumptions in the contract pricing and should therefore be prima-facie evidence of attribution, otherwise it has no value.
7. We disagree that going concern is unhelpful. All contracts should bear some of the allocation of cost that a business is required to make to sustain itself (its capability and/or capacity). If costs go unallocated to contracts, then companies cannot achieve reference group profitability levels (which are the fair and reasonable target under S13). In bullet 2 of 4.28 the link from cost to contract is the SSROs construction and not a requirement of the law.

8. We welcome the SSRO's definition of research allowability in terms of timing. We consider the logic convoluted and stretching of the concept of 'enabling'. A different approach as set out in 3. and 4 above would be simpler and clearer for all parties.
9. We believe that more discussion is required around what research costs are allowable, the SSRO definition of 'sphere of interest' in 4.38 was a welcome attempt, however consideration of costs that maintain capacity (or going concern), that are outside of this sphere is required. The suggestion in 4.39 of 'related to the subject of the contract being priced' is wholly inadequate. This means the majority of research is likely to be unallowable, and therefore not recovered. Companies' costs of sustaining essential or desirable capacity will either be a reduction in company profit or companies will reduce research investment which would be contrary to the declare position of MoD in the document "The Defence Capability Framework (MOD_The Defence Capability Framework_July 2022 (publishing.service.gov.uk)) published on 12th July 2022, para 12 in particular (on Page 19) which states "We want to focus our collective resources and incentivise industry investment in R&D which will inform future investment decisions by being clear about our enduring challenges and priorities for investment". This does not limit it to a specific contract, but is broader in the sense that it applies to the ongoing business and its investments generally.
10. We find the section on sales and marketing costs confusing, and make the following comments:
    a. 4.41. Selling and marketing costs are distinct from bid costs, they are indirect in nature, not as the SSRO state 'directly or indirectly recoverable'. Further, if sales are competitively priced, the costs are not included in the price that the customer pays, the price is, competitive (not related to cost). The last sentence *'contractors submit that other firms who purchase their services must pay a disproportionate amount of sales and marketing overheads'*, is incorrect, the costs are a reduction in the company profitability.
    b. Furthermore the comparator group incur sales and marketing costs all the time to survive, yet the use of the comparator cost does not make any adjustment for removing these elements of cost so if they represent a true comparison why should Defence companies be penalised unfairly.

a. 4.43 We support the SSRO's statement (as the Statutory Guidance elaborates) that ***'sales and marketing generates economies of scale within the business which the MOD will benefit from, then the guidance already provides for allowability to be evidenced onthose grounds'***. The MoD's application (in the bullet points in 4.43) is not supported, is not Statutory Guidance and is inconsistent with the above statement.
b. 4.44. This paragraph requires clarification, and appears inconsistent with para 4.43 (which looks to the economic benefit)
    i. The first bullet relates to bidding costs, which are not included in selling and marketing costs.
    ii. Selling and marketing costs are overhead in nature and are usually spread over all costs in line with agreed methodologies. Industry rarely can assess what work the sales and marketing costs is required for, although it will cover such things as customer relations, account management and other sustaining features of doing business. This statement appears inconsistent with the SSRO statement above in b.
    iii. We do not understand the bullet points in 4.44, sales and marketing costs are general in nature, and do not relate to customers directly, they are therefore attributed over the whole overhead base.
c. Industry finds this section confusing between the retention of the existing guidance (4.45), and specific attribution to contracts, further there appears to be confusion between bidding costs and sales and marketing costs.

8. MoD costing rates are not used to manage the business, they are for costing and pricing single-source contracts only. They therefore have no purpose in incentives and efficiency (4.48). Attribution must be reasonable and follow proper drivers of cost, this will lead to proper allocation of cost. The SSRO statement *'there could be incentives to over-allocate cost to a single source contract in order to reduce cost (and thereforeprice) of competitive contracts'* has no meaning. Competitive contracts have a competitive price, a change of allocation of MoD cost will not change the competitive price, this should be withdrawn. Further, with open book and transparency demanded by the regulations we question the assumption that single source contracts are being loaded – they reflect the true cost of doing single source business which is a different thing altogether.
9. Re 5.3 and 5.15, as above we continue to reject the 'enabling' requirement.
10. As discussed above, we do not agree with the examples in 5.15:
    a. 5.15 (i). The example of BU HR costs may lead to restrictive application, as the pool may receive attributed cost from the legal entity or head office HR as well, which should be allowable if appropriately apportioned.
    b. 5.15 (i). We are concerned that the definition of research is narrow and does not cover the scope of the research of the business unit.

4.8 We believe fairness should frame consideration of "attribution" (direct or indirect cost). Causality may be one of a number of considerations when determining a Fair Attribution:
- It is fair that a cost, solely caused by the contract, has 100% of that cost attributed to it (direct cost).
- An indirect cost, that is distant from the specific contract (and other contracts), but necessary to the continued functioning of the business, is not easily considered in terms of causality (to a contract), but its costs must be "Fairly" shared across all the contracts (to achieve S13 requirements).

4.15 As our response at 4.8

4.28 We understand the MOD and SSRO believe including the term "the costs of maintaining a going concern" would be unhelpful. The reason we proposed its inclusion is because it is an explicit requirement when contracting with Government. As included in our prior submission:

We would request the SSRO reconsider the r conclusions at 4.28.

Allowable cost guidance consultation

Consultation response form

The MOD Commercial Toolkit explains the requirement of Government for a “going concern” capable of discharging the contract. Only suppliers with “good standing, capability and capacity to deliver the contract” should be invited to bid and they must “remove potential suppliers who are disqualified or have weaknesses that would make them unlikely to be able to deliver the contract.” The tool kit explains how to discharge these requirements and instructs reference to the Defence and Security Public Contracts Regulations (DSPCR) 2011 and in particular, regulations 23 to 26, which explain criteria for rejection, requirements regards a contractors economic and financial standing and technical and professional abilities. The toolkit also covers the requirement to support UK prosperity and innovation.

These should remain important considerations in regards to how allowable costs are allocated and assessed. Otherwise by disallowing costs that are essential to meet these requirements undermines the MoD requirements and policy towards how it selects suppliers and awards contracts.

4.30 Could the SSRO please provide support to their conclusion at 4.30?

We do not see the response to Q17, of the Q&A's, as providing an answer to the points raised by industry. Q17 explains the CG costs are not adjusted when determining the PLI and explains the reasons for this. Industry contention is that CG profits are net of costs that, under the SACG, would be disallowed. Therefore, the PLI used when calculating the BPR is a "lower" profit rate than if the PLI is restated for disallowed costs.

4.36 Whilst we agree with the discussion at 4.36, we think, if (say) Engineering is seen as essential or desirable capability and that research is an important activity towards its sustainment, then other tests (e.g. goods or services could not have been provided but for the research having been previously undertaken) are unnecessary.

Furthermore, any “tests” as included in the discussion at 4.36 should not be limited to just MOD single source contracts. MOD should be interested in all their current and future contracts and contracting types. Indeed, the context should be broad enough to consider Gov't policy being pursued: UK prosperity, innovation, levelling up, up skilling, investment, etc.

4.36 bullet 2 might be improved by being changed to "win and deliver UK Defence contracts"

4.45 Regards sales and marketing costs, we agree with the conclusion reached and that current SACG is maintained.

4.46 We recommend the SSRO reconsider industry’s prior input on the topic of indirect pricing rates as a tool for incentivising efficiency.

Industry explained why rates are not a mechanism for driving efficiency and provided two examples to help explain this point. In the simple examples provided, just the denominator (hours) changed. You may have a lower rate by being less efficient (it took more hours to produce given output), or conversely a higher rate from being more efficient (it took fewer hours).

Industry's position is that indirect rates are an outcome of moving numerators and denominators, they are not a vehicle to easily understand or drive efficiency without full

understanding of context (impact on the rates itself and the impact on the charge to contracts). We believe other tools are better suited to drive and benchmark efficiency, such as the use of firm priced contracts where the incentive is on the contractor to perform efficiently to increase the return on the costs incurred as well as shareholder value as another guiding principle in regards to efficiency.

In previous input, we explained, a fundamental requirement, of an indirect costing rate, is that it meets statutory accounting requirements. It also explained the necessary link between the costing rate structure, in a business' ERP system and that used in pricing rates in order that DeFCARS contract reporting and post costing can be conducted by the conversion of actual costing rates, recorded in the accounting system (against the contract), into pricing rates.

By means of example:
In a complex businesses with vertically integrated Bills of Material (BOM): A part is made in the machine shop (hours incurred and material) and issued into stock when complete. Then the part is issued as a material item, to a sub assembly, along with other parts, and work conducted to create the sub-assembly. When complete the sub assembly is issued to stock. The sub assembly is then issued, as a material item, from stock to the project/ contract for final assembly. Assembly hours are incurred at the project level, assembling together all the sub-assemblies. To convert all the hours incurred and any material uplifts from internal costing rates to pricing rates you need to identify all the hours and material uplifts throughout the BOM (not just those booked at the top level project). Consistency between costing and pricing rate denominator (recovery base) is vital, as is the classification of indirect costs allowable in "production" costs, if statutory requirements are to be met and DefCARS reporting achieved within required timescales.

Table 2 – Research and timing
As commented above, at 4.36: If Engineering is an essential or desirable capability and R&D is a key activity in sustaining this capability, why isn't that test, on its own, adequate?

5.13 We are confused by the statement that "the requirements of allowable costs can only be met to the extent that the parties understand the specific contract or contracts to which the rates will apply – a rate cannot meet the requirements of allowable costs in the absence of a contract…." and "it cannot be fully determined, however, that a particular cost is an allowable cost under a qualifying contract in accordance with the requirement of section 20(2) of the Act, until the contract under consideration is being priced."

We would observe that rates are agreed, at a business unit level, somewhat independently of any specific contract. For instance:

- Actual rates are agreed (at a BU level) looking at the total activity/recovery base as compared to the BU's actual allowable indirect costs; whilst,
- Forward (estimated) rates are agreed assuming estimated indirect costs and an estimate of the recovery base. This forward estimate of the recovery base will include assumptions regarding new contracts being won that may or may not be realised.

Rates being agreed as allowable, independent of a specific contract, is also discussed at 5.5 where it is explained the MOD are proposing the SSRO could make a

determination on the rates independently of a specific contract so as only the rates are determined and not a contract's price.

We presume the SSRO mean a cost, including a rate, only becomes relevant to the DRA when used in pricing or post costing a qualifying contract?

5.15 Appropriate We found the discussion here a little confusing. It is written as if rates are constructed with a contract in mind and how it enables its performance. Indirect rates are generally "process based" (e.g.: a rate for 5 axis machining, a rate for manufacture of composite blades), not contract based. A contract that requires that process/activity will be charged that common rate (for the common process) either as part of the material cost issued to the contract or as a booking of time against the contract (see earlier example at 4.46).

We also recommend language used in guidance needs to embrace all ways of working. Some businesses may have dedicated support functions such as HR and dedicated research, included in the BU. Other groups may have a "central services" approach where the activities are conducted as a division, or group, and relevant costs are recharged to the business unit (i.e. the same costs may sit in different places with different groups).

Question 1: Please share your views on proposed guidance changes in the consultation document to Section 2 – Application of the guidance.

Section 2 application of the guidance response.

1. Statutory Allowable Cost Guidance (SACG) 2.2
   As the proposed guidance at 2.2 does not cover all the important topics that are covered in the existing SACG 2.2 we assume this is a new, additional, paragraph rather than a substitution.

2. Proposed SACG 2.6
   The Act places the onus on the contractor to evidence AAR. Some of the suggested sources of information may not be available to the contractor (e.g. will MOD be willing to share information they hold? How will third party evidence be obtained, at what cost, and how will it be made relevant to the circumstances of the single source requirement?).

3. We recommend "2.6.a. the specific requirements and circumstances of the contract;" is reconsidered if it is to better facilitate consideration of indirect costs involved in meeting Government's broader requirements, distant from the contracts deliverables, but necessary to contracting with Government.
   As stated previously, the agreement of rates is often conducted without reference to a specific contract.

4. In 6.5, the SSRO state *'the Secretary of State may have information pertaining to costs incurred in performing similar activities and there may be information available from third party sources which can provide insights into the costs typically incurred in the performance of deliverables similar to those required by the contract'.* Whilst the MoD may hold this data, it cannot be disclosed to a

third party and is therefore of limited use. How does the SSRO believe that it would be used in discussion with a contractor?

5. ‘New paragraph after existing paragraph 2.4….’. This paragraph is not required, it relates to reporting requirements, this guidance should be limited to allowable cost guidance solely. Likewise in proposed 2.6 ‘information held by the Secretary of State’ should be removed unless it pertains to the contractor in question or is publicly available.

Allowable cost guidance consultation

Consultation response form

Question 2: Please share your views on proposed guidance changes in the consultation document to Section 3 – the AAR principles.

Section 3: The AAR principles

1. Proposed SACG 3.5
   Again, we do not fully appreciate how the SSRO statement "... allowable costs cannot be fully concluded until ...claimed.. under a contract" works in relation to the agreement of indirect pricing rates?
   We presume it means an agreed rate is not relevant to the DRA until it is used on a qualifying contract?
   Rates are agreed, at BU level, before their use in forward pricing, or post costing, of contracts. They are not re-agreed at the point each contract is priced, reported, or post costed.
   The MOD are proposing changes to legislation to mean rates can be referred for a determination, independent of a contract. That being the case doesn't that imply/explain pricing rates and their requirement to meet S13 and S20 is independent of their use on a qualifying contract?

2. Re 3.8. As stated in the answers to question 1, we do not agree with the use of the narrow term 'enabling', the SSRO should explain why the US FAR stating 'necessary for the overall operation of the business' is not appropriate here.
3. Re 3.8.(c). Whilst this expansion is welcomed, it is defined to narrowly by only considering 'qualifying defence contracts and subcontracts'. If (c) ended after the words 'proper operation of the business.' that would be reasonable. It is not possible for contractors or the MoD to assess for future contracts whether they will be qualifying contracts or not, therefore this criterion cannot be met. With DSIS changes permitting the MoD to choose not to compete, it is even less possible to predict what may be a qualifying contract and what will not.
4. Re 3.9. Again we believe that this is stated in an unduly restrictive manner. This would allow using the example of research, the recovery of research that 'include a capability that is required to deliver the contract in question or similar contracts'. Research is rarely for the contract in question, research could be in an area of interest to the future MoD's requirements, but different to a specific contract's output, and therefore not allowable, which seems contrary to the latest statement published by MoD in their Defence Capability Framework. This wording is unhelpful and will contradict the current policy statement in that document and goes directly against DSIS. This wording must be reconsidered and written in a pragmatic manner.
   We suggest wording such as:
   "Delivering the contract in question may require sustaining an essential or desirable capability. These capabilities are those appropriate to: the contract in question, similar contracts, and those required by Government policy, Defence requirements (including the suitable contractor requirements as set out by the Defence and Security Public Contracts Regulations (DSPCR) 2011), along with the various regulatory requirements associated with the market".
5. We believe if 3.9 embraces all the costs required of a compliant Defence contractor, this would resolve many of the issues seen when agreeing indirect costs and remove the need for much of the proposed changes to SACG Section 4.

Allowable cost guidance consultation

Consultation response form

Question 3: Please share your views on proposed guidance changes in the consultation document to Section 4 – Cost accounting and financial reporting

Comments in addition to Q2 comments

6. 4.1 Direct cost definition, the word 'allocated' is preferred to 'traced'.
7. 4.4 *'Additional care will be needed where the contractor's costing system for work under contract to the Secretary of State is different from that usedfor other work, as the costing systems may not be directly comparable'*. The costing system used for qualifying contracts is usually used only for that purpose, pricing and costing MoD single-source contract. No additional care is required, the costing system is not directly comparable, as it includes only AAR costs and is allocated in a manner acceptable to the MoD (QMAC). We suggest that this sentence is removed, if required DSAG is happy to explain the systems usually used to the SSRO.
8. 4.8 See previous comment on 'enable'.
9. 4.9 In stating *'that a particular cost is an allowable cost under a qualifying contract in accordance with the requirement of section 20(2) of the Act until the contract to which the rate is to be applied is being priced'*, the SSRO are inviting the MoD to first challenge the overhead rate and subsequently challenge its application to a specific contract when the MoD may challenge reasonable general business costs.
10. 4.10 (i) as already stated, we believe the example of business unit HR costs will be misconstrued to disallow the legal entity and head office HR costs that are appropriate to include.
11. 4.10 (ii) we are concerned that in some circumstances the utilisation of the resource is impossible to ascertain or it is not proportionate to measure, in these cases a simple and reasonable methodology is chosen. The guidance should reflect this.
12. Illustrative example. DSAG finds this example confusing and its publication may create misunderstandings. We suggest that the example is supplemented by simple numbers, and this is fully discussed with the MoD/Industry prior to publication. Note, few accounting systems record the square footage utilisation of contract requirements. Utilities would rarely have a separate rate.

Allowable cost guidance consultation

Consultation response form

Question 4: Please share your views on proposed guidance changes in the consultation document to Section 5 – Guidance on specific cost type: Part D – Research and development costs.

1. As previously stated DSAG believes that the guidance in 6.10 on research will not provide a reasonable outcome:
    a. It is unlikely as per bullet 1 that the current research cost ('the research' is the current cost) enabled the current contract deliverables. Research is undertaken prior to application in a contract unless the contract includes the requirement of research.
    b. Bullet 2 will be the only way that research is allowable, and it will all relate to the words to deliver the contract '*and others like it*'. Companies may invest in various technologies, when the research is undertaken the outputs may not be known or the technology may be of interest to the MoD, but not for a contract **like** the contract being priced. This definition would disallow either type of cost, we believe both examples should be allowable, therefore bullet 2 requires a more flexible and expansive re-write.

Allowable cost guidance consultation

Consultation response form

Question 5: Do you have any other views you wish share or feedback on the consultation document?

Current SACG A.3.1
Redundancy costs:
We recommend removing from guidance "…but only if approved by the Secretary of State" to better reflect the requirements of SACG Section 3 the AAR principles.
If the caveat is not removed it requires modification to explain the MOD's agreement is required for any settlements that are in excess of that payable based on contracts of employment and precedence operated by that company in relation to redundancy settlements.
The current inclusion of the caveat has led to MOD pursuing exclusion of any payments in excess of statutory minimum. We would contend a reasonable person informed of the facts (a judge) would conclude settlement should be based upon contractual terms and precedence and as such these costs meet AAR.

With regard to indirect costs, we believe it would be of benefit if SACG included the examples and logic the SSRO explained in their consultation of 2018/2019 on "Pricing guidance summary of consultation responses" at 2.11 through 2.15.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/919774/Pricing_guidance_summary_of_consultation_responses_January_2019A.pdf

Allowable cost guidance consultation

Consultation response form

Overview

This response form should be read in conjunction with the consultation document.

This is a public consultation, which is open to anyone with an interest in the SSRO's two statutory aims of ensuring that good value for money is obtained in government expenditure on qualifying contracts, and that parties to those contracts are paid a fair and reasonable price. We also welcome comments from people or organisations with a particular interest in non-competitive defence procurement. The consultation will close on 16 August 2022.

Please respond by 5.00pm on Friday 18 July 2022.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand. Completed response forms should be sent.

- by email to: **consultations@ssro.gov.uk** (preferred)
- by post to: Allowable cost consultation responses, SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB
- by telephone, including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Allowable cost guidance consultation

Consultation response form

Your details

Name:

Andrew Palmer

Organisation (if you are responding on behalf of an organisation):

Ministry of Defence, Single Source Advisory Team

Position (if you are responding on behalf of an organisation):

SSAT Deputy Head - Compliance

Consultation questions

Consultees do not need to answer all the questions if they are only interested in some aspects of the consultation.

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail. This will help us to understand the basis for your answer and inform our finalisation of the guidance. As a minimum, please include the paragraph number(s) your comment refers to.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by marking one of the boxes below.

Yes [x] No [ ]

Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

Allowable cost guidance consultation

Consultation response form

Question 1: Please share your views on proposed guidance changes in the consultation document to Section 2 – Application of the guidance.

1. The MOD has reviewed the proposed guidance changes to Section 2 - "Application of the guidance", described in the consultation document at pages 25–28.

2. We agree the rationale behind the changes at para 6.3 of the Consultation Document, *"that the Allowable Costs guidance may be applied to costs for which the rates are agreed at a business unit level. The guidance frequently refers to 'the contract'" and 'the QDC in question'", which may limit its application to business unit level discussions about allowable costs. The SSRO proposes to include language that more explicitly recognises that when allowable costs are agreed at a business unit level: • the specifics of the contract(s) to which the MOD may apply the rates cannot be fully ascertained when rates are agreed, and; • the costs may be recovered, in whole or in part, across multiple contracts."*

3. We therefore support the inclusion of the new para 2.2, which clarifies that Allowable Costs guidance (ACG) may also support earlier agreements of cost recovery rates. We also support in general the inclusion of examples in the ACG, as helpful to users, although great care must be taken to ensure that readers cannot interpret them as complete and comprehensive statements of the application of the guidance.

4. We support the SSRO proposal to include a new paragraph after existing ACG paragraph 2.4, in a new section called Statutory Reports (before Records and Information section in Part 2). We know from compliance monitoring activities that some contractors who perhaps have only one QDC or QSC, are less aware than others of the SSCR reporting requirements. We agree it would be helpful to alert these more infrequent suppliers to the separate SSRO guidance on contract and supplier reporting.

5. We support the changes to existing ACG paragraph para 2.6, to make more explicit the sources of evidence which may be used by contracting parties in establishing whether costs are allowable. However, we would not want this to detract in any way from the onus DRA Section 20 places on the prime contractor to demonstrate that their costs are allowable – other source of information may be available and relevant, but the initial justification for a proposed cost is for the contractor to put forward.

6. We believe statutory guidance should be developed to bring greater clarity to the question of what costs are allowable in the absence of sufficient evidence being provided to justify a cost. We also make comments later in this response to the effect that a clearer definition of 'reasonable' is needed (see our para 10 below, against Question 3). Such a definition would be applicable to all costs that a supplier proposes to recover through a QDC or QSC (not just those costs agreed at a business unit level and recovered through QBU recovery rates).

Allowable cost guidance consultation

Consultation response form

Allowable cost guidance consultation

Consultation response form

Question 2: Please share your views on proposed guidance changes in the consultation document to Section 3 – the AAR principles.

1. The MOD has reviewed the proposed guidance changes to Section 3 - “The AAR principles”, described in the consultation document at pages 29-32.

2. The MOD agrees with the proposed changes as drafted, although suggests additions to para 3.9 as follows: “Delivering the contract in question may require sustaining an essential or desirable capability. This may include a capability that is required to deliver the contract in question or similar contracts in the future. The costs of sustaining an essential or desirable capability are more likely to be considered an allowable cost of a particular contract if there is an explicit, recorded agreement between the parties that the MOD requires that essential or desirable capability to be maintained. This particularly applies to the costs of idle facilities”.

Allowable cost guidance consultation

Consultation response form

Question 3: Please share your views on proposed guidance changes in the consultation document to Section 4 – Cost accounting and financial reporting

Allowable cost guidance consultation

Consultation response form

1. The MOD has reviewed the proposed guidance changes to Section 4 - "Cost accounting and financial reporting", described in the consultation document at pages 33-36. We note the proposal at para 6.9 to completely replace paragraphs 4.1 to 4.7 of the current ACG. We have the following comments and suggestions:

2. Table 3 - the definition of 'Direct Cost' should be amended to read "A cost that can be traced to a discrete package of goods, works or services specified under a particular qualifying contract."

3. Table 3 - the definition of 'Overhead cost or overhead Direct Cost' should be amended to read "A cost that is used by multiple activities and which cannot be traced, or that the parties agree not to trace, to a discrete package of goods, works or services specified under a particular qualifying contract".

4. Table 3 - the definition of 'Indirect cost or indirectly recovered cost' should be amended to read "A cost that is ~~apportioned and~~ allocated and apportioned to a particular qualifying contract using a cost recovery rate. Indirect costs may ~~typically~~ include overheads. Some direct costs, such as labour, may be applied indirectly as a matter of convenience. The methodology detailing in what circumstances costs will be applied either directly or indirectly should be unambiguous".

5. Para 4.3, reference to Q in QMAC should be Questionnaire, not 'Quantified'.

6. Para 4.4 - we suggest this is amended to read "In order to be allowable, the contractor must be able to demonstrate that costs have been allocated in a way that is reasonable in the circumstances and which avoids any systematic over or under recovery. In general, a reasonable method is one which most closely aligns the driver of a particular cost to the recovery base. Additional care will be needed where the contractor's costing system for work under contract to the Secretary of State is different from that used for other work, as the costing systems may not be directly comparable".

7. Para 4.9 – suggest one deletion, as follows: "For cost recovery rates to be consistent with the requirements of allowable costs, a cost recovery rate, when is applied to a suitable cost recovery base, should produce a cost ~~estimate~~ which is allowable".

8. Para 4.10, bullet (i) 'Appropriate' – We believe much of the text here belongs against 'attributable', not 'appropriate'. 'Appropriate costs' should be about the costs a supplier can spend money on and expect to be recover through a QDC/QSC. We do not understand the second sentence that "It is not a requirement that a cost that is included in a cost pool meets the requirements of allowable costs" (assuming its inclusion in the cost pool will lead to its inclusion in a cost recovery rate that is then used in pricing a QDC or QSC). Although this section is about AAR as it applies to 'indirect costs and cost recovery rates', we see no reason why the guidance that applies should be any different to the general description of 'appropriate' at para 3.11 of the ACG:

> 3.11 A cost is appropriate if it is of a type and arising from an activity that:
> a. a reasonable person informed of the facts would consider enables the performance of the QDC or QSC in question; and
> b. would withstand public scrutiny

9. Para 4.10, bullet (ii) 'Attributable'. We believe the 'HR example' give against bullet (i) Appropriate, should be an example used against this bullet (ii) Attributable. We also suggest the example should be amended as follows: "Examples of costs which may be appropriate include: the HR cost of the relevant business unit delivering the contract(s); research in the domain of the scope of the contract(s); and other business enablers or costs that need to be incurred for the contracting company to function lawfully and efficiently, and that exist for the benefit of ~~the~~ a group of customers that may include the MOD." ~~or are required for the contracting company to function lawfully or efficiently~~

10. Para 4.10, bullet (iii) 'Reasonable'. We strongly disagree with the proposed wording, and the implication that costs are justifiable if they are at a level which the "contractor typically incurs in similar circumstances". While we note that statement continues with the caveat that they should also "exhibit suitable levels of efficiency and productivity", the example goes on to suggest one measure might be if the costs are "consistent with historical trends". Does this mean the contractor's own trends, or some external benchmark? If it is the former, it is not acceptable.

11. The MOD view is that what is required is a definition of reasonable that asserts that "the quantum of costs in the pool are justifiable if they are of a similar level that a well-run company operating under competitive market pressure to maximise efficiency, would be expected to incur and allocate to contracts".

12. Para 4.11 – Suggest amended to read "The parties will need to apply judgement in agreeing the type and standard of evidence that it is reasonable for the contractor to provide ~~in order~~ to demonstrate that their estimated, actual and claimed costs within recovery rates……."

13. Para 4.11 'Illustrative example' – We do not find the example particularly helpful. We strongly disagree with the wording of the final para, which suffers from the same dangers that we read into para 4.10(iii), see comments above. We regard the use of the term 'recent trends' as unacceptable when it is not clear whether this means trends in the suppliers own cost history (in which case MOD would still find it unacceptable), or trends akin to the rationale that MOD would like to see in the ACG (i.e. cost trends exhibited by a well-run company operating under competitive market pressure to maximise efficiency). In addition, we do not think the reference to the Rates Comparison Report (RCR) is helpful at this stage, give the intention in the current Review of Legislation is to abolish the requirement for an RCR.

Allowable cost guidance consultation

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Allowable cost guidance consultation

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Question 4: Please share your views on proposed guidance changes in the consultation document to Section 5 – Guidance on specific cost type: Part D – Research and development costs.

- The MOD has reviewed the proposed guidance changes to Section 5 - "Guidance on specific cost type: Part D – Research and development costs", described in the consultation document at page 37.

- We suggest a new first bullet. "The costs of R&D are more likely to be considered an allowable cost of a particular contract if there is an explicit, recorded agreement between the parties that the scale and nature of the R&D is necessary for the contractor to be able to meet MODs long-term needs".

- Middle bullet of proposed wording. We suggest this be amended to read "the goods or services could not have been provided but for the research, or research of a similar nature, having been undertaken in the past;"

Allowable cost guidance consultation

Consultation response form

Question 5: Do you have any other views you wish share or feedback on the consultation document?

1. The MOD has reviewed the proposed “Other Changes” (page 38)

2. The MOD proposes that the E.1.1 proposal is amended to - “obsolescent stock write-offs” – we propose to change this to “reasonable stock losses and obsolescence costs” consistent with the remainder of the paragraph

3. Proposal on E.4.4 – we would like confirmation that the proposed change is a widely accepted definition of a ‘notional transaction’.