Open Book Contract Management Guidance

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1 Acknowledgements

Writing this guidance has been a journey of discovery and iteration; I picked up the remit of testing and re-writing the guidance in April 2015 but would like to acknowledge all of those who contributed to the initial draft guidance as well as those who proved that it could be implemented practically.

The initial draft guidance was produced by two of my Complex Transactions Team (CTT) colleagues, Abraham Myer and Andrew Pleming. They assembled the methodology through consulting with government departments who were already using a form of Open Book Accounting in some of their contracts; they used two advisors to provide external subject matter expertise and Mark Adams (VP Strategic Relationship Management, Toyota Motor Europe) to give a leading edge industry practitioner’s perspective. This provided the backbone for the Open Book Contract Management (OBCM) methodology that was presented to the meeting of government permanent secretaries, MGS(O), early in 2015. Following this meeting, the Cabinet Office arranged for the CTT to test the methodology practically on some government contracts by way of pilots before becoming policy.

To test the methodology, I was assisted in the main by my colleagues in CTT and four government departments (DWP, MoD, FCO and DH) who had existing contracts that were suitable. I extend my thanks to these departmental teams for their efforts and their constructive feedback; in particular I my thanks go to David Beeson (DWP), Shaun Robinson (DWP) and Ian Baker (DWP) who facilitated many meetings, provided some of the template tools and have started to create organisational structures that will support the roll out of this methodology. The feedback I received was excellent; it gave me the impetus to re-write the guidance in a slightly modified form that should be easier to follow. Victoria Stephens assisted me very ably through its many iterations to get to this final form.

Lastly, I would like to express my thanks to colleagues in the Crown Commercial Service policy section, Jason Waterman and Emma Gallacher, who are helping to get this methodology over the final hurdle and make it policy. I do hope that it provides you sufficient guidance and inspiration to construct and manage more transparent contracts in the future and to continue in our relentless drive towards achieving best value for the public purse.

Alan Wain
Cabinet Office, Complex Transactions Team
2 How to use this guidance

From here, this guidance is divided into 7 sections: the first four provide an introduction to Open Book Contract Management (OBCM) and general guidance that should be read for any OBCM arrangement; the final three sections provide detailed the approaches to OBCM that are dependent upon contract category or ‘Tier’. Once you have determined the relevant ‘Tier’ of complexity for your contract, and so the level of OBCM required, you can skip to the appropriate section (one of the last three) that sets out the process and tools for that Tier. The appendices of the guidance will contain more examples that will help you to implement the chosen approach.

Throughout the guidance we have used the following symbols to help highlight important information:

**Worked example**
In order to improve the understanding, we have included some worked examples to demonstrate how the concept would be implemented in practice

**Warning!**
Where we believe that the application of OBCM could generate issues, we provide guidance to act as a warning of this

**TIP**
At times there will be helpful hints or tips in the guidance to assist you in the application of OBCM. The important ones are highlighted with this symbol for ease of reference
**Reminder**
Occasionally, we repeat certain points to re-emphasise them or to remind you of the earlier text. This symbol serves to remind you that it is a point that has been discussed earlier in the document.

**Key Point**
There are some points in the guidance that we think are essential to the OBCM method and its implementation. We highlight these for special attention with this symbol.
3 Introduction to OBCM

Open Book Contract Management (OBCM) is a structured process for the sharing and management of charges & costs and operational & performance data between the supplier and the client. The aim is to promote collaborative behaviour between client and supplier through financial transparency. The outcomes should be a fair price for the supplier, value for money for the client and performance improvement for both over the contract life.

OBCM has been deliberately named to differentiate it from the more well known term of Open Book Accounting (OBA) as the strategic objective extends way beyond reporting, or accessing, accounting data and into areas of collaborative working with suppliers to control costs, improve processes and create value throughout the lifecycle of the contract. It is through the collaborative working that we believe additional value will be driven. The ideal team to implement OBCM will be a ‘Golden Triangle’ of commercial, financial and subject matter experts who can work knowledgeably with the supplier community.

3.1 Scope

This Guidance is for the use of central government departments planning the management of contracts for IT, Business Process Outsourcing (BPO) and Facilities Management (FM). It is not directed towards contracts for single source supply (as used extensively within the MOD) or construction contracts where established approaches already exist.

3.2 Who should read this?

OBCM is by its nature cross-functional; and therefore this guidance is aimed at those working in areas such as Commercial Management, Finance, and Audit. One of the main challenges of implementing effective OBCM is integrating its management both cross-functionally and across the levels of responsibility. This guidance seeks to provide a common point of reference for all groups and presumes a certain level of capability e.g. qualifications or experience in: commercial or procurement disciplines; contract management; or finance with experience of managing a 3rd party supply contract or other operational experience.
3.3 Background & Purpose

The Public Accounts Committee published a report on Contracting-Out Public Services to the Private Sector on 14 March 2014\(^1\). The report found that there was a lack of a standard, consistent approach to Open Book across government, with no published guidance on how and at what level it should be applied. As part of the government’s response to this report, the Crown Commercial Service (CCS) carried out a study on the use of Open Book in government contracts and drafted guidance on the use of Open Book Contract Management (OBCM).

This guidance document is intended to support government bodies in adopting these recommendations and will explain how using OBCM principles can lead to a better outcome in terms of both delivery and Value for Money. There is a common misconception (fuelled by the use of the term ‘Open Book Accounting’) that only accountants can use OBCM and that departments do not have the necessary specialist resource. This guidance shows how existing contract management teams, supported by training and working collaboratively with their finance and operational teams, can apply OBCM and achieve the benefits of more transparency and better decision making. The guidance has been developed using best practice from the NAO, MOD, CCS and other government bodies (see Appendix 1) and after extensive conversations with contract managers in central government departments.

3.4 The Aims of OBCM

OBCM is one initiative in a long-term programme to improve government’s commercial capability. It complements other initiatives to improve transparency, deepen industry collaboration and accelerate the development of the commercial and finance professions.

The intention of OBCM is to provide a consistent approach that can be applied to a broad range of different contracts. This starts with an assessment of the needs of the contract, to determine the type and level of Open Book practices that should be applied. This assessment uses a tiered framework (the “Open Book Application Model”), which allows Open Book to be used in a proportionate way depending on the risk level and complexity of the contract. Complex or high-risk contracts will be assigned to Tier 3 or 4 whereas simpler contracts will fall into Tier 1 or 2. You should use Open Book on those contracts where the additional cost is justified by the perceived level of benefits and risk.

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\(^1\) HC Committee of Public Accounts, Contracting out public services to the private sector, Forty-Seventh Report of Session 2013-14, HC 943, February 2014
3.5 Collaboration

The success of using Open Book techniques to manage contracts depends on the creation of a new, collaborative culture that eliminates adversarial, opportunistic behaviour by either side, while not dissuading frank discussion to resolve business challenges. Collaboration in OBCM is specifically defined as:

“Openness that supports data driven discussions that are proportionate to driving behaviour change to increase contract cost efficiency and performance.”

A collaborative culture should be motivated by both the best interests of the customer and also those of the supply chain. In order to encourage this culture, it may be practical for customers to take steps such as organising facilitated workshops or co-locating staff to build mutual trust and confidence in both parties. For more complex contracts, we also suggest creating a formally contracted Commercial Optimisation Review Board. This will be a part of the Strategic Board that sits above the Delivery Board and will be crucial in creating and sustaining the collaborative culture; members of the Board will need a good knowledge of, and commitment to, the OBCM process.

Collaboration can start during the procurement process with pre-market engagement setting the tone and testing the limits for financial transparency. In Open or Restricted procurements, dialogue and/or collaboration is not permitted but Competitive Dialogue or Competitive with Negotiation procedures will allow you to further develop the principles before contracting with your selected supplier.
4 Approach Outline

The overall approach to OBCM is summarised by the diagram on the right. It shows:

A. the **Decision Tool** used to decide the optimal benefit/cost “Tier” of OBCM application (see below);

B. the **Application Model** which identifies the proportionate set of tools and processes for that Tier; and

C. **5 Tools** used in OBCM processes and collaborative behaviours.

The Tools are only applied fully for more complex contracts in Tiers 3 or 4. They are built around agreeing and tracking *allowable* costs: those that qualify as being *appropriate* and *attributable* and so valid costs within the contract. A clear definition of allowable costs is then used in assessing whether the costs incurred are *reasonable*.

The cycle portrayed in the diagram applies through the full commercial life cycle of procurement, contract and exit management. The processes and tools are applied iteratively and selected based upon the type of contract, its stage in the contract lifecycle and your strategic objectives.

### 4.1 Strategic Objectives

When considering whether or not to use OBCM for your new contract procurement, contract extension or contract change notice (CCN), it is worth asking two key questions:

1. does the contracting process accommodate this approach?
2. if it does, what are the strategic objectives that OBCM is trying to achieve?
In new contract procurement, OBCM can be accommodated in a straight-forward way as the customer is able to determine what is being procured and how. By contrast, whether a contract extension or CCN can accommodate this approach will be predetermined by the original contract or your ability to negotiate an OBCM mechanism with the supplier.

Assuming that the OBCM can be accommodated, your strategic objectives will help you to determine the level of detail that you will require from the process, how invasive the process will be and what tools you will need to use (which are described later in this guidance).

The following checklist, though not exhaustive, will help you to assess your OBCM approach:

✓ Do you have a good understanding of what the costs should be (the ‘should be’ cost) and intend to use OBCM to ensure that you are comparing all contracts on a like-for-like basis? If so, a lighter touch OBCM approach may be appropriate.

✓ Are you using the OBCM process to gain a better understanding of the ‘should be’ costs? If so, this will result in more work during the pre-procurement stage as you will need to establish a common base for suppliers to propose their costs and for you to analyse them on a like-for-like basis.

✓ Do you expect that there will be several CCNs during the course of the contract delivery and want to control the costs associated with CCNs? If so, you will need to establish which costs are allowable in future and embed them within contract schedules at the contract award stage. You will also need to determine which costs are fixed and which are variable.

✓ Are there features of the contract, which will require collaborative working with the supplier, following contract award, to develop innovative ways of delivering the solutions? If so, this will require a comprehensive approach that both embeds allowable costs in the contract schedules and sets up the processes for how you and your supplier will work together to achieve optimal collaboration.

✓ Are the risks of the service being procured well understood or is there likely to be some pricing of uncertainty due to a novel approach for example. If so, you may consider using the OBCM approach to separately identify the risks that are being priced into the bid; you might also consider mechanisms to share in the upside benefits if the risks do not materialise though careful commercial planning needs to be done in advance.

✓ Do you have a good understanding of the quantum of benefits that may be delivered through an OBCM approach? This will determine how much effort you should plan to put into the OBCM approach you are following.
The last bullet in the list above is one that must be considered at all times when you are determining the OBCM approach to follow. I once asked a friend of mine that used to be a professional drummer what it was that made the difference between a good drummer and an excellent one. His answer was “it’s really simple; it is about knowing what to leave out”. Working through every single tool and process described in this guidance is a large undertaking. This will be necessary for some contracts but not for others. Therefore, good commercial judgement MUST be exercised throughout this process to ensure that the potential benefits of OBCM ALWAYS outweigh the costs that will be incurred in executing it. Such skill and judgement will not be gained entirely through reading this guidance booklet but should be accessible either within your department or within other government organisations. A critical success factor for your contract will be that you take the responsibility for finding these capabilities and tapping into them; in turn, you will enhance your own capability eventually reaching a point where you can exercise the necessary judgement yourself.

The remainder of this guidance will provide you with the detail of the processes and tools that are required for successful implementation of OBCM. The first step is to determine the relevant ‘Tier’ for your contract. Following this, the guidance is arranged in sections that specifically relate to each Tier and the processes and tools to be used for each of them. Therefore, after working through the first section, you may skip the sections on Tiers that are not relevant. The appendices of the guidance will contain more examples that will help you to implement the chosen approach.

4.2 Costs

The main purpose of OBCM is to gain transparency of costs. The majority of this guidance refers to supplier costs, which are NOT the same as the price. They can be distinguished in the following way:

- **Supplier costs** are the costs which suppliers actually incur, or expect to incur, in delivering the service that you are buying.

- The **price** is what you pay for those services, which includes the supplier costs but adds on margin and any contingency or risk pricing the supplier wishes to charge.

Our objective in OBCM is to gain maximum transparency of those costs such that we are well informed as to the add-ons that then become the price we pay. For the remainder of this guidance, when we refer to costs, we mean supplier costs with one exception; when we are specifically referring to the customer cost model, this is the amount that the customer will pay to the supplier, so will include the profit and risk add-ons described above.
5 OBCM Tiers

The approach outline (Section 3) encouraged you to think about the strategic objectives for your contract. This is highly relevant to the first step of OBCM, which is to decide to which Tier your contract should be assigned so that you can determine the most appropriate processes and tools to apply to it. It is at this stage that the greatest amount of commercial judgement needs to be applied; the guidance will give you a structure for deciding the most appropriate Tier that will work in most cases but you will need to harness your resources to make the final determination as to whether the Tier you are allocating the contract to will deliver good benefits without being outweighed by the costs.

5.1 Decision Tool: to identify the Tier

To decide the optimal “Tier” of OBCM application, we will look broadly across nine different dimensions that characterise most contracts. Contracts that are high-risk or complex will fall into the higher Tiers. Generally, contracts are assigned to a Tier by evaluating these dimensions with the highest score assigned to any of them being the recommended Tier for the contract. For example, if the contract can be described as ‘Tier 1’ due to a fixed scope and single provider but Tier 3 due to being high risk, then the contract should be assigned to Tier 3 (though good commercial judgment should be used in reaching this decision).

When deciding the Tiers, along with the associated processes, you will need to determine whether you have the resources to execute your chosen level of OBCM. Therefore, it is worth doing an early assessment of a portfolio of contracts so that you can determine the likely resource demand that will occur over a period of time and prioritise your contracts if necessary. As prioritisation would mean that some contracts would get less attention than others, it is good practice to introduce a governance process around this decision-making.

Figure 2 illustrates the nine dimensions and provides examples of the characteristics of a contract that will qualify it being assessed into the boxes in the columns representing the Tiers. Later, you will see that the processes and tools that are used for the higher Tiers are much more invasive and, therefore, generally more expensive to administer.
## Figure 2: Decision tool

<table>
<thead>
<tr>
<th>Dimensions</th>
<th>Limited</th>
<th>Incremental</th>
<th>Transformational</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope Change</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service Lines</td>
<td>Single</td>
<td>Multiple; integrated to outcomes</td>
<td>Multiple; decoupled outcomes</td>
</tr>
<tr>
<td>Supply Chain</td>
<td>Single Provider</td>
<td>Simple</td>
<td>Complex</td>
</tr>
<tr>
<td>Price model</td>
<td>Fixed Price</td>
<td>Variable Price</td>
<td>Incentivised</td>
</tr>
<tr>
<td>Volume</td>
<td>Fixed</td>
<td>Variable</td>
<td>Uncertain</td>
</tr>
<tr>
<td>Dependencies</td>
<td>Few</td>
<td>Certain &amp; internal</td>
<td>Uncertain &amp; external</td>
</tr>
<tr>
<td>Saving Potential</td>
<td>Limited</td>
<td>Low</td>
<td>Medium</td>
</tr>
<tr>
<td>Innovation</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Value/ Risk</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
</tr>
</tbody>
</table>

**Tier 1**: Verify  
**Tier 2**: Verify and Control  
**Tier 3**: Manage  
**Tier 4**: Partner
5.2 Application Model

Having assessed the characteristics of the contract and provisionally assigned it to a Tier, the ‘Application Model’ is used to determine which processes and tools should be used. The frequency of using the processes and tools, and how invasive the process might be, increases progressively as you move towards Tier 4.

After provisionally assigning your contract to a particular Tier you should review the Application Model and determine whether the resources needed for the process and tools associated with that Tier are proportionate to the benefits it will provide. If not, you may conclude that your contract should be in a lower Tier to the one initially determined. Alternatively, sensitive contracts may suggest that you should use the processes and tools associated with a higher Tier.

Figure 3: OBCM Application Model
The tools associated with each of the Tiers are detailed in later sections of this guidance but are listed below against the descriptions for the boxes in the Application Model for reference.

**Table 1: Application of tools & processes to the OBCM Tiers**

<table>
<thead>
<tr>
<th>What</th>
<th>Description</th>
<th>OBCM Tools used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invoice charges</td>
<td>The invoice charges are simply the layout of the charging lines on the supplier’s invoice that allow you to verify that the invoice is accurate</td>
<td>• Cost Units &amp; Drivers</td>
</tr>
<tr>
<td>Performance data</td>
<td>The performance data will relate to performance measures built into the contract and volumetric measures that are used to calculate the invoice charges</td>
<td>None</td>
</tr>
</tbody>
</table>
| Customer cost model   | The model you initially build to invite suppliers to populate in the bid. The cost lines in a customer cost model may not align exactly with the supplier’s own chart of accounts, so some translation will be required to populate it. In more complex models, you will adjust the cost lines to align with the chosen supplier’s accounting system to reduce administrative effort and create a supply cost model | • Contract Cost Register  
• Cost Units & Drivers |
| Supply cost model     | The same as the customer cost model except that the detailed cost lines will be directly comparable to account codes and cost information held in the supplier’s own financial systems enabling easy download of information for monthly reporting. | • Contract Cost Register  
• Cost Units & Drivers |
| Control Protocols     | Serve to indicate where data for volumetric driver information will be obtained from (i.e. the single source of the truth) and also key metrics that will be used to assess whether costs are in line with expectations (e.g. average call handling time might be used to track performance of a contract where call handlers are paid on a price per minute rate) | • Control Protocols               |
| Commercial optimisation | This is the governance process that is put in place to periodically review the costs of the contract and, in collaboration with the supplier, proactively assess cost reduction measures that may be implemented | • Commercial optimisation reviews |
NHS Supply Chain Contract

The contract was originally signed in 2006 and was set to have a ten year duration with the option to extend for a further five years. It is a significant contract that annually procures around £1.5bn of goods for NHS Trusts and distributes them as required. The supplier makes a return by generating margin on all the products that it buys and distributes.

The Department of Health recently decided that it would negotiate new OBCM arrangements with the supplier in exchange for a two year extension; monthly services payments would be based on reimbursement of costs plus an agreed fixed margin with opportunities for the supplier to earn bonus payments through reducing its operating costs and through delivering cash-releasing savings from its procurement activities; the NHS Trusts still have the freedom to choose whether to use this service or not.

Assessment of the dimensions in the ‘Decision Tool’ showed that at least five (Scope, Service, Pricing, Volume and Savings) would fall into the Tier 3 definitions. On review of the ‘Application Model’, all the processes and tools for Tier 3 were considered to be appropriate. However, the team decided to make the use of ‘Commercial Optimisation’ more active through monthly operational meetings and quarterly Board level reviews. As the supplier already had its own operational budgeting model, this was modified to include only ‘Allowable Costs’ and used as a ‘Supplier Cost Model’ for the purposes or comparing actuals to budget in the OBCM arrangements. The decisions on ‘Commercial Optimisation’ and ‘Supplier Cost Model’ would theoretically apply to Tier 4 but would help to deliver the cost savings and transparency sought in this situation.

In summary, therefore, the team will use the following processes and tools to manage this contract extension:

- Contract Cost Register
- Cost Units and Drivers
- Supply Cost Model
- Commercial Optimisation Review
- Control Protocols
5.3 Next steps

The above section is mandatory and is applied to all contracts for which you expect to use OBCM. The Tier to which you have assigned your contract will determine the next steps. The following four sections provide detailed requirements for each Tier. Therefore, having completed the activity for this Section 4, you may now skip directly to the section that covers the Tier relevant to you.
6 OBCM applied to Tier 1

Tier 1 contracts are not specialised, widely available, have costs that are easily understood and are probably fixed-price for simple services (i.e. commoditised services); a typical example may be the provision of security services at a fixed hourly rate of £x. Therefore, managing the contract will only require that the charges that are being invoiced be verified as accurate and true (i.e. the services have actually been delivered).

While included in the overall approach to OBCM, these are the simplest form of contracts, so need little in the way of sophisticated processes or tools. Best practice contract management techniques should be applied.

6.1 Processes & tools applied to Tier 1 contracts

As discussed in Section 3, at each Application Tier there is an incremental, proportionate build of processes and tools. These are mapped against Tier 1 below:

Table 1: Processes & Tools for Tier 1 Contracts

<table>
<thead>
<tr>
<th>Process or Tool</th>
<th>Managing inputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Cost Register</td>
<td>✗</td>
</tr>
<tr>
<td>Cost Units and Drivers</td>
<td>✓</td>
</tr>
<tr>
<td>Supply Cost Model</td>
<td>✗</td>
</tr>
<tr>
<td>Commercial Optimisation Review</td>
<td>✗</td>
</tr>
<tr>
<td>Control Protocols</td>
<td>✗</td>
</tr>
</tbody>
</table>

6.2 Cost Units and Drivers

Cost Units are all types of costs that drive contract charges. For a simple Tier 1 contract, the Cost Units are likely to be fixed costs and it should be clear from the contract how the supplier measures the units of consumption (i.e. the drivers) and how they calculate the charges from this. During the bidding process, the costs may be compiled in a spreadsheet to aid transparency of how fixed costs are assembled. However, during the operation of the contract, you will be verifying that the service has actually been performed and the fixed cost is what you expected. If Management Information (MI) is required for this verification process, it should be detailed in a contract schedule.
## Worked Example:

**Cost Units & Drivers tool**
A government department has agreed a fixed-price service contract for 12 security guards to man three positions, 24/7, at a fixed cost of £41,100 per month.

The fixed price bid submitted by the successful supplier had the following cost units and drivers information:

<table>
<thead>
<tr>
<th>Cost Item</th>
<th>Cost Unit</th>
<th>Driver</th>
<th>Volume per month</th>
<th>Charge (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost Units &amp; Drivers</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guard</td>
<td>£100/day</td>
<td>Days</td>
<td>30.44</td>
<td>3,044</td>
</tr>
<tr>
<td>Guards per position</td>
<td>£3,044/guard</td>
<td>Rotating shifts</td>
<td>4</td>
<td>12,176</td>
</tr>
<tr>
<td><strong>Cost Calculation Model</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Positions</td>
<td>£12,176/position</td>
<td>positions</td>
<td>3</td>
<td>36,528</td>
</tr>
<tr>
<td>Guard uniforms</td>
<td>£10/Mo./guard</td>
<td>guards</td>
<td>12</td>
<td>120</td>
</tr>
<tr>
<td>Admin. on cost</td>
<td>£300</td>
<td>Fixed monthly</td>
<td>N/A</td>
<td>300</td>
</tr>
<tr>
<td>Contingency for absence</td>
<td>3% of guard pay</td>
<td>Fixed monthly</td>
<td>£36,528</td>
<td>1,096</td>
</tr>
</tbody>
</table>

**TOTAL COSTS PER MONTH**

|                               |                  |                  |                  |            |
| TOTAL FIXED PRICE CHARGES PER MONTH |                  |                  |                  | 41,100    |

| Margin                       | ~8%              | Monthly costs    | £18,971          | 3,056      |
Invoice verification

In the above example, a government department has agreed a fixed-price service contract for 12 security guards to man three positions, 24/7, at a fixed cost of £41,100 per month.

The customer will need to establish a monthly process to verify that each of the guard positions were manned 24/7 before making the invoice payment to the supplier. A simple weekly check of the guard logging system can be used to achieve this.

<table>
<thead>
<tr>
<th>Day</th>
<th>M</th>
<th>T</th>
<th>W</th>
<th>T</th>
<th>F</th>
<th>S</th>
<th>S</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shift</td>
<td>E</td>
<td>L</td>
<td>N</td>
<td>E</td>
<td>L</td>
<td>N</td>
<td>E</td>
</tr>
<tr>
<td>East door</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Front gate</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>North road</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

**Key:** E = Early Shift, L = Late Shift, N = Night Shift
7 OBCM applied to Tier 2

Tier 2 contracts are more complex than Tier 1 as they deal with variable elements e.g. changing volume demand over time or mixed resources all at different costs. Payment by Results (PbR) services may also fit into this Tier but more complex PbR will be more effectively managed via a Tier 3 approach. These services should still be relatively commoditised and so can easily be purchased in measurable units. Therefore, as with Tier 1, managing the contract will require only that the invoiced charges are verified as accurate and true (i.e. the services have actually been delivered). The key difference is that more sophisticated measures will have to be put in place for measuring or tracking volume usage and performance.

7.1 Processes & tools applied to Tier 2 contracts

As discussed in Section 3, at each Application Tier there is an incremental, proportionate build of processes and tools. These are mapped against Tier 2 below:

<table>
<thead>
<tr>
<th>Process or Tool</th>
<th>Managing inputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Cost Register</td>
<td>✓</td>
</tr>
<tr>
<td>Cost Units and Drivers</td>
<td>✓</td>
</tr>
<tr>
<td>Supply Cost Model</td>
<td>✓</td>
</tr>
<tr>
<td>Commercial Optimisation Review</td>
<td>✗</td>
</tr>
<tr>
<td>Control Protocols</td>
<td>Periodic</td>
</tr>
</tbody>
</table>

7.2 Contract Cost Register (CCR)

A Contract Cost Register (CCR) is a list of ‘allowable’ and ‘non-allowable’ costs. It is used extensively in Tiers 3 & 4. As Tier 2 is focused on supplier outputs, extensive effort does not need to be put into understanding the full make up of the detailed supplier costs. However, the CCR can be used effectively in the procurement process to define which costs are ‘Allowable’.

For the avoidance of doubt, the CCR is referring to those costs that can be charged transparently in the contract and will be the suppliers’ own costs (i.e. those it expects to incur), known as Allowable Costs.

The customer Charge (or Price) for specific services can be represented as:
Open Book Contract Management; Guidance

**Charge (Price) = Allowable Costs + Margin**

Where ‘Allowable Costs’ are those Direct and Indirect (e.g. some types of overhead that would be expected to be charged to the contract) costs that are attributable to the delivery of the services; other costs that are not attributable (e.g. some types of overhead costs such as sponsorships, bad debt provisions, costs for remedies for supplier errors, etc.) would fall within the definition of ‘Margin’. Depending on your strategy for the use of OBCM, risk or contingency pricing may be classified as ‘Allowable Costs’ for transparency or as a component of margin. Classifying costs in this way provides a means of comparing costs on a like-for-like basis and understanding the margin a supplier is expecting to take from the contract. ‘Allowable Costs’ are discussed in more detail below and more comprehensive guidance on ‘Allowable Costs’ can be found in the Single Source Costs Standards².

**Note:** It is very important to consider what falls within the definition of ‘Allowable Costs’. The ‘Margin’ element in the ‘Charge’ equation above may be the sum of profit expected plus Indirect/Overhead costs plus risk contingencies that are not included as ‘Allowable Costs’, so it could be higher than most people commonly expect. People equate ‘Margin’ directly with the profit a supplier is making on a contract, so if too many non-allowable indirect costs exist, explaining the apparent ‘Margin’ or profit may be more problematic. A recent NAO report³ recommended “Government needs to develop a more sophisticated understanding of these profits, so that it can improve the incentives in its contracts and its negotiations with suppliers”. Furthermore, the increased transparency that you achieve through ‘allowing’ some indirect/overhead costs gives you greater ability to compare these cost lines for multiple contracts with the same supplier and provide a new basis for negotiation.

If you already know the ‘Should Be’ cost of the services being procured, then the CCR can be used to request that suppliers complete a pricing model (i.e. fill in a spreadsheet) based on the Allowable Cost lines that will be in your ‘Should be’ cost model.

If you do not already know the ‘Should Be’ cost make up of the services being procured, then you should develop some initial assumptions and build a first pass CCR. The model should then be tested and refined using pre-procurement engagement processes such as supplier boot camps. The completed cost models, based on an agreed CCR, returned by suppliers as part of their bids will provide a valuable source of comparison of costs and margins.

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³ Open Book Accounting and Supply Chain Assurance: NAO report HC 91-I SESSSION 2015-16, 1 July 2015
7.2.1 Allowable costs

In the procurement process, three tests are used to ascertain whether a type of cost (or ‘cost line’) presented by a supplier is an ‘Allowable Cost’ for the purposes of bid comparison. Such costs will need to meet all of the three criteria outlined below.

Table 3: Allowable Costs: Criteria, Qualifying Definition and Tool

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Qualifying definition for a cost</th>
<th>Example: software licence costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Appropriate</td>
<td>In its character and nature, it must represent a cost that is expected to be incurred in the conduct of delivering the service in question and should be able to withstand public scrutiny.</td>
</tr>
<tr>
<td>2</td>
<td>Attributable</td>
<td>It represents an instance of cost unit correctly allocated in delivering the contract outputs (i.e. it is incurred in fulfilment of the service).</td>
</tr>
<tr>
<td>3</td>
<td>Reasonable</td>
<td>It should not exceed what might be expected to be incurred in the normal delivery of the service.</td>
</tr>
</tbody>
</table>

What cost lines are included?
How is the line costed?
Why is the line costed at that value?
The following checklists extracted from the Single Source Costs Standards\(^4\) may be used to assist your assessment of ‘Allowable Costs’. All criteria must be met for a cost to qualify as an allowable cost:

**Appropriate Cost Checklist**
- Is it a cost that would be expected to be incurred in the delivery of the service?
- Is the cost suitable for the purpose of the qualifying service?
- Would the inclusion of the cost withstand public scrutiny?
- Is the inclusion of the cost fair and equitable?

**Attributable Checklist**
- Is the treatment of the cost consistent with normal business practices?
- Is it consistent with the firm’s normal accounting practices?
- Is the cost borne by the supplier?
- Is there a causality of the cost to the contract?
- Is the cost identifiable?
- Is the cost incurred in fulfilling the specification of the contract?
- Can it be evidenced that the cost has not been recovered elsewhere?

**Reasonable Checklist**
- Is it congruent with meeting the contract performance requirements?
- Would the cost withstand public scrutiny?
- Are cost estimates based on empirical evidence, where this is possible?
- Is the cost consistent with any sector/market benchmarks?
- Is the quantum of cost consistent with good business practice?
- Do the costs deliver good value for money to the UK taxpayer?

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**Contract Cost Register**

A government department is seeking to engage subject matter expertise to develop specific category management strategies and sourcing plans for:

- Specialist capital equipment categories
- Technical maintenance teams
- Consumable products to support the capital equipment

The sourcing plans for each are expected to produce cash releasing savings of at least 20% of costs currently being incurred. Therefore, an incentive scheme will be introduced for the subject matter experts whereby bonuses may be earned on a sliding scale for sourcing plans that result in demonstrable savings over 20%. As there is no certainty around the 20% savings expectation, the government department does not expect the subject matter experts to take (and price) risk of not achieving this target, so there will be no equivalent downside potential in the contract.

Following a supplier boot camp to discuss the requirements with potential service providers, the government department established that the following costs would be ‘Allowable’:

<table>
<thead>
<tr>
<th>Cost Component</th>
<th>Allowable Costs</th>
<th>Non-Allowable Incl. in Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project Manager basic pay</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Partner grades</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Director grades basic pay</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Staff grades 1,2 &amp; 3 basic pay</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Admin staff</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Trainees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Temporary staff</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Bonuses relating to this contract</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Overtime</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Pensions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Travel &amp; subsistence</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Profit on operations</td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

And that a reasonable amount of travel will be involved in the development of the category strategies; non-Allowable costs are to be incorporated into the service provider’s margins.
7.3 Cost Units & Drivers

Cost Units & Drivers are used to calculate costs that vary with different volumes of activity that may occur in a contract. The Cost Unit component is simply the base element of the cost (e.g. cost per hour, cost per person, cost per KWh). The Cost Driver in its simplest form is the variable element that is multiplied by the Cost Unit to yield the costs for that component. In the case of semi-variable cost elements the cost may increase only incrementally once a certain threshold of volume, or the Cost Driver, has been exceeded. In addition, the OBCM approach seeks to understand the causal factors for the volumetric driver as well as the actual number being used. For example, software licences may cost £100 each and a volume of 70 licences are reported as costs, so we need to understand whether each laptop has one licence, or whether some are configured without, and whether the number of laptops is driven directly by the number of staff associated with the service to fully understand this cost line. Through this analysis, we can establish an audit trail as to the correct values to be included in the cost model.

Depending upon the complexity of the variable elements in the contract, you should choose whether separate documents containing outlining the individual Cost Units & Drivers is required or whether it would be straightforward to construct a model that takes account of the Cost Units & Drivers alongside other fixed cost lines; in some Tier 2 contracts, this will be possible and an example presentation of the cost lines is shown below.
The cost units and drivers tool may be used either during the procurement process or during contract delivery to assess where focus should be placed to achieve lower costs.

**Example 1**, a call centre may have a cost per minute for calls with the volumetric driver being the total number of minutes spent handling calls. However, a focus on the average handling time for the calls (AHT) and what is driving that (e.g. too long an introduction, an algorithm with too many steps or too much complexity, too long on call completion courtesies, etc...) may reveal some significant cost
saving opportunities. If picked up in the procurement phase, you may choose to implement performance measures associated with AHT or evaluate the algorithms used. If picked up afterwards, you may negotiate different introduction or exit scripts with the service provider.

Example 2, travel costs using own transport are incurred at a rate of £0.40 per mile with the volumetric driver being the total number of miles travelled. However, a focus on the locations of the projects or an emphasis on the use of alternatives such as public transport or video meetings may reveal some opportunities to save costs. If picked up in the procurement phase the assumptions can be modified, caps applied or policies on travel set within the specification. If picked up afterwards, you may negotiate the use of alternatives with the service provider.

7.4 Supply Cost Model

The Supply Cost Model brings together elements of the CCR, the Cost Units tool and the Cost Drivers tool to create a working model of the costs incurred. The model will either be used to generate the monthly invoices or as a forecasting tool to establish significant variances between actual costs incurred and those predicted by the tool. In Tier 2, we are still contracting for outputs so the Supply Cost Model will most likely be used for generation of the monthly invoice, which will flex the agreed cost model using defined Cost Drivers but will not account for the actual costs that the supplier incurs (e.g. in the above worked example, staff at grade 2 will always be charged at £500/day regardless of what an individual staff member’s pay actually is).

It is important that both you and your main stakeholders understand that the modelled Supply Costs are meant to reflect what the supplier pays for its inputs. The amount that you will be charged on a monthly basis will be dependent upon the contract type, and will include a Margin (see 6.2 above). Additionally, in Tier 2, once the procurement process is complete, a fixed rate is agreed and the actual costs incurred become less important. The table below illustrates this point, indicating how the Supply Cost Model might be used for the different Tier 2 contract types:
Table 4: Application of Supply Cost Model

<table>
<thead>
<tr>
<th>Contract Type</th>
<th>Possible application of Supply Cost Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment by Results (PbR)</td>
<td>The Supply Cost Model will create the basis for calculating the payment per result, which will be the calculated costs incurred plus the supplier’s margin plus any risk premium the supplier will charge. Once modelled, this becomes the basis for payment and actual costs incurred are of no interest to you as the customer</td>
</tr>
<tr>
<td>Complex variable priced with inputs not commoditised</td>
<td>This will follow the same pattern as PbR above. However, once the Supply Cost Model is constructed, it may continue to be used to flex the variable cost elements in order to determine the monthly invoice. A model of this type is illustrated in the worked example above. Remember that the agreed supplier margin payments will be added to the costs indicated by the Supply Cost Model</td>
</tr>
<tr>
<td>Change Control Notices</td>
<td>Use the Supply Cost Model to predict the relevant cost lines to agree the CCN charge. In the case of Tier 2 contracts, you will most likely refer back to the models that were submitted by the supplier in the procurement process to provide the basis for discussion about the cost of the change</td>
</tr>
</tbody>
</table>

At all Tiers, you will want to model the *Charges* to be paid to the supplier. However, Supply Cost Models can require a significant degree of maintenance and so the frequency at which they are updated and their level of detail should be commensurate with the complexity of the contract and the corresponding application Tier. For Tier 2 applications the Supply Cost Model will be used mainly during the procurement process, and then a summarised version may be used to calculate the monthly charges where variable volumes or activity are driving the total invoice value. The model may then be referenced only on an annual basis to check that the original assumptions are still valid or as and when contract change notices are required.

### 7.5 Control Protocols

Use of the Control Protocols is likely to be less frequent in Tier 2 contracts than in those for the higher Tiers but element are still applicable and you should exercise judgement as to where and how frequently to apply them. Control Protocols are pre-contract agreements which:

- detail the source of information used in calculating volumetric Cost Drivers (i.e. which reports are used to calculate volumes and where they come from such as finance, operations etc...) This allows the customer to verify figures if they change from one month to the next
- identify key ratios that will be used to alert both parties of potential cost drift
- test that Allowable Costs still meet the criteria that was applied for attributable and reasonable at the beginning of the contract
7.5.1 Key ratios

Good financial management often relies on ratios or interrelationships between different costs to provide a first sign of costs drifting from and expected norm in a dynamic system. For example, manufacturers of goods may use inventory turns per year to better understand working capital movements, financial services may use debtor days and creditor days to understand the efficiency of the operation and call centres may use average call handling time to better understand overall cost drift even though cost per minute remains in control. The Control Protocols will, through discussion with your service provider, identify the key ratios that should be monitored and will build them into the monthly reporting cycle.

“Control” as opposed to “audit” is used to refer to the activities within OBCM. These control activities should be resourced from within the OBCM team with the contract specific knowledge that they possess. Arm’s length audits by external agents would not be suitable. However, Open Book Provisions should contract the rights to conduct and respond to a formal audit.

7.5.2 Testing Allowable Costs

Allowable Cost Reviews are proposed at 5 Stages in the contract life-cycle in order to set up the initial Contract Cost Register, then test for relevance during the course of the delivery of the services.

![TESTS]

Where Charges are derived from Costs, the Reviews should take place at 5 Stages as either Detailed or On-going reviews:

**Detailed, One-off, Reviews**

‘Detailed’ or ‘One-off’ reviews are scheduled at salient contract points:

**Stage 1 Pre-Contract:** A review at this stage aims to capture the processes that are in place for supplier compliance. Such reviews are time intensive since they include the initial set up compared to subsequent reviews. They can easily be delayed to post contract but the customer’s commercial position will be weaker if that were to occur
Stage 2 Initial: A review takes place at the first supplier invoice post award of the contract to ensure that costs claimed are aligned with the Allowable Costs agreed

Stage 5 Exit: A review is scheduled for the final account stage to gain insights for other contracts

Update, On-going Reviews

‘Update’ or ‘On-going’ reviews happen periodically during the delivery of the contract.

Stage 3 Update: This review will monitor the contract at a level proportionate to any problems encountered at detailed reviews (i.e. if a service provider seems to be breaching agreements on the CCR, then the frequency of checking will increase).

Stage 4 CCN: This review will look at material change controls in the contract. CCNs will require any changes to the deliverables to be represented in the revised operational and cost criteria going forward in order to maintain reliable operational and cost data for future reviews.

TIP

The CCR, Contract Costs Units & Drivers and the Supply Cost Model become important tools at your disposal when negotiating CCNs or preparing for contract exit conditions as they provide the necessary transparency to costs that should be charged and give you a strong foundation for negotiations on points of difference.
8 OBCM applied to Tiers 3 & 4

In Tier 3 & 4 contracts we begin to exercise some control over the supplier’s input costs, as well as focusing on outputs. These services are highly unlikely to have been commoditised and so are more likely to result from procurement procedures involving dialogue with the suppliers e.g. Competitive Dialogue or Competitive Dialogue with negotiation.

The key difference between Tier 3 and Tier 4 contracts is the likely level of collaboration with the supplier and the degree to which the services required can be fully specified up-front, even following the procurement procedures mentioned above. Given the similarity of the processes and tools to be applied, this section will deal with both Tiers simultaneously, pointing out the differences wherever they occur.

Remember, the decision tool in Section 4 indicated that Tier 4 contracts would be limited to those that are transformational in nature and that are likely to involve a Joint Venture or some other very close collaborative partnership with the supplier. Therefore, most contracts for which you would expect to exercise some control over supplier inputs will be assigned to Tier 3.

The table below illustrates the definitions of contract inputs and outputs that you may be expecting to influence:

Table 5: OBCM Data Definitions

<table>
<thead>
<tr>
<th>Supply Inputs/Outputs</th>
<th>Data types</th>
<th>Data Categorisation</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inputs</td>
<td>Supply Cost</td>
<td>Financial</td>
<td>The cost to the Supplier, not the Customer, for the services</td>
</tr>
<tr>
<td></td>
<td>Operational</td>
<td>Non-Financial</td>
<td>Volumes related to what the contract consumes in delivering its performance outputs.</td>
</tr>
<tr>
<td>Outputs</td>
<td>Charges</td>
<td>Financial</td>
<td>What the Supplier charges for the contract</td>
</tr>
<tr>
<td></td>
<td>Performance</td>
<td>Non-Financial</td>
<td>Non-financial data related to what the contract is delivering to the Customer</td>
</tr>
</tbody>
</table>
8.1 Processes & tools applied to Tier 3 & 4 contracts

As discussed in Section 3, at each Application Tier there is an incremental, proportionate build of processes and tools. These are mapped against Tiers 3 & 4 below:

Table 6: Processes and Tools for Tiers 3 & 4

<table>
<thead>
<tr>
<th>Process or Tool</th>
<th>Managing inputs &amp; outputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Cost Register</td>
<td>✓</td>
</tr>
<tr>
<td>Cost Units and Drivers</td>
<td>✓</td>
</tr>
<tr>
<td>Supply Cost Model</td>
<td>✓</td>
</tr>
<tr>
<td>Commercial Optimisation Review</td>
<td>✓</td>
</tr>
<tr>
<td>Control Protocols</td>
<td>✓</td>
</tr>
</tbody>
</table>

8.2 Contract Cost Register (CCR)

A Contract Cost Register (CCR) is a list of ‘allowable’ and ‘non’-allowable’ costs. It is used extensively in Tiers 3 & 4 as a mechanism to control the contract input costs. Due to the complexity of Tier 3 & 4 contracts, you will most likely develop the CCR and cost model in collaboration with suppliers either prior to issuing a procurement notice or during a competitive dialogue process although you should always start with a ‘straw man’ based on your best understanding of the types of cost (cost lines) that will be incurred in delivering the contract.

For the avoidance of doubt, the CCR is referring to those costs that can be charged transparently in the contract and will be the suppliers’ own costs (i.e. those it expects to incur), known as Allowable Costs.

The customer Charge (or Price) for specific services can be represented as:

\[
\text{Charge (Price)} = \text{Allowable Costs} + \text{Margin}
\]

Where ‘Allowable Costs’ are those Direct and Indirect (e.g. some types of overhead that would be expected to be charged to the contract) costs that are attributable to the delivery of the services; other costs that are not attributable (e.g. some types of overhead costs such as sponsorships, bad debt provisions, costs for remedies for supplier errors, etc..) would fall within the definition of ‘Margin’. Depending on your strategy for the use of OBCM, risk or contingency pricing may be classified as ‘Allowable Costs’ for transparency or as a component...
of margin. Classifying costs in this way provides a means of comparing costs on a like-for-like basis and understanding the margin a supplier is expecting to take from the contract. ‘Allowable Costs’ are discussed in more detail below and more comprehensive guidance on ‘Allowable Costs’ can be found in the Single Source Costs Standards\(^5\).

**Note:** It is very important to consider what falls within the definition of ‘Allowable Costs’. The ‘Margin’ element in the ‘Charge’ equation above may be the sum of profit expected plus Indirect/Overhead costs plus risk contingencies that are not included as ‘Allowable Costs’, so it could be higher than most people commonly expect. People equate ‘Margin’ directly with the profit a supplier is making on a contract, so if too many non-allowable indirect costs exist, explaining the apparent ‘Margin’ or profit may be more problematic. A recent NAO report\(^6\) recommended “Government needs to develop a more sophisticated understanding of these profits, so that it can improve the incentives in its contracts and its negotiations with suppliers”. Furthermore, the increased transparency that you achieve through ‘allowing’ some indirect/overhead costs gives you greater ability to compare these cost lines for multiple contracts with the same supplier and provide a new basis for negotiation.

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\(^6\) Open Book Accounting and Supply Chain Assurance: NAO report HC 91-I SESSSION 2015-16, 1 July 2015
### 8.2.1 Allowable costs

In the procurement process, three tests are used to ascertain whether a type of cost (or ‘cost line’) presented by a supplier is an ‘Allowable Cost’ for the purposes of bid comparison. Such costs will need to meet all of the three criteria outlined below.

**Table 7: Allowable Costs: Criteria, Qualifying Definition and Tool**

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Qualifying definition for a cost</th>
<th>Example: software licence costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Appropriate</td>
<td>In its character and nature, it must represent a cost that is expected to be incurred in the conduct of delivering the service in question and should be able to withstand public scrutiny.</td>
<td>Laptop costs are included in costs and require software licences that are appropriate to the services being delivered.</td>
</tr>
<tr>
<td>2 Attributable</td>
<td>It represents an instance of cost unit correctly allocated in delivering the contract outputs (i.e. it is incurred in fulfilment of the service).</td>
<td>One licence is expected for each laptop computer and there are 70 laptops costed.</td>
</tr>
<tr>
<td>3 Reasonable</td>
<td>It should not exceed what might be expected to be incurred in the normal delivery of the service.</td>
<td>100 licences have been costed. Why the 30 excess. Error? Bundled discount? etc.</td>
</tr>
</tbody>
</table>
The following checklists extracted from the Single Source Costs Standards\(^7\) may be used to assist your assessment of ‘Allowable Costs’. All criteria must be met for a cost to qualify as an allowable cost:

**Appropriate Cost Checklist**
- Is it a cost that would be expected to be incurred in the delivery of the service?
- Is the cost suitable for the purpose of the qualifying service?
- Would the inclusion of the cost withstand public scrutiny?
- Is the inclusion of the cost fair and equitable?

**Attributable Checklist**
- Is the treatment of the cost consistent with normal business practices?
- Is it consistent with the firm’s normal accounting practices?
- Is the cost borne by the supplier?
- Is there a causality of the cost to the contract?
- Is the cost identifiable?
- Is the cost incurred in fulfilling the specification of the contract?
- Can it be evidenced that the cost has not been recovered elsewhere?

**Reasonable Checklist**
- Is it congruent with meeting the contract performance requirements?
- Would the cost withstand public scrutiny?
- Are cost estimates based on empirical evidence, where this is possible?
- Is the cost consistent with any sector/market benchmarks?
- Is the quantum of cost consistent with good business practice?
- Do the costs deliver good value for money to the UK tax payer?

Appendix 2 contains a spreadsheet example of a detailed CCR that was used in an actual contract negotiation to illustrate the level of detail that may be produced when we wish to align the supplier’s own financial system reporting with the CCR in order to make monthly reporting of costs less onerous. An extract from that spreadsheet is shown in the worked example below:

---

8.3 Cost Units & Drivers

Cost Units & Drivers are used to calculate costs that vary, or are flexed, with different volumes of activity that may occur in a contract. The Cost Unit component is simply the base element of the cost (e.g. cost per hour, cost per person, cost per KWh). The Cost Driver in its simplest form is the variable element that is multiplied by the Cost Unit to yield the costs for that component. In the case of semi-variable cost elements the cost may increase only incrementally once a certain threshold of volume, or the Cost Driver, has been exceeded. In addition, the OBCM approach seeks to understand the causal factors for the volumetric driver as well as the actual number being used. For example, software licences may cost £100 each and a volume of 70 licences are reported as costs, so we need
to understand whether each laptop has one licence, or whether some are configured without, and whether the number of laptops is driven directly by the number of staff associated with the service to fully understand this cost line. Through this analysis, we can establish an audit trail as to the correct values to be included in the cost model.

Depending upon the complexity of the variable elements in the contract, you should choose whether separate documents containing outlining the individual Cost Units & Drivers is required or whether it would be straightforward to construct a model that takes account of the Cost Units & Drivers alongside other fixed cost lines.

Appendix 3 contains a spreadsheet example of a detailed Unit Costs & Drivers that was used in an actual contract negotiation alongside the CCR that is illustrated in the Appendix 2. An extract from that spreadsheet is shown in the worked example below:
## Tier 3 Unit Costs & Drivers

A government department was seeking to negotiate a contract change notice whereby the charging model would move to a cost plus margin basis. This required the construction of a detailed CCR along with Unit Cost & Driver statement in order to define the costs model:

<table>
<thead>
<tr>
<th>Ref</th>
<th>Function</th>
<th>Unit Cost Driver</th>
<th>Source of Data</th>
<th>Data manual or automated</th>
<th>Why is this a key unilateral driver</th>
<th>Cost/Markup</th>
<th>Corresponding account code</th>
<th>Baseline fixing sales (indications) or whether baseline will fall for cost savings (calculations and how)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Employment - All Cost Centers</td>
<td>Annual Bonus/Pointers agreed via individual achievements on TAF forms</td>
<td>Value paid to several reports linked to TAF term deciding entitlement to employee.</td>
<td>Manual</td>
<td>Annual bonus is accessed at a fixed % against payroll dependent upon employees’ achievements against bonus objectives. Entitlement varies, e.g., Jan is often usually paid following year April.</td>
<td>A/L</td>
<td>AC_5999 Management Incentive Program Bonus</td>
<td>This is a common variance that does not reflect a flow adjustment to baseline</td>
</tr>
<tr>
<td>B</td>
<td>Document Scanning</td>
<td>Number of Documents and Data Captured</td>
<td>Report Source File/Vendor of Print CCR Summary Report/Special 104-105-13</td>
<td>Automated</td>
<td>The number of documents scanned and the rate customers are charged is the unit which will determine the monthly cost incurred.</td>
<td>Finance &amp; Exec</td>
<td>AC_05999 Other Operational Overhead Service</td>
<td>This is an area that will reflect an adjustment to baseline. The adjustment would be the volume charge from baseline multiplied by the current unit price (taking account of any fixed cost elements such as Salaried arrangements)</td>
</tr>
<tr>
<td>C</td>
<td>Accounts Payable</td>
<td>Number of Payables Processed</td>
<td>Oracle ERP/Report “NDEGO Invoice Manual &amp; Line Statistics”</td>
<td>Automated</td>
<td>The number is then based on the current forecast likelihood. The forecast becomes unacceptable when we have a significant variance which will drive requirement for additional headcount/livetime</td>
<td>Finance &amp; Exec</td>
<td>AC_59999 Payables Invoices</td>
<td>This could be impacted by volumes; the relationship is not directly proportional, so any adjustment to baseline will be by agreement between the Parties</td>
</tr>
<tr>
<td>D</td>
<td>Accounts Receivable</td>
<td>Number of Invoices Billed</td>
<td>Oracle ERP/Report “NDEGO Accounts Receivable - Accounts Receivable Report for Payable Accounts Receivable &amp; Change Management”</td>
<td>Automated</td>
<td>The number is then based on the contract forecast likelihood. The forecast becomes unacceptable when we have a significant variance which will drive requirement for additional headcount/livetime</td>
<td>Finance &amp; Exec</td>
<td>AC_59999 Payables Invoices</td>
<td>This could be impacted by volumes, the relationship is not directly proportional, so any adjustment to baseline will be by agreement between the Parties likely to be via a business case</td>
</tr>
<tr>
<td>E</td>
<td>Warehouse Volume Transported</td>
<td>Actual volume (by tiers, pallets, etc.) based productivity metrics given required hours to be worked.</td>
<td>ShelfReport “Fence Ties Warehouse Management System (REPLICATION/Real Pairs)”</td>
<td>Automated</td>
<td>The amount of volume tied is calculated then determined to be the amount of direct labor required… Back-up or down.</td>
<td>Operations</td>
<td>AC_59999 Other Labor Pay</td>
<td>This would adjust an adjustment to baseline but in circumstances where the adjustment can only be offset by labor changes in the same activities with their current unit price and fixed volumes known by warehouse Allocation/Inventory activity will be the change from baseline volume multiplied by current price</td>
</tr>
</tbody>
</table>
8.4 Supply Cost Model

The Supply Cost Model brings together elements of the CCR, the Cost Units tool and the Cost Drivers tool to create a working model of the costs incurred. The model will either be used to generate the monthly invoices or as a forecasting tool to establish significant variances between actual costs incurred and those predicted by the tool. In Tier 3 & 4, we are contracting for inputs as well as outputs so the Supply Cost Model and CCR will be used extensively to validate invoice charges and to monitor actual cost performance against expected.

It is important that both you and your main stakeholders understand that the modelled Supply Costs are meant to reflect what the supplier pays for its inputs and not its charging model. The amount that you will be charged on a monthly basis will be dependent upon the contract type, and will include a Margin (see 7.2 above). You must also understand the charging model as this may also include risk premiums that, through collaborative efforts between you and your supplier, may be eliminated or reduced over time resulting in lower charges. The table below illustrates how the Supply Cost Model might be used for the different Tier 3 & 4 contract types:

**Table 8: Application of Supply Costs Model**

<table>
<thead>
<tr>
<th>Contract Type</th>
<th>Possible application of Supply Cost Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost plus margin</td>
<td>Here the Supply Cost Model becomes a monthly forecasting tool since the actual costs incurred will be those that are paid to the supplier plus an agreed margin. The tool will be valuable in identifying significant variances that can be discussed with the supplier</td>
</tr>
<tr>
<td>Change Control Notices</td>
<td>Use the Supply Cost Model to predict the relevant cost lines to agree the CCN charge</td>
</tr>
<tr>
<td>Transformational with some inputs unknown</td>
<td>Use the principles of the CCR (Allowable Costs) and precedence on variable costs to incorporate new lines into the Supply Cost Model when new inputs are agreed</td>
</tr>
<tr>
<td>Any</td>
<td>Use the Supply Cost Model to perform scenario planning for future operational changes, or cost reduction initiatives</td>
</tr>
</tbody>
</table>
At all Tiers, you will want to model the Charges to be paid to the supplier. However, Supply Cost Models can require a significant degree of maintenance and so the frequency at which they are updated and their level of detail should be commensurate with the complexity of the contract and the corresponding application Tier. For Tier 3 & 4 applications the Supply Cost Model will be used extensively for the production of the bids. The cost model used in the bid will then be reviewed and updated either six monthly or quarterly dependent on the level of collaboration and transformation in the delivery. Additionally, in a cost plus margin contract, the Supply Cost Model is used to generate a cost forecast each month for comparison against actual costs to determine significant variances, which need to be investigated.

8.4.1 Modelling Supply Costs in the Procurement

The optimum time to secure agreement on the CCR, ‘allowable costs’ and the Supply Cost Model is during the procurement process so as to make best use of any competitive tension. Restricted or Open Procurement processes will only allow for some discussion on the structure of the Supply Cost Model during pre-procurement activity whereas some Tier 3 & 4 contracts will allow for further negotiation if using competitive dialogue or competitive with negotiation procedures. The diagram below illustrates how you might leverage a dialogue process to establish a robust model before contract signature:

Figure 4: Agreeing Cost Drivers within the Negotiated Procedure with Competition

- **1) Sourcing Strategy**
  - meet with suppliers with multi-functional experts to propose the Contract Cost Register

- **2) OJEU**
  - Publish Requirements
  - provide Outline Customer Cost Models to each bidder

- **3) Dialogue**
  - Use this phase to get the Final Customer Cost Model explicit
  - Cost Units & Drivers outlined

- **4) Evaluation of Tenders**
  - use Model to evaluate:
    - like-for-like cost comparison
    - margin and any maximum margin

- **5) Prior to award**
  - Modify to create a Supply Cost Model that reflects the awarded bidder’s operating model
  - Cost Units & Drivers agreed
Each supplier will typically allocate costs to lines in a slightly different manner. However, you should prescribe the Model on the same basis to ensure comparability in evaluation. Once the contract is awarded, it may then be necessary to adjust the model to make it work more efficiently with the winning supplier’s actual reporting systems. These adjustments will not change the overall costs but may reallocate them to different line definitions corresponding to the supplier’s accounting system. You should take care not to lose the integrity of the system you have set up in the course of these adjustments and ensure all changes are agreed prior to contract award.

There are some contracts where the government department has been able to negotiate direct access to the supplier’s GL system through remote log on facility. This allows the supplier’s costs to be interrogated without the need for requests for information that result in additional administrative burden and time delays.

Models are contract specific and therefore we make no suggestion for which specific model to use. Instead, a proposed scope for an OBCM Tier 4 integrated Charges and Cost Model is included at Appendix 4.

### 8.5 Commercial Optimisation Reviews

Commercial Optimisation Reviews (CORs) support customer-supplier collaboration. These are important meetings at which to discuss costs associated with service delivery and explore ways of reducing those costs for mutual benefit. The CORs work as part of the overall contract governance process and, ideally, the process and frequency of the meetings are captured within a contract schedule. Tier 3 & 4 contracts are expected to be more collaborative in nature, so are more likely to have specific cost reduction measures, for example:

- **Cost reduction KPIs**: the contract may have specific performance requirements on the supplier to reduce costs over time
- **Gain share mechanism**: whereby both parties take a share of any positive initiatives that reduce the cost of delivery of the services
- **Risk mitigations**: where initial risks are unquantifiable and a supplier is required to bear the risk, it will most likely include a risk premium. If these premiums can be made explicit via the Contract Cost Register, it is possible to build in terms whereby the overall cost of the service is reduced if the risks do not materialise. Note, you may need to include a gain/pain share mechanism to make this work effectively

The results of the CORs should be documented to create a point of reference for future meetings and a record of actions taken.
### Commercial Optimisation Review Register

This example shows two decisions that are made following a COR meeting. The first decision demonstrates how costs and benefits may be shared; the second shows how the cost impacts of a particular risk (fuel price increase) can be mitigated to provide mutual benefits:

#### Decision 1: Cost Sharing Opportunity

**Opportunity/Threat:** Cost reduction through shared costs for software development.

**Dependency:** Software development cost

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost reduction</td>
<td>Regular</td>
<td>Supplier</td>
<td>Regular</td>
<td>Client</td>
<td>Supplier</td>
<td>Regular</td>
<td>Supplier</td>
<td>Regular</td>
<td>Client</td>
</tr>
<tr>
<td></td>
<td>55%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
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</tbody>
</table>

**Recommendations:**
- Implement software updates in regular intervals.
- Regularly review and update the contract allocations.

**Risk Management Action:**
- Implement regular updates to minimize the risk of software obsolescence.

**Priority:** High

**Decision:** Implement regular updates to minimize the risk of software obsolescence.

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#### Decision 2: Risk Mitigation

**Opportunity/Threat:** Fuel price increase.

**Dependency:** Fuel consumption

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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fuel price increase</td>
<td>High</td>
<td>Regular</td>
<td>High</td>
<td>Regular</td>
<td>High</td>
<td>Supplier</td>
<td>Regular</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Regular</td>
<td></td>
<td></td>
<td>Regular</td>
<td></td>
<td>高</td>
</tr>
</tbody>
</table>

**Recommendations:**
- Increase fuel efficiency through regular maintenance.
- Monitor fuel consumption and adjust the contract accordingly.

**Risk Management Action:**
- Implement regular maintenance checks to increase fuel efficiency.

**Priority:** High

**Decision:** Increase fuel efficiency through regular maintenance checks.
8.5.1 Contract Management Plan

It is always a good idea to develop a plan for how you will apply OBCM principles to manage the contract once the services are being delivered as well as applying the principles to procuring the contract in the first place. The CCS Contract Management standards can be found on the gov.uk web site at: https://www.gov.uk/government/publications/commercial-capability-contract-management-standards

8.6 Control Protocols

Control Protocols are pre-contract agreements which:

- detail the source of information used in calculating volumetric Cost Drivers (i.e. which reports are used to calculate volumes and where they come from such as finance, operations etc...) This allows the customer to verify figures if they change from one month to the next
- identify key ratios that will be used to alert both parties of potential cost drift
- test that Allowable Costs still meet the criteria that was applied for attributable and reasonable at the beginning of the contract

8.6.1 Key ratios

Good financial management often relies on ratios or interrelationships between costs to provide a first sign of costs drifting from and expected norm in a dynamic system. For example, manufacturers of goods may use inventory turns per year to better understand working capital movements, financial services may use debtor days and creditor days to understand the efficiency of the operation and call centres may use average call handling time to better understand overall cost drift even though cost per minute remains in control. The Control Protocols will, through discussion with your service provider, identify the key ratios that should be monitored and will build them into the monthly reporting cycle.

“Control” as opposed to “audit” is used to refer to the activities within OBCM. These control activities should be resourced from within the OBCM team with the contract specific knowledge that they possess. Arm’s length audits by external agents would not be suitable. However, Open Book Provisions should contract the rights to conduct and respond to a formal audit.
8.6.2 Testing Allowable Costs

Allowable Cost Reviews are proposed at 5 Stages in the contract life-cycle in order to set up the initial Contract Cost Register, then test for relevance during the course of the delivery of the services.

**TESTS**

Where Charges are derived from Costs, the Reviews should take place at 5 Stages as either Detailed or Ongoing reviews:

**Detailed, One-off, Reviews**

‘Detailed’ or ‘One-off’ reviews are scheduled at salient contract points:

**Stage 1 Pre-Contract:** A review at this stage aims to capture the processes that are in place for supplier compliance. Such reviews are time intensive since they include the initial set up compared to subsequent reviews. They can easily be delayed to post contract but the customer’s commercial position will be weaker if that were to occur.

**Stage 2 Initial:** A review takes place at the first supplier invoice post award of the contract to ensure that costs claimed are aligned with the Allowable Costs agreed.

**Stage 5 Exit:** A third review is scheduled for the final account stage to gain insights for other contracts.

**Update, Ongoing Reviews**

‘Update’ or ‘Ongoing’ reviews happen periodically during the delivery of the contract.

**Stage 3 Update:** This review will monitor the contract at a level proportionate to any problems encountered at detailed reviews (i.e. if a service provider seems to be breaching agreements on the CCR, then the frequency of checking will increase).

**Stage 4 CCN:** This review will look at material change controls in the contract. CCNs will require any changes to the deliverables to be represented in the revised operational and cost criteria going forward in order to maintain reliable operational and cost data for future reviews.
The CCR, Contract Costs Units & Drivers and the Supply Cost Model become important tools at your disposal when negotiating CCNs or preparing for contract exit conditions as they provide the necessary transparency to costs that should be charged and give you a strong foundation for negotiations on points of difference.

### 8.7 Case Study

DWP let a new contract to the Centre for Health and Disability Assessment (CHDA) to deliver Work Capability Assessments. CHDA will provide full cost and performance visibility under a cost plus contract with incentives built around the achievement of target costs. Appendix 5 contains a case study for this contract where some of the tools and techniques described above were applied.
Appendix 1. Referenced Documents

The Guidance references existing contract management guidance per below, supplemented with any other references as foot notes.

**CCS Contract Management Standards**


These include the following three documents plus a template:

1. Contract Management Principles
3. Contract Management Guidance
   - The Plan and example ‘monitoring schedule’ in the Contract Management Standards (see above) should be augmented with OB activities.

**CCS Contracting for Value - standard terms & conditions**


This is the Model Services Contract (MSC) for common good and services; it is anticipated that OBCM updates will be added to a future version. Referenced Terms that are not defined in this document are defined in Schedules 7.1 & 7.5 of the MSC.

**Single Source Cost Standards**

This is the Statutory guidance on Allowable Costs used by the MOD (and is the source of the approach applied allowable costs in this guidance):

Appendix 2. Example Contract Cost Register

A recent contract negotiation following OBCM principles developed a detailed Contract Cost Register (CCR) [See separate attachment: Appendix 2 – Contract Cost Register.xls]
Appendix 3. Example Cost Units and Drivers

A recent contract negotiation following OBCM principles developed a Unit Costs and Drivers schedule, which references the CCR in Appendix 2 [See separate attachment: Appendix 3 – Cost Units and Cost Drivers.doc]
Appendix 4. Financial Modelling Scope; Tier 3 & 4

This is a scope, by Worksheet, of what might be included in a Financial Model, Charges and Costs:

Worksheet 1 - Map & Basic Instructions

This should show the relationship diagram with links to sheets outlining:

- What type of Worksheets each on is, whether:
  - Information
  - Input
  - Calculation
  - Output

- Basic instructions for how to enter and operate key elements including:
  - Dates
  - Revenue and Cost Inflation
  - Inputs
    - Volumetric tables - accounts tables
    - Transaction Times
    - Benchmark
    - Labour Splits
    - Transaction Handling Assumptions
    - Labour Rates
    - Cash Rates
    - Interest Rates
    - Transaction Charges

Worksheet 2 - Term Sheet (Information)

This should be aligned to contract schedules and labeled accordingly replicating the contract schedule of charges linked to their assumptions and bases of calculation and their related input and output sheets locations.

Worksheet 3 - Assumption Inputs (Input)

Assumption inputs should be broken down and labeled as being either specific or general. They should then be broken out into specific fixed ones for the term of the project and then inputs which are variable by month or year throughout the contract term. Items such as setup costs should be labeled and clearly identified.
Worksheet 4 - Account Volume Inputs (Input sheet)

Assumption inputs should be broken into appropriate accounts types and sections and input cells should be clearly labeled.

Calculation Worksheets follow; these should be:

- Labelled as calculation rather than Input sheets
- Calculation cells should be protected.
- The time periods should total left to right, months to years.
- Formulae should be dynamically linked to input sheets.

Worksheet 5 - Supplier 1 Income (Calculation)

Revenue tables should be clearly labeled and aligned where possible to input tables.

Worksheet 6 - Supplier n Income (Calculation)

Revenue tables should be clearly labeled and aligned where possible to input tables.

Worksheet 7 - Staff Costs and other Direct Operating Costs (Calculation)

This should include all direct costs such as
Worksheet 8 - Indirect Costs (Calculation)

If these costs are in scope (OBCM would exclude them) then this sheet should include all indirect costs such as

<table>
<thead>
<tr>
<th>Fixed / Other Costs</th>
<th>Set-up/Implementation Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Costs</td>
<td>Risk Costs</td>
</tr>
<tr>
<td>Fixed / Other Costs</td>
<td>Horizon and Technology cost</td>
</tr>
<tr>
<td>Fixed / Other Costs</td>
<td>Fixed Cost of Cash</td>
</tr>
<tr>
<td>Overheads</td>
<td>Corporate Overheads</td>
</tr>
</tbody>
</table>

Worksheet 9 - Summary Output (Calculation that is dynamic)

This sheet links all inputs and outputs into one sheet clearly identifying and summing the following:

- P & L with key percentages such as
  - COGS %, rev % of overhead; gross margin %, rev % of overhead; net margin % etc.
- Cash flow
- Gain share / Benchmarking adjustments

Worksheet 10 - Financial Statement Summary Output (Calculation) - Dynamic

- The same as the P & L in 9, but labeled as per the Supplier's cost chart of account items per the agreed charging mechanism.

Worksheet 11 - Financial Statement Summary Output (Calculation) - Baseline

- The same as the P & L in 9, but fixed based on the assumptions at contract inception.
- This will be used e.g. for gain share purposes and to track the life of contract profit vs. profit at inception of contract.
Worksheet 12 - Invoice Summary Output (Calculation)

- Summarises WORKSHEET 9 & 10 into the charging invoice format as agreed in the contract
- This would be these compared to the Baseline to ascertain and quantify e.g. a % reduction in cost objective.
Appendix 5. Case Study

DWP let a new contract to the Centre for Health and Disability Assessment (CHDA) to deliver Work Capability Assessments. CHDA will provide full cost and performance visibility under a cost plus contract with incentives built around the achievement of target costs [See separate attachment: Appendix 5 – Case Study – Health and Disability Assessment.doc].
Appendix 6.  Glossary

**Allowable Costs**: Costs that are deemed appropriate, attributable and reasonable within the contract.

**Commercial Optimisation Reviews (CORs)**: Meetings at which the costs associated with service delivery are discussed, with a view to devising ways to reduce these costs for mutual benefit.

**Contract Cost Register (CCR)**: A list of ‘allowable’ and ‘non-allowable’ costs.

**Control Protocols**: Indicate where data for volumetric driver information can be obtained and also key metrics that will be used to assess whether costs are in line with expectations.

**Cost Drivers**: The units of consumption that are used to calculate the charges.

**Cost Lines**: Individual cost types, which the supplier will incur.

**Cost Units**: Types of costs that drive contract charges.

**Customer Cost Model**: Model built to invite suppliers to tender for the contract and includes detailed cost lines.

**Price**: The amount you pay for a service, which includes the supplier costs and adds a margin and any contingency or risk pricing which the supplier wishes to charge.

**Supplier Costs**: The costs the supplier actually incurs, or expects to incur, in delivering the service.

**Supply Cost Model**: Model indicating detailed cost lines which are directly comparable to the account codes and cost information held in the suppliers’ own financial systems. The Supply Cost Model will often be an adaptation of the Customer Cost Model.