

**SSRO**

Single Source  
Regulations Office

## Allowable Costs guidance review 2019

Stakeholder responses to a working paper on uncertainty and risk

October 2019

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# 1. Introduction

- 1.1 Section 20 of the Defence Reform Act 2014 (the Act) states that the SSRO must issue guidance about determining whether costs are Allowable Costs under qualifying defence contracts (QDCs) or qualifying sub-contract (QSCs). The SSRO aims to keep its guidance current and relevant and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.2 The current Allowable Costs guidance was published in spring 2019.<sup>1</sup> The SSRO, in consultation with stakeholders, prioritised a review in 2019 of the guidance in Part H: Risk-related costs and associated guidance in Part E.5: Insurance.
- 1.3 As part of the review, which commenced in April 2019, the SSRO:
  - a. issued a working paper to the SSRO's Operational Working Group whose members are from the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors;
  - b. held group and individual meetings with members of the OWG to discuss the issues raised by the working papers; and
  - c. received written responses to the working paper from eight stakeholders, including the MOD, ADS (on behalf of its member organisations), and six contractors.
- 1.4 The SSRO would like to take this opportunity to thank these stakeholders for sharing their views with us.
- 1.5 This paper provides a summary of the working paper and the feedback stakeholders provided on it. Input from stakeholders has helped the SSRO to develop proposals for revising its Allowable Costs guidance in these areas, which have been issued for a public consultation of eight weeks (14 October 2019 to 6 December 2019).<sup>2</sup>
- 1.6 The SSRO provides separate guidance on the cost risk adjustment made at Step 2 of the process to determine the contract profit rate for a QDC or QSC.<sup>3</sup> The SSRO plans to review that guidance in 2020. That review will follow the completion of the current Allowable Costs guidance consultation and the SSRO's review of contract profit rates. It will also consider any relevant recommendations for legislative change which may be provided by the SSRO to the Secretary of State in June 2020 as a result of its current review of legislation.

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<sup>1</sup> SSRO (2019) *Allowable Costs Guidance (Version 4)*.

<sup>2</sup> SSRO (2019) *Allowable Costs Guidance Review 2019: Consultation on Changes for 2020/21*.

<sup>3</sup> SSRO (2019) *Guidance on the Baseline Profit Rate and its Adjustment (Version 5)*.

## 2. Responses to the working paper

- 2.1 We set out below a summary of the key points made by stakeholders in relation to the topics covered in the working paper and how this has informed the SSRO's proposals for changes to the guidance.

### General comments

#### *Stakeholder feedback*

- 2.2 Industry respondents and the MOD welcomed further guidance on the consideration of uncertainty and risk in determining Allowable Costs, subject to this being principles-based and not prescriptive. ADS considered that the guidance needed to be flexible to reflect the different types of risks and uncertainty that contractors encounter as a result of contract requirements or factors outside the contractor's control. Another industry respondent noted that providing guidance on this topic that could be followed consistently in all circumstances was difficult but important to assist the relevant parties to reach an agreement on the allowability of costs.
- 2.3 ADS noted that there were a range of reasons why there may be uncertainty when estimating the costs required to perform a contract for defence equipment or support. These included the high-value, low-volume nature of procurements, the time required to develop a new capability and the length of time equipment may remain in service, giving rise to the potential for obsolescence. The nature of the risks and level of uncertainty were also affected, it said, by the work to be performed, the contractor's experience in performing this type of work and factors external to the contract, such as market conditions. Another industry respondent noted that risks may also arise for the contractor as a result of the failure of the contracting authority to perform its obligations as expected.
- 2.4 ADS noted that the MOD's commercial policy guidance indicates that risk should lie with the party best able to manage it and considered this should be reflected in the guidance.

#### *SSRO response*

- 2.5 The SSRO considers it would be helpful to revise its guidance concerning uncertainty and risk to aid understanding by stakeholders. It continues to consider that principles-based guidance is most helpful to accommodate the range of circumstances relevant to the determination of Allowable Costs in QDCs and QSCs. The proposed guidance seeks to interpret and expand on the principles underpinning the requirements of Allowable Costs already present in Section 3 of the guidance. It also highlights (H.1.2) the need to consider the guidance on specific cost types in Section 5 when considering uncertainty and risk.
- 2.6 We note the different types of risks highlighted by respondents. In preparing the proposed guidance the SSRO has been mindful of the need for it to be applicable to a range of contracts which may be subject to different types of uncertainty and risk. However, the guidance is only concerned with the effect of uncertainty and risk on the Allowable Costs of the contract. Uncertainty and risk which has no effect on the Allowable Costs are not relevant to their determination.
- 2.7 The SSRO notes the position outlined in the MOD's commercial policy on the most appropriate allocation of responsibility for risk but does not consider that this is a matter to be addressed within the Allowable Costs guidance. The allocation of responsibility for risk is a matter for the parties to determine given the specific circumstances under consideration.

## Use of terms

- 2.8 The working paper sought to clarify usage of a number of terms related to concepts which the SSRO considered relevant to this aspect of the guidance. The SSRO considers that consistent understanding of terms by the relevant parties would be an aid to application of the guidance. The working paper included definitions of the terms 'uncertainty', 'estimated Allowable Costs', 'actual Allowable Costs', 'cost risk', 'contingency' and 'management reserve', with reference where appropriate to definitions used by reputable bodies, such as the International Organization for Standardization and the Project Management Institute. The SSRO considered the definitions were helpful to the interpretation of the AAR principles, while recognising that alternative definitions of the terms might legitimately be employed for other purposes, for example, cost estimating, project management or accounting.

## Stakeholder feedback

- 2.9 Respondents highlighted the need for the SSRO's guidance to support a common understanding in the use of terms such as 'contingency' or 'uncertainty'. Some suggested particular definitions based on existing usage within their organisations. ADS, for example, considered that the terms 'risk' and 'uncertainty' were distinct as risk referred to something that was measurable, whereas uncertainty was not. The MOD considered that a risk was a discrete event which may or may not occur and which would affect the cost borne by the contractor whereas uncertainty, in the context of Allowable Costs, should be used to describe the extent to which actual costs might vary from expected costs. Another industry respondent considered it would be helpful if the guidance noted a distinction between risk (an outcome which may or may not arise with an estimated impact and likelihood of occurrence) and uncertainty (an outcome which is certain to occur but with a potentially wide range of cost variability) – even if the SSRO's guidance applied equally to both.
- 2.10 Some respondents also indicated the need for care in the use of more generic terms like 'anticipated', 'expected' or 'low probability' which may have a specific meaning in the context of estimating uncertainty. If such terms were used, some respondents considered it would be helpful for the meaning to be explained and for these to be consistent with more general usage in relation to risk assessment. For the MOD, for example, 'expected cost' had a specific meaning. It suggested that, for discrete risks, the expected cost was the likelihood that a risk would materialise multiplied by the impact on the cost borne by the contractor. Where more sophisticated cost modelling techniques were used for part of the cost, the MOD considered the expected cost would be the mean (average) figure.
- 2.11 The MOD's definition of the term 'contingency' (a sum included in the price to cover costs that might be borne by the contractor but which had not been picked up through the risk management or cost modelling processes) was different to the Project Management Institute (PMI) definition included in the working paper. One industry respondent explicitly supported the use of the PMI definition while another considered it would be more appropriate to use a definition provided by the UK Association for Project Management (APM).

## SSRO response

- 2.12 The SSRO recognises the need for care in the use of terms within its guidance to ensure ease of understanding and consistent application by the MOD and contractors. As the responses to the working paper demonstrated, some topic-specific terms such as 'uncertainty', 'risk' and 'contingency' have different meanings for different stakeholders. Conversely, stakeholders use different terms when referring to the same thing. Our proposed guidance provides definitions or uses general terms where we consider these will facilitate understanding by stakeholders to support consistent application of the guidance across a range of different contracts.

- 2.13 We recognise the distinction highlighted by respondents between the terms 'risk' (an outcome which may or may not occur) and 'uncertainty' (an outcome which is sure to occur but with a range of possible values) but do not consider these different types of uncertainty require different treatment within the guidance on determining Allowable Costs. Both are forms of uncertainty whose impact on estimating the costs of performing the contract need to be understood to determine whether costs meet the requirements of Allowable Costs. Our proposed guidance (H.1.1) defines an uncertain cost for the purpose of the guidance with reference to uncertainty about occurrence and amount. However, it is not our intent that the meaning attached to any terms within the guidance should override how those terms are understood by stakeholders for other purposes, for example, in the practice of cost modelling. The consideration of whether a particular cost (uncertain or known) is an Allowable Cost for the purpose of contract pricing should focus on the nature, purpose and amount of the cost and not be affected by any categorising label applied to it by stakeholders, for example, whether it is called 'contingency' or 'management reserve'.
- 2.14 Where stakeholders have indicated that precision is needed in the use of general terms, such as 'expected', 'anticipated', 'low' or 'high', our proposed guidance seeks to provide this, or identifies the relevant principles and considerations such that stakeholders might consistently apply the guidance through the use of professional judgement.

#### **The effects of uncertainty on Allowable Costs**

- 2.15 The working paper considered the relevance of uncertainties in pricing contracts using different contract pricing methods. It described the potential for uncertainty in determining estimated Allowable Costs and the likely absence of uncertainty in determining actual Allowable Costs. It noted that while the Regulations do not specify how uncertainty is to be addressed or quantified the SSRO's guidance indicates that the Allowable Costs (estimated or actual) should be the costs which are incurred or anticipated to be incurred to enable the performance of the contract. It highlighted the need to consider a range of possible outcomes when determining estimated Allowable Costs and introduced the concept of faithful representation as one that the SSRO considered was relevant to cost estimation.

#### **Stakeholder feedback**

##### *Expected cost*

- 2.16 ADS and the MOD agreed that the Allowable Costs should be the expected cost of performing the contract. The MOD, however, provided more specific definitions of what was meant by the term 'expected cost', relating it to the mean value of estimates resulting from cost modelling techniques. ADS considered that the expected cost would include the estimated Allowable Costs, contingency and management reserve where appropriate.
- 2.17 The MOD considered that in determining Allowable Costs consideration should be given to whether the contractor was 'well-run' and 'taking all reasonable steps to optimise efficiency'.
- 2.18 One industry respondent queried the SSRO's assertion that an estimate of total Allowable Costs which excluded costs that it was anticipated would be incurred and which fulfilled the requirements of Allowable Costs would not satisfy the AAR test. It wondered whether this implied that the contracting parties could not agree to exclude such costs.

##### *Contract pricing method*

- 2.19 Industry respondents considered that the guidance should support consideration of cost risk in estimated Allowable Costs without reference to the contract pricing method, which is only relevant to determining who bears any cost risk. One suggested that an estimate of Allowable Costs at the time of agreement might be expected for the purpose of budgeting and understanding cost uncertainty, even if a contract was to be priced using actual Allowable Costs determined during the contract or after contract completion.

- 2.20 ADS considered that it would be inappropriate for a contingency for costs that it was expected would be incurred to mitigate or manage risks to be disallowed where the risks for which the contingency was provided did not materialise. Another industry respondent noted that while an estimate of the Allowable Costs in a cost-plus contract at the time of agreement was useful for budgeting, there should be no expectation that the ultimate price paid for the contract should include any estimated contingency that had not actually been incurred in performing the contract.
- 2.21 In response to the SSRO suggesting that some element of actual Allowable Costs might, in fact, be estimated due to not being directly observable, ADS indicated that while some actual costs could not be determined by direct observation a contractor would always be able to explain how the cost was calculated. Another industry respondent considered it was inappropriate to refer to actual costs that had been apportioned indirectly to contracts in some way as being 'estimated'.

#### *Faithful representation*

- 2.22 Industry respondents questioned the need for any specific guidance related to the consideration of whether cost estimates provided a faithful representation of the costs that were expected to be incurred. One believed that matters of completeness and freedom from error were considered by other aspects of the contract approvals process. ADS questioned how the neutrality of estimates would be assessed. Another was concerned that, by the application of logic, an estimate that was, as suggested in the working paper, 'neither overly optimistic nor overly pessimistic' would, of necessity, be the mean of any range of estimates – whereas the SSRO had indicated it had no intention of prescribing how costs were estimated.

#### **SSRO response**

- 2.23 With regard to expected cost, the SSRO considers that the expected cost in the context of the SSRO's Allowable Costs guidance is, simply, an estimate of the total amount of the actual costs which the contractor expects to incur which meet the requirements of Allowable Costs. We recognise the relationship between measures of 'expected value' and the mean, as appears to have been drawn upon by the MOD in its response and agree that such measures of central tendency are useful in forecasting. However, exploiting the mean or other statistics in the application of cost estimating necessitates professional judgement to ensure an estimate accords with the estimating objective.<sup>4</sup> For this reason we do not consider the expected cost as it is intended to be understood for the purpose of determining Allowable Costs in QDCs and QSCs can be prescribed to be the mean average of a number of estimates, a specified point on a range, or an amount derived by other specified estimating techniques. Deriving an appropriate estimate of Allowable Costs requires the parties to use a methodology which is suitable for the purpose given the circumstances and the SSRO does not consider its guidance should prescribe the approach(es) to be taken. Our proposed guidance (H.1.3) makes this clear.
- 2.24 With regard to contractors being well run and optimising efficiency, we consider that it would not be fair and reasonable for the contract price to be unduly affected by uncertainty arising from a contractor's inability to estimate or manage costs where it would be reasonable to expect them to do so. The existing guidance (3.14d) indicates that 'uncertainty and risk affecting estimated costs' is a circumstance which may be considered in determining whether a cost is reasonable in the circumstances. Our proposed guidance (H.1.3) indicates the need for contractors to have due regard for economy and efficiency in the use of resources and to consider (H.2.6) whether uncertainty surrounding costs is consistent with the contractor's experience in performing similar contracts.

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<sup>4</sup> The definition of 'expected value' as it relates to the mean average has a precise statistical interpretation and may produce an estimate of actual costs which in practice it is not possible to achieve.

- 2.25 With regard to the relevant parties agreeing to exclude from the Allowable Costs certain costs of the contractor which fulfil the requirements of Allowable Costs, we accept that the legislation does not prohibit this. Section 15(2) of the Act requires that the contract price is based on Allowable Costs, and Section 20(2) requires that in determining whether costs are Allowable Costs, the relevant parties must be satisfied that they are appropriate, attributable to the contract, and reasonable in the circumstances (the AAR test). The legislation does not impose the reverse requirement that any cost which satisfies the AAR test must be an Allowable Cost. Nor does it require the parties to assess whether costs which are not claimed to be Allowable Costs under the contract satisfy the AAR test. We would emphasise, however, that Allowable Costs should be of an amount that 'a reasonable person informed of the facts would consider consistent with enabling the performance of the QDC or QSC in question' (3.13a of the existing guidance).
- 2.26 We have noted the feedback about preparing guidance which is applicable irrespective of contract pricing method. We consider that the point in time at which the relevant parties determine whether a particular cost is an Allowable Cost will influence whether and how uncertainty should be considered. We accept, however, that the guidance might be used to determine the Allowable Costs at different points in time for different purposes. For example, as suggested, it might be used at the time of agreement to estimate the price of a contract whose ultimate price will be based on actual Allowable Costs. Our proposed guidance, therefore, seeks to be broadly applicable to determining Allowable Costs for contracts, regardless of contract pricing method or the point in time at which Allowable Costs are being determined.
- 2.27 With regard to the matter of faithful representation in cost estimates, the SSRO maintains this is a relevant consideration. We note, however, the challenges raised by respondents and do not propose introducing any specific guidance on this at the present time.

### **Contingency**

- 2.28 The working paper noted that contractors may wish to include an element of contingency related to cost uncertainty in their estimates of Allowable Costs, and that the Regulations did not specify how this should be quantified for the purpose of contract pricing. The paper identified some ways in which the requirements of Allowable Costs might assist with the determination of whether contingency is an Allowable Cost and how evidence might support this. Specific consideration was given to the challenges of determining the allowability of contingency for 'high-impact, low-probability' events; risks that can't be reliably quantified and unforeseeable events.

### **Stakeholder feedback**

#### *Quantification*

- 2.29 Industry respondents agreed there was no need for the SSRO to provide guidance on cost estimating as this was an area of industry expertise. They noted that there were different approaches to quantifying uncertainty and extensive professional guidance available on how to apply these. Approaches highlighted by respondents included both quantitative and qualitative risk analysis, estimation (approximation) and historic cost approaches. Some approaches, respondents said, relied more heavily on professional judgement than historic evidence. In some cases, contingency may not be identified separately from costs. The SSRO's guidance, respondents suggested, should not require a particular approach to be taken for a contingency to be determined as an Allowable Cost, nor imply any benchmarks as to what, if any, proportion of Allowable Costs might be permitted as a contingency.



2.30 ADS agreed, noting that the Regulations did not require any specific approach to estimating uncertainty in the pricing of contracts. It indicated that the MOD procured a wide variety of goods and services making a standard approach to estimating uncertainty inappropriate. It noted also that contractors in different circumstances might have different risk appetites depending on the requirements of the contract, their experience and the external business environment.

2.31 ADS contested that a contingency that was the sum of a number of individual contingencies would be reasonable in the circumstances without an assessment of the aggregate amount of contingency.

*Evidence*

2.32 Industry respondents indicated that a contingency for known unknowns would be linked to a project risk register, which identifies the risks included in the costs (and, by inference, those excluded).

2.33 One industry respondent agreed that the guidance might usefully indicate the sort of information that it would be useful to consider when determining whether uncertain costs met the requirements of Allowable Costs. It suggested that relevant evidence might include risk registers, assumptions, dependencies, exclusions, and descriptions of volatility in cost estimates, whether arrived at by three-point estimates or other means. It noted that in some cases the use of multiple approaches to cost estimation might be appropriate to triangulate an appropriate value for inclusion in cost estimates.

2.34 This respondent also considered that while it was sometimes difficult to demonstrate that costs met the requirements of Allowable Costs, a consideration by the contracting authority of the balance of probabilities would be conducive to the parties reaching an agreement on Allowable Costs and facilitate the swifter agreement of contracts following bid submission.

2.35 Another industry respondent felt it would be helpful for the guidance to acknowledge that the evidence available to demonstrate a cost was Allowable might vary depending on the extent of cost certainty. It said costs ranged from those which were virtually certain with known magnitude to others which were uncertain or even impossible to predict (unknown unknowns). It considered that the nature of some uncertainty around highly complex, long-term work programmes would impact on the evidence available. It suggested that evidence might include supplier quotes or be estimates based on historic experience or expert opinion.

*High-impact, low-probability events*

2.36 Industry respondents agreed that guidance on the consideration of high-impact, low-probability events would be helpful, although they considered that care was needed in defining such events. One considered it would be useful to relate any guidance to widely accepted methods for assessing and modelling risk. Another considered that the complex and unique nature of such risks meant that these were, in many cases, dealt with through contract exclusions or limitations of liability. While acknowledging that these risks should be managed in some way other than through Allowable Costs, one industry respondent considered it would be useful to clarify that these should not be addressed through a cost risk adjustment.

*Risks that can't be reliably quantified*

2.37 One industry respondent indicated that risks which could not be reliably quantified should either be included in the Allowable Costs by agreement or excluded from the contract. It was unacceptable, it suggested, for risks to be borne by contractors for which no associated provision had been made in the Allowable Costs.

### *Unforeseeable events*

- 2.38 Respondents considered that account should be taken in agreeing contracts for the potential costs arising from risks that could not be identified at the time of agreement (unknown unknowns). One indicated that such costs, where they arose, were often of greater detriment to a contract than those uncertainties that had been anticipated. Another referred to the findings from a 1996 study by the National Audit Office which found that only 39 per cent of technical issues arising in a sample of 28 equipment projects were identified at the risk assessment stage of the projects.
- 2.39 Respondents considered the guidance might usefully provide clarification in this area, but they expressed different views on how such potential costs should be accounted for. Some industry respondents indicated that such risks should be covered by a management reserve, included in the Allowable Costs with, one added, a positive cost risk adjustment to provide an incentive to the contractor for accepting exposure to the additional risks. One considered that contingency for unspecified costs could not be included in Allowable Costs. Another considered that, if an amount could not be agreed for inclusion in the Allowable Costs, the uncertainty might be reflected in the cost risk adjustment or be reflected in the choice of contract pricing method. Another suggested that it may be more appropriate to deal with these through specific contract provisions and for the allowability of costs to be determined at the point of occurrence. Another considered it may be appropriate to use a mix of contract terms, limitations of liability and inclusion within Allowable Costs.
- 2.40 The MOD proposed a definition of 'contingency' as an amount included in the price of the contract to cover costs that might be borne by the contractor, but which have not been identified through risk management or cost modelling processes. It considered that contingency for such unknown unknowns may be an Allowable Cost where there was clear evidence that these had frequently increased costs for historic projects, or that the cost modelling technique employed systematically underestimated expected costs. It also suggested that where such a contingency for costs that might be borne by the contractor was included in the Allowable Costs, the guidance should prohibit contractors from seeking any further relief from the contracting authority for unforeseen costs, beyond that which might be payable under a Final Price Adjustment, except where these fell into specifically agreed categories.

### *Post-mitigated uncertainty*

- 2.41 Respondents agreed that where the contractor takes action to mitigate the uncertainty surrounding costs, and the costs of mitigating action are deemed to be Allowable Costs, the amount of the uncertain costs which are determined to be Allowable Costs should reflect the post-mitigated circumstances. The MOD went further, suggesting that the value of risk in Allowable Costs should be calculated on the assumption that all reasonable mitigation had been carried out.

### **SSRO response**

- 2.42 Contractors have options as to how they incorporate risk and uncertainty in their cost estimates and different approaches may be required in different circumstances. The SSRO does not consider that it should provide guidance on which approach to cost estimation should be used when determining Allowable Costs, although we do think it is important to consider the appropriateness of the approach taken to the circumstances of the case. We also consider that, in some cases, it may be appropriate to consider the result of more than one estimating approach in arriving at an estimate of Allowable Costs. Our proposed guidance (H.1.3 and H.2.3) reflects these considerations.

- 2.43 We do not agree with ADS that a contingency for uncertain costs that was the sum of a number of individual contingencies would automatically meet the requirement to be reasonable in the circumstances without an assessment of the aggregate amount of contingency. Consideration would need to be given to how each of the individual contingencies had been calculated and any portfolio effect resulting from aggregation. As noted above (paragraph 2.23), the application of mathematical procedures in cost estimation requires professional judgement. What may be appropriate in one case may not be in another. Our proposed guidance (H.1.5) indicates that, depending on the circumstances, the guidance may be applied at the level of particular costs, or to costs in aggregate, or with reference to both particular and aggregated costs. However, whichever approach(es) are used, the aim of cost estimation is to generate an estimate that anticipates the actual Allowable Costs the contractor will incur in performing the contract having due regard for economy and efficiency in the use of resources (H.1.3). The amount of any risk contingency element in Allowable Costs should be consistent with this requirement (H.2.4).
- 2.44 With regard to evidence, we agree that it would be desirable for the relevant parties to take a proportionate approach to determining what evidence is required to be satisfied that uncertain costs meet the requirements of Allowable Costs. The SSRO recognises that uncertainty surrounding costs is easier to characterise with reference to historic evidence in some cases than in others where estimation may rely more heavily on professional judgement. The current guidance at paragraph 2.6 indicates the need for the relevant parties to take a proportionate approach in determining evidence requirements. We do not think any additional specific guidance is required with regard to evidencing uncertain costs but our proposed guidance (H.1.7) reiterates the need for a proportionate approach. We consider that the breadth and diversity of potential evidence to support the determination of Allowable Costs and the circumstances in which it may be more or less relevant limits the usefulness of identifying specific types of evidence in the guidance.
- 2.45 We note and have considered the various comments made by respondents in relation to 'high-impact, low-probability' events, risks that can't be reliably quantified and unforeseeable events. Our proposed guidance (H.1.1) doesn't seek to differentiate between these categories of uncertain costs, preferring a more general definition of what constitutes an uncertain cost. We do not consider, in the light of stakeholders' comments, that distinguishing between different categories of uncertain costs would be particularly helpful. Instead, the proposed guidance (H.2.1) defines risk contingency element in more general terms as 'an element of the costs the contractor estimates it will incur to enable performance of the contract whose actual allocation to particular cost items cannot be known at the time the Allowable Costs are determined'. The guidance takes the position (H.2.2) that any risk contingency element, regardless of how it is categorised by the relevant parties, may be an Allowable Cost subject to satisfying the requirements of Allowable Costs.
- 2.46 The proposed guidance recognises (H.1.7) that uncertainty surrounding some costs is easier to quantify and evidence than others, and that (H.1.3) the approach or approaches to be taken when determining an estimate of uncertain costs should be appropriate to the circumstances of the case. This reflects the comments from stakeholders.

- 2.47 On the specific matter of whether uncertain costs arising from unforeseeable events excluded from the Allowable Costs should be reflected in a cost risk adjustment to the contract profit rate, we do not consider that the cost risk adjustment should be regarded as a contingency for uncertain costs. To do so would imply an expectation that the profit element in the contract price was in fact an element of cost. As indicated in the proposed guidance (H.1.3), we consider that an estimate of Allowable Costs should aim to anticipate the actual Allowable Costs the contractor will incur in performing the contract. Accordingly, all risk must be considered in forming that estimate. Where this is the case, the contractor may expect to earn the agreed amount of profit (which may include an uplift or reduction – the cost risk adjustment – to reflect the risk that the contractor’s actual Allowable Costs differ from its estimated Allowable Costs). Where the cost risk adjustment is considered to act as a contingency for uncertain costs identified but not included in the estimate of Allowable Costs, this would effectively reduce the contractor’s agreed profit and lower its reward for taking risk. We consider this would impact on the achievement of a fair and reasonable contract price. We are giving further consideration to the matter of cost risk adjustment in contract profit rates in 2019/20 and plan to review the guidance we provide on this in 2020.
- 2.48 With regard to the MOD’s suggestion, the SSRO does not consider that prohibiting a contractor from seeking relief from the MOD should its actual costs exceed the estimated Allowable Costs used to determine the contract price is a matter for the Allowable Costs guidance. Relief might be available in some cases through the application of the final price adjustment, through the operation of contract terms and conditions or through an agreed amendment of a contract. We would note, however, that if it is anticipated at the time of agreement that a contractor may seek relief for cost growth during the contract, this may suggest the estimate of Allowable Costs does not, in fact, anticipate the actual Allowable Costs the contractor will incur in performing the contract (as required by the proposed guidance at H.1.3) and should be reconsidered.
- 2.49 As indicated in our working paper, our proposed guidance (H.1.4) requires that an estimate of Allowable Costs should take into account the anticipated effects of any actions agreed by the relevant parties to mitigate uncertainty in the contractor’s costs. What mitigation should reasonably be expected is a matter of judgement for the relevant parties, having regard to the respective costs and benefits. We do not agree that the Allowable Costs guidance should require action be taken to mitigate uncertain costs, but the proposed guidance (H.3) does indicate how the parties might determine whether the costs of mitigating uncertainty satisfy the requirements of Allowable Costs.

### **Risk mitigation**

- 2.50 The working paper noted that some uncertainty regarding estimated costs might be reduced or removed through action taken by contractors and that these actions, where it was reasonable to expect them, were relevant considerations in determining Allowable Costs. It highlighted the need to consider what mitigation would be reasonable in the circumstances and how the costs of mitigation might be determined to be Allowable Costs. The paper indicated that where action was taken to mitigate uncertainty the amount of the uncertain costs which were determined to be Allowable Costs should reflect the post-mitigated circumstances. Specific consideration was given to insurance as a form of mitigation with an indication of principles that the SSRO considered would be relevant to determining whether insurance costs were Allowable Costs.

**Stakeholder feedback**

- 2.51 One industry respondent considered that additional guidance on whether costs of risk mitigation are Allowable Costs would be helpful. Another indicated that contractors will seek to mitigate costs in all contracts regardless of pricing method, which was beneficial to the MOD in lowering the total cost of acquisition. As such, they considered it would be incongruous for the costs of mitigation to be excluded from Allowable Costs. Excluding mitigation costs would, it said, result in risk being transferred back to the contracting authority. Another industry respondent sought clarification on the SSRO's suggestion that 'costs of risk mitigation that are associated with uncertain costs which are not Allowable Costs in the contract would not be attributable to the contract and, therefore, not Allowable'. They considered this implied that no risk mitigation costs would be Allowable. The MOD considered that reasonable mitigation costs were Allowable Costs.
- 2.52 One industry respondent noted that not all risks will be mitigated as it is not always possible or practical to do so. It agreed that it would be sensible to consider how the costs of any mitigating actions compared to the benefits of reduced risk and uncertainty as a result of those actions. Another suggested that mitigation should not be expected where it did not represent value for money. Another noted, with specific reference to insurance, that it may be more economical in some cases to mitigate risk in a QDC/QSC through a policy providing cover for a number of contracts including the contract in question than to purchase insurance specifically for the contract in question. This would be, it suggested, a relevant consideration in determining whether the cost of such a mitigation was an Allowable Cost.

**Insurance**

- 2.53 ADS considered that a more principles-based approach to guidance on insurance costs was preferable to the current approach where a few types of insurance were identified specifically. It agreed with the suggestion in the working paper that only those costs of insurance that related to potential Allowable Costs in the contract should be Allowable. It considered it would be neither appropriate nor reasonable, for example, for the taxpayer to pay for insurance which protects the contractor from costs arising from a breach of contract it had committed.
- 2.54 One industry respondent considered that the guidance should reflect that some insurance may be required by the contract terms, often including waivers of subrogation, named co-insured and indemnities to principles provisions on business and project specific policies.
- 2.55 The same respondent considered that the guidance needed to say how Allowable Costs for uninsured risks would be determined if insurance costs for those risks were not deemed Allowable Costs; and indicate whether a contingency for a deductible (insurance excess) which might be incurred would be an Allowable Cost.

**SSRO response**

- 2.56 Our proposed guidance (H.3) focuses on costs associated with mitigating cost uncertainty and seeks to clarify when such costs may be Allowable Costs. It pays particular attention to when the costs of such mitigation might be considered to enable the performance of the contract (H.3.2) and identifies considerations when determining whether the costs are reasonable in the circumstances (H.3.3).

- 2.57 The proposed guidance is intended to apply to the determination of both estimated Allowable Costs and actual Allowable Costs. We have given particular consideration to the possibility that the estimated effect of mitigation may differ from the actual effect of mitigation. The proposed guidance makes clear that it is the 'estimated' cost reduction (H.3.3a.ii) and 'anticipated' benefits (H.3.3b) which should be considered in determining whether the costs of mitigation demonstrate due regard for economy, and efficiency in the use of resources, regardless of the point in time at which the Allowable Costs are determined. However, whether a cost of mitigation forms part of the Allowable Costs used to determine the price of the contract will depend on the choice of regulated pricing method.
- 2.58 We welcome respondents' support for our proposal to revise the guidance on insurance to ensure this more comprehensively addresses how the AAR test should be interpreted in determining whether insurance costs are Allowable Costs. Our proposed guidance (E.5) seeks to identify the relevant principles.
- 2.59 In proposing changes to the guidance, we are mindful that contractors may adopt a variety of approaches to insurance, including self-insurance in some cases, and that the guidance needs to be applicable to a wide range of circumstances. We are mindful also that it is generally not good value for money for the government to take out commercial insurance to manage risk as it is able to pool and spread its risks and to finance the costs of risks that materialise. Particular care is, therefore, needed in determining whether the costs of insurance meet the requirements of Allowable Costs in QDCs and QSCs.
- 2.60 We note that some insurance may be required by the terms of contracts. This will clearly be a relevant consideration in determining whether the costs enable the performance of the contract and is attributable to it. But it does not negate the need for consideration by the relevant parties as to whether the costs satisfy the requirements of Allowable Costs.
- 2.61 We do not agree that there is a need for specific guidance on how the allowability of costs associated with uninsured risks should be determined; whether they relate to policy deductibles (excesses), costs exceeding the limits of the insurer's liability, or risks for which the costs of insurance are deemed not to be Allowable Costs. We consider that the existing guidance is sufficient to assist the relevant parties to determine whether costs associated with uninsured risks meet the requirements of Allowable Costs and the proposed guidance reflects this (E.5.6).

### **Cost risk adjustment**

- 2.62 The working paper noted that the approach taken to incorporating cost uncertainty in estimated Allowable Costs has implications for the determination of any cost risk adjustment (CRA) in the contract profit rate for a QDC or QSC. It indicated that the SSRO will review its guidance on the CRA in 2020 following the consideration of relevant matters in its review of contract profit rates and informed by work we understand is being undertaken by the MOD in 2019 on an approach to determining an appropriate adjustment for a particular contract. The paper invited stakeholders' views on whether there were any implications for the CRA arising from the review of Allowable Costs guidance on uncertainty and risk.

### **Stakeholder feedback**

- 2.63 Some industry respondents considered that there needed to be clarity in the guidance on how the treatment of uncertainty and risk in determining Allowable Costs, particularly with regard to 'unknown unknowns' or 'high-impact, low-probability' risks, relates to or impacts on the CRA in determining the contract profit rate for a QDC/QSC. Another considered that guidance on uncertainty in determining Allowable Costs needed to be considered in combination with guidance on the application of the CRA and also with regard to guidance on the incentive adjustment (the fifth step in the process to determine a contract profit rate – which may provide an additional incentive to contractors for enhanced contract performance).

- 2.64 Respondents expressed slightly differing views on the purpose of the CRA. The MOD considered that the CRA was to deal with the extent to which actual costs might vary from expected costs (which it had specifically defined). It said the adjustment should not be used to compensate contractors for the expected cost impact of risks. For ADS, determining the CRA required consideration to be given to the confidence interval at which the estimate of Allowable Costs had been compiled. It said the CRA should include an allowance for the variability of any risk contingency or management reserve that had been included in the Allowable Costs. One industry respondent considered that the purpose of the CRA remained ambiguous to some extent. It noted, however, the reference in the working paper to Section 17(2) of the Act and Regulation 11(3) which indicates that the CRA is to 'reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs', which it, and another respondent, referred to as 'risk outside of cost'.
- 2.65 Two industry respondents agreed with the position described in the working paper, that the CRA should not be regarded as a contingency against cost overrun, although in practice, subject to the pricing method of the contracts, the additional profit expected as a result of the adjustment might be reduced by cost overruns. One considered that the CRA should be a reward for additional risk taken, incentivising contractors to bear more risk.
- 2.66 Industry respondents had different views on how the CRA might apply to contracts using different pricing methods. One considered that potential cost/profit variance (and, therefore, the need for CRA) was only an issue for contractors in fixed price contracts. Another, however, considered that cost-plus contracts might have varying levels of complexity requiring different degrees of management effort to manage costs and risks, which should be reflected in an appropriate CRA.
- 2.67 One industry respondent considered that specific guidance may be needed on how the CRA deals with sunk costs at the time of agreement (or contract amendment), where risk had previously been borne by the contractor and had either materialised or hadn't.
- 2.68 One industry respondent noted that it was not yet clear what progress was being made by the MOD and contractors with regard to a mechanism for determining an appropriate CRA. Another queried whether the MOD's efforts to develop a framework for determining an appropriate CRA for a QDC/QSC were even necessary given its stated aim.

### ***SSRO response***

- 2.69 We recognise the points raised by stakeholders about the need for an integrated approach to changes in the Allowable Costs guidance on uncertainty and risk and the guidance on the CRA in determining contract profit. While the SSRO does not intend to review its guidance on the CRA until 2020 it has been considering the principles relevant to this and has issued two working papers in 2019 to members of its Operational Working Group related to profit principles and the CRA. The SSRO considers that there is a logical sequence to its planned development of its guidance, which starts with setting the foundations for considering how uncertainty informs the determination of Allowable Costs.
- 2.70 The SSRO does not have any current plans to review its guidance on the incentive adjustment but we have noted the point raised by the respondent will engage further with stakeholders on priorities for future work in the coming months.
- 2.71 Section 17(2) of the Act and Regulation 11(3) state the purpose of the CRA, as noted above. We have noted the differing views presented by stakeholders regarding the purpose of the CRA. Through its review of contract profit rates, the SSRO has been engaging stakeholders in a discussion about the principles relevant to the determination of profit, including those related to reward for risk taking. We expect to provide further thinking on matters related to the CRA in a public consultation on possible recommendations to the Secretary of State for changes to the Act and Regulations and in our 2020 review of the SSRO's CRA guidance.

- 2.72 The SSRO's current guidance on the CRA addresses how the contract pricing method might inform consideration of the contractor's exposure to variance between estimated and actual Allowable Costs. It does not currently address matters related to sunk costs. Our review in 2020 will provide an opportunity for stakeholders to provide more detailed representations on both these matters.
- 2.73 We look forward to hearing more from the MOD in due course on the outcome of its discussions with industry on a mechanism for determining an appropriate CRA.

### **Other matters**

#### ***Contingent liabilities after contract completion***

- 2.74 ADS indicated that a price based on actual costs may still contain an estimated contingency to cover costs arising from one or more contingent liabilities. For example, a 2 per cent contingency may be included to cover warranty costs.
- 2.75 We consider that where a liability to incur some future cost arises due to an obligation which enables the performance of the contract, the allowability of the cost should be determined in the same way as for any other uncertain cost under the contract. Our proposed guidance reflects this position.

#### ***Risk of liquidated damages***

- 2.76 In a similar vein, the MOD and one industry respondent considered that the possibility of a liquidated damages clause being enforced by the MOD where the contractor was in breach of contract was an uncertain cost for which a contingency might be held by the contractor. Both considered that such a contingency might be an Allowable Cost.
- 2.77 Liquidated damages are imposed for the purpose of providing compensation to the injured party in the case of a breach of contract. The current guidance (E.3) states that compensation [paid by a contractor] is not an Allowable Cost. In general, we think it unlikely that it could be considered appropriate for an injured party (in this case the contracting authority) to be expected to pay for its own compensation, as would be the case if such a cost were an Allowable Cost in a QDC/QSC. We understand, however, that the MOD may find it beneficial to allow a contingency for such costs in order to facilitate agreement of particularly stretching performance targets.
- 2.78 At this stage we are not persuaded to remove the general presumption against compensation for damages being an Allowable Cost. However, we accept there may be circumstance where some discretion is required. We believe it would be necessary to clearly identify these circumstances in the guidance to ensure the requirements of Allowable Costs are consistently considered. More detailed consideration of this matter is required, which should include consideration of the other performance incentive mechanisms provided for under the regime.
- 2.79 Costs incurred by a contractor that enable it to perform the contract and, in so doing, avoid the risk of liquidated damages may be Allowable Costs subject to being appropriate, attributable to the contract and reasonable in the circumstances.

#### ***Baseline profit rate***

- 2.80 ADS considered that the SSRO should demonstrate that the risk in contracts performed by comparator group companies was comparable to that in QDCs and QSCs. This was necessary, it said, to provide assurance that the baseline profit rate which provided the basis for determining contract profit rates could support the achievement of fair and reasonable prices.



2.81 The SSRO has published extensive analysis on the actual profits earned by the companies that make up the baseline profit rate comparator groups, given the risks they face, and how these compare to the profits of the MOD's main suppliers.<sup>5</sup> The range of contract profit rates achievable using the 2019/20 baseline profit rate compares favourably with the MOD's main suppliers. This gives us confidence that an appropriate group of comparator companies has been selected. We will update this analysis as part of the 2020/21 rates recommendation to the Secretary of State.

#### **Changes to reporting**

2.82 Our working paper did not identify any specific changes to reporting in the areas under review.

#### **Stakeholder feedback**

2.83 No feedback was provided by stakeholders on reporting matters.

#### **SSRO response**

2.84 No changes to reporting related to uncertainty and risk or insurance are proposed at this time.

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<sup>5</sup> <https://www.gov.uk/government/publications/2019-contract-profit-rate>

