

Allowable Costs Guidance Review 2019

Responses to the consultation on Changes for 2020/21

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1. ADS Group

SSRO Consultation – Allowable Costs Guidance Review 2019, Consultation on Changes for 2020/21, October 2019

ADS Responses to Questions in Paragraph 5.1 in Consultation Document

Question	ADS Response
Do the proposed revisions make the guidance more or less clear?	ADS considers that in general, the proposed changes make the Guidance clearer and easier to apply. Recognition that there must be some case-by-case consideration of the circumstances and how this affects application of the Guidance is particularly welcomed.
Will the proposed revisions make the guidance more or less easy to apply?	As above.
Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?	Clearer definition of, and distinction between, 'risk', 'contingency', 'management reserve' and 'uncertain cost', their functions, and how and when they are used would be welcomed. At present, the terms appear to be used interchangeably and in combinations creating uncertainty and ambiguity.
Do you have any concerns regarding the proposed publication and application dates of the revised guidance?	ADS believes that proposed schedule is achievable.
What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2020?	Members would welcome resolution of the Cost Risk Adjustment and its application during 2020.

SSRO

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Allowable Costs guidance review 2019
Consultation on changes for 2020/21

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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 2019.¹ 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:
- 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;
 - held group and individual meetings with members of the OWG to discuss the issues raised by the working papers;
 - 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 A summary of the working paper and the feedback provided on it by stakeholders has been published separately.² The SSRO would like to take this opportunity to thank OWG members for sharing their views with us. Their input has helped the SSRO to develop the proposals for revision to its guidance that are contained in this document for public consultation.
- 1.5 The SSRO invites all interested parties to comment on the draft guidance contained in sections 2 and 3 of this document by 6 December 2019. The proposed timetable for publication and application of the final guidance is contained in section 4. Our consultation questions and details of how to respond to the consultation are contained in section 5.
- 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.³ The SSRO plans to review that guidance in 2020. That review will follow the completion of this 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.

¹ SSRO (2019) *Allowable Costs Guidance (Version 4)*.

² SSRO (2019) *Allowable Costs Guidance Review 2019: Stakeholder Responses to a Working Paper on Uncertainty and Risk*.

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

2. Uncertainty and risk

We propose to rename Part H of the current Allowable Costs guidance, replacing 'Risk-related costs' with 'Uncertainty and risk'.

The current guidance in Part H will be replaced with the guidance below.

Key to changes: Text deleted **Text revised/moved** **Text added**

Existing guidance	Proposed guidance	Purpose of changes
	H.1 Costs which are uncertain in occurrence or amount	
	<p>1. For the purpose of this guidance, a contractor's cost is uncertain if:</p> <p>a. it may or may not be incurred by the contractor; or</p> <p>b. the actual amount of the cost incurred may differ from the estimated amount of the cost; or</p> <p>c. it possesses both of the characteristics described above.</p>	<ul style="list-style-type: none"> Explains what we mean by a cost being uncertain. This is consistent with the distinction made by stakeholders between risk, a cost which may or may not occur, and uncertainty, a cost which will occur, but with unknown amount.
H.1.1 Risk that can be estimated and modelled may be an Allowable Cost within the contract price if agreed by the Secretary of State. Costs associated with compensating the contractor for such risk should be evidenced, be appropriately modelled, and only be recovered once.	2. When determining Allowable Costs, a contractor's uncertain costs may be Allowable Costs subject to satisfying the requirements described in this Part, Section 3 and any other relevant Part of Section 5 of this guidance.	<ul style="list-style-type: none"> Clarifies that uncertainty about a cost does not preclude it from being an Allowable Cost. Highlights that the determination of allowability for an uncertain cost is essentially the same as for a known cost. Reminds users of the guidance that there may be other Parts of Section 5 relevant to the determination of whether an uncertain cost is an Allowable Cost.
H.1.3 Given that there is no consistent definition of the various terms relating to risk, the underlying principle to be applied is that costs associated with compensating the contractor for risk should be clearly evidenced and only be recovered once.		

Commented [TM1]: Risk, contingency, uncertain costs (and management reserve?) should be defined and use consistently throughout the comment. One possible approach would be to use the Programme Management Institute (PMI) definitions for known unknowns/unknown unknowns. This would improve clarity.

Commented [TM2]: Define term - does it include uncertain costs arising out of risk or contingency or both (and management reserve)? Adopting the PMI definitions suggested above would improve clarity.

Existing guidance	Proposed guidance	Purpose of changes
(See H.1.1)	<p>3. When a cost is uncertain, the actual amount that will be incurred by the contractor can only be estimated. The approach or approaches to be taken when determining an estimate of uncertain costs should be appropriate to the circumstances of the case. An estimate of Allowable Costs should aim to anticipate the actual Allowable Costs the contractor will incur in performing the contract, having due regard for economy and efficiency in the use of resources.</p>	<ul style="list-style-type: none"> Clarifies that how uncertain costs are quantified in determining Allowable Costs should take account of the circumstances of the case. Indicates that the aim of cost estimation is to anticipate the actual Allowable Costs.
	<p>4. In determining an estimate of Allowable Costs the parties should consider costs already incurred by the contractor, known future costs, uncertain costs, the anticipated effects of any actions agreed by the relevant parties to mitigate uncertainty in the contractor's costs (see Part H.3) and the terms and conditions of the contract.</p>	<ul style="list-style-type: none"> Clarifies that an estimate of Allowable Costs should consider actions to mitigate uncertainty and the fulfilment of contract terms and conditions.
	<p>5. In applying this guidance to uncertain costs, the relevant parties should consider the type, purpose and estimated amount of the uncertain costs. 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.</p>	<ul style="list-style-type: none"> Indicates the different ways in which the guidance may be applied to determine Allowable Costs.
	<p>6. Where uncertain costs are aggregated to form a risk contingency element in the Allowable Costs, the relevant parties should have regard to Part H.2 of this guidance.</p>	<ul style="list-style-type: none"> Notes the relationship to 'risk contingency element', in relation to which a contractor has particular reporting obligations.
(See H.1.1 and H.1.3)	<p>7. The uncertainty surrounding some costs is easier to quantify and evidence than for other costs. The relevant parties should take a proportionate approach to determining what type and standard of information is required about the occurrence or value of costs in order to be satisfied that those costs are Allowable Costs, having regard to the guidance at paragraph 2.6.</p>	<ul style="list-style-type: none"> Clarifies that there is a need for proportionality when considering the evidence required about uncertain costs.

Commented [TM3]: This will in part depend upon the estimating norms of the contractor. Trying to agree a P50 estimate and then contingency for all Allowable Costs lines would be tedious.

Will the 'estimate' be the 'expected cost of performing the contract'?

Commented [TM4]: Sunk costs, costs incurred up to the point of conversion to a QDC, the costs of pre-contract mitigation actions taken by the contractor prior to contract award? The guidance should make it clear if these are included in the 'already incurred' category.

Commented [TM5]: Many of the actions will not be agreed but are down to intended or future management decisions. Clarify that these actions have been agreed and recorded in the original contract.

Commented [TM6]: Suggest use of the word 'relevant' is reviewed throughout the document – no one is going to consult someone who is non-relevant or irrelevant!

Commented [TM7]: ADS believes this reporting requirement should be reviewed. It would appear to serve no useful purpose and the data quality will be very poor.

Existing guidance	Proposed guidance	Purpose of changes
	H.2 Risk-contingency element	
	1. For the purpose of this guidance, risk-contingency element means 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.	<ul style="list-style-type: none"> Provides a very broad definition of risk-contingency element which may include known uncertainties and risks and 'unknown unknowns'.
	2. A risk-contingency element in the contractor's costs may be an Allowable Cost subject to satisfying the requirements of this guidance.	<ul style="list-style-type: none"> Makes clear that a risk-contingency element may be included in the Allowable Costs.
(See H.1.1)	3. The approach or approaches to be taken when quantifying a risk-contingency element in costs should be appropriate to the circumstances of the case.	<ul style="list-style-type: none"> Clarifies that how any risk-contingency element is quantified should take account of the circumstances of the case.
	4. The amount of any risk-contingency element in Allowable Costs should be consistent with the requirement in Part H.1.3 that an estimate of Allowable Costs should aim to anticipate the actual Allowable Costs the contractor will incur in performing the contract, having due regard for economy and efficiency in the use of resources.	<ul style="list-style-type: none"> Reiterates that in estimating Allowable Costs the parties should seek to predict the actual Allowable Costs that will be incurred by the contractor.
	5. The assessment of whether a risk-contingency element is an Allowable Cost should consider: <ol style="list-style-type: none"> whether the uncertain costs to which the risk-contingency element may be allocated are of a type and arising from activities that would, if incurred, satisfy the requirements of costs that are appropriate; whether the uncertain costs to which the risk-contingency element may be allocated would, if incurred, satisfy the requirements of costs that are attributable to the contract; and whether the amount of the risk-contingency element is reasonable in the circumstances. reasonable 	<ul style="list-style-type: none"> Requires the relevant parties to consider the characteristics of the uncertain costs that a risk-contingency element is intended to cover in determining whether the contingency is an Allowable Cost.

Commented [TM8]: Is this section about 'Risk' or 'Contingency'? The section muddles the two terms.

Commented [TM9]: Muddles risk and contingency. Suggest following theme in H.1 – events that are expected to happen but whose effect on costs is uncertain get a 'contingency' whereas if it is not known if the event will or will not occur it is a risk which receives a 'risk allowance'.

Commented [TM10]: The remainder of this sentence creates ambiguity and uncertainty. Suggest deleting.

Commented [TM11]: Is the expected Allowable cost?

Commented [TW12]: How is reasonable in the circumstances tested at the time of pricing? Actuals must be considered reasonable from the view of the uncertainty when the cost in question was committed to.

in the circumstances at
the time of pricing.

Existing guidance	Proposed guidance	Purpose of changes
	<p>6. In determining whether the amount of any risk-contingency element is reasonable in the circumstances, the relevant-parties should consider:</p> <p>a. the extent and nature of the uncertainty surrounding the costs to which the risk-contingency element may be allocated; and</p> <p>b. whether a reasonable person with relevant experience informed of the facts would consider the uncertainty surrounding those costs was consistent with that to be expected for the contractor's experience in performing similar contracts.</p>	<ul style="list-style-type: none"> Identifies additional considerations when determining whether a risk-contingency element is reasonable in the circumstances. Indicates that contingency for uncertainty should be consistent with the contractor's experience in performing the work required.
	<p>7. Where there are no uncertain costs there should be no requirement for a risk-contingency element in Allowable Costs.</p>	<ul style="list-style-type: none"> Clarifies that a contingency would not be an Allowable Cost where costs are known.
	<p>8. The SSRO provides separate guidance for contractors on the reporting of data on any element of risk-contingency in Allowable Costs.⁴</p>	<ul style="list-style-type: none"> Directs contractors to associated guidance on reporting the risk-contingency element of Allowable Costs.
	<p>H.3 Costs associated with mitigating uncertainty</p>	
	<p>1. Contractors may take action to reduce the extent of any uncertainty surrounding the occurrence or amount of the costs of performing the contract. The cost of such mitigating action may be an Allowable Cost subject to satisfying the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.</p>	<ul style="list-style-type: none"> Clarifies that the costs of mitigating uncertainty affecting costs may be Allowable Costs.
	<p>2. In determining whether the cost of mitigating uncertainty affecting a cost or costs is an Allowable Cost, it may be considered to enable the performance of the QDC or QSC in question when the cost or costs whose uncertainty is being mitigated satisfy the requirements to be appropriate and attributable to the contract.</p>	<ul style="list-style-type: none"> Clarifies when the costs of mitigation may be considered to enable the performance of the contract.

Commented [TM13]: The contractor may not have any experience in performing similar contracts.

Commented [TM14]: The mitigating actions may be taken on a whole company basis. The Guidance should allow the parties to agree whether the cost of taking action on a whole company basis should be recovered via the rate structure or an agreed proportion of the total allocated directly to the contract.

4 SSRO (2019) *Defence Contract Analysis and Reporting System (DefCARS): Reporting Guidance and System User Guide for Defence Contractors (Version 6)*.

Existing guidance	Proposed guidance	Purpose of changes
	<p>3. In determining whether the cost of mitigating uncertainty affecting costs is reasonable in the circumstances the relevant parties should ascertain <u>at the time of price agreement</u> whether:</p> <p>a. due regard for economy and efficiency in the use of resources is demonstrated by the relative amounts of:</p> <ul style="list-style-type: none"> ■ the cost of the mitigating actions; and ■ the estimated reduction in the amount of a cost or costs as a result of the mitigating actions; and <p>b. any other benefits are anticipated to arise for the Secretary of State as a result of the mitigating actions.</p>	<ul style="list-style-type: none"> • Additional guidance on how the parties might consider whether the costs of mitigation demonstrate due regard for economy and efficiency in the use of resources. • Clarifies, particularly for contracts priced on actual Allowable Costs, that it is the estimated effect of mitigating actions that is relevant, not what actually occurs. • Clarifies that consideration should be given to other benefits anticipated to arise for the Secretary of State from mitigating actions, for example, greater certainty as to contract schedule performance.
	<p>4. The costs of mitigating uncertainty affecting aspects of contract performance other than costs may also be Allowable Costs subject to satisfying the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.</p>	<ul style="list-style-type: none"> • Clarifies that the costs of mitigating other types of uncertainty may also be Allowable Costs although we do not consider any specific guidance is required to assist in determining whether these are Allowable Costs.
<p>H.1.2 A risk over which the contractor has no or little control, may be covered under the provision of an adjustment to the baseline profit rate if the relevant evidence is provided. Further detail on the basis of a cost risk adjustment is covered in the SSRO's Guidance on the Baseline Profit Rate and its adjustment.</p>	<p>H.4 Cost risk adjustment</p> <p>1. In determining the price of a QDC or QSC, cost risk is the possibility that the actual amount of costs which are determined to be Allowable Costs will differ from the estimated amount of those costs. The presence of cost risk may be reflected through the agreement of a cost risk adjustment in determining the contract profit rate for a QDC or QSC. The SSRO provides separate specific guidance on cost risk adjustment.⁵</p>	<ul style="list-style-type: none"> • Relates uncertainty to cost risk and directs the relevant parties to the SSRO's guidance on cost risk adjustment in determining the contract profit rate for a QDC or QSC.

Commented [TM15]: This determination must be made at the time of pricing only, it cannot be retrospective.

Commented [TM16]: It would be helpful to include an explicit confirmation that the CRA can be applied even when a contingency is included as the CRA addresses areas that by their natures cannot be estimated.

Commented [TM17]: It would be helpful to clarify that risk is different to contingency and management reserve, and that it relates specifically to business risks. The revised wording 'estimated amount' will help to address the 'unknown unknowns' e.g. government actions, inflation, rate changes, items that cannot be captured as dependencies at the time of pricing, variability of cost risk within management reserve beyond reasonable estimated range risk etc. which have been challenged previously.

5 SSRO (2019) *Guidance on the Baseline Profit Rate and its Adjustment (Version 5)*.

3. Insurance

We propose to replace Part E.5 – Insurance in the current Allowable Costs guidance with the guidance below.

Key to changes: Text deleted Text revised/moved Text added

Existing guidance	Proposed guidance	Purpose of changes
<p>E.5.1 The costs of insurance may be Allowable, but the nature of the insurance cover will be material to whether the costs satisfy the Appropriate, Attributable and Reasonable test. The costs of insurance covering buildings and equipment, employer’s liability or vehicles and plants may be Allowable.</p>	<p>1. The costs of insurance, for example, insurance premiums, may be Allowable Costs, subject to satisfying the requirements of this guidance.</p>	<ul style="list-style-type: none"> Replaces the existing guidance on types of insurance for which the costs are Allowable or not with principles-based guidance that can be applied more generally to a range of circumstances.
<p>E.5.2 However, it would be neither appropriate nor reasonable in the circumstances for the taxpayer to pay for the contractor to be covered against its own poor performance in delivering the contract in question and, accordingly, the costs of such insurance should not be Allowable.</p>		
<p>E.5.3 Accordingly, insurance against faulty workmanship (see E.2 above), defective parts, breach of contract or loss of profit associated with poor performance should not be Allowable. If insurance cover is partly for a purpose for which the costs are not Allowable, then the whole of the insurance costs should not be Allowable. A part of the costs may be Allowable if the contractor demonstrates what the cost would be with any inappropriate, non-attributable or unreasonable cover excluded.</p>		

Existing guidance	Proposed guidance	Purpose of changes
	<p>2. The costs of insurance may be considered to enable the performance of the QDC or QSC in question when the uncertain costs which would be met <u>or reduced</u> by the insurance provider should they be incurred, would, in the absence of the insurance, satisfy the requirements to be appropriate</p>	<ul style="list-style-type: none"> Clarifies when the costs of insurance may be considered to enable the performance of the contract.
	<p>3. In determining whether the cost of insurance is reasonable in the circumstances the relevant parties should ascertain whether the costs demonstrate due regard for economy and efficiency in the use of resources given the estimated impact of the insured event on the costs of performing the contract and the likelihood of its occurrence.</p>	<ul style="list-style-type: none"> Additional guidance on how the parties might consider whether the costs of insurance demonstrate due regard for economy and efficiency in the use of resources. Clarifying, particularly for contracts priced on actual Allowable Costs, that it is the estimated impact of insured events that is relevant, not what actually occurs.
(See E.5.3)	<p>4. The contractor may purchase insurance for risks associated with a single contract or multiple contracts. Accordingly, the costs of insurance may be applied directly or indirectly to contracts.</p> <p>5. Where insurance provides cover for risks arising from multiple contracts, the benefits of that insurance may accrue disproportionately between those contracts and will be impossible to ascertain at the time of purchase. Accordingly, the relevant parties should agree a methodology for the allocation of insurance costs to contracts that seeks to ensure those costs are equitably apportioned.</p>	<ul style="list-style-type: none"> Clarifies that insurance costs may be applied directly or indirectly to contracts. Notes that the method for allocating insurance costs across multiple contracts should seek to ensure costs are equitably apportioned – as required of costs that enable the performance of the contract.
	<p>6. Uninsured costs associated with insured events, for example policy excesses or deductibles, or costs exceeding the limits of insurance cover may be Allowable Costs subject to satisfying the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.</p>	<ul style="list-style-type: none"> Clarifies that no specific additional guidance is required for uninsured costs associated with insured events.

Commented [TM18]: Suggest amending guidance to read '... met **or reduced** ...' as in many cases the contractor will be unable to recover 100% if the costs under an insurance claim.

Commented [TM19]: This statement is flawed - insurance costs are always greater than the expected cost of incurrence x likelihood. This represents the profit and administration costs of the insurer. Companies pay for certainty and pay a premium for it.

4. Application of the revised guidance

- 4.1 Following due consideration of any points raised in response to this public consultation, and approval by the SSRO's Regulatory Committee, the SSRO intends to publish a summary of consultation responses and its revised guidance on the topics covered herein by 31 January 2020. This will allow stakeholders time to raise awareness of guidance changes with relevant staff and amend, where considered necessary, any of their policies or procedures prior to application of the guidance.
- 4.2 The SSRO proposes that the revised guidance will apply to all contracts which become qualifying defence contracts or qualifying sub-contracts on or after 1 April 2020.
- 4.3 The proposed timetable for concluding guidance changes for 2019/20 on the topics in this consultation is summarised below (Table 1).

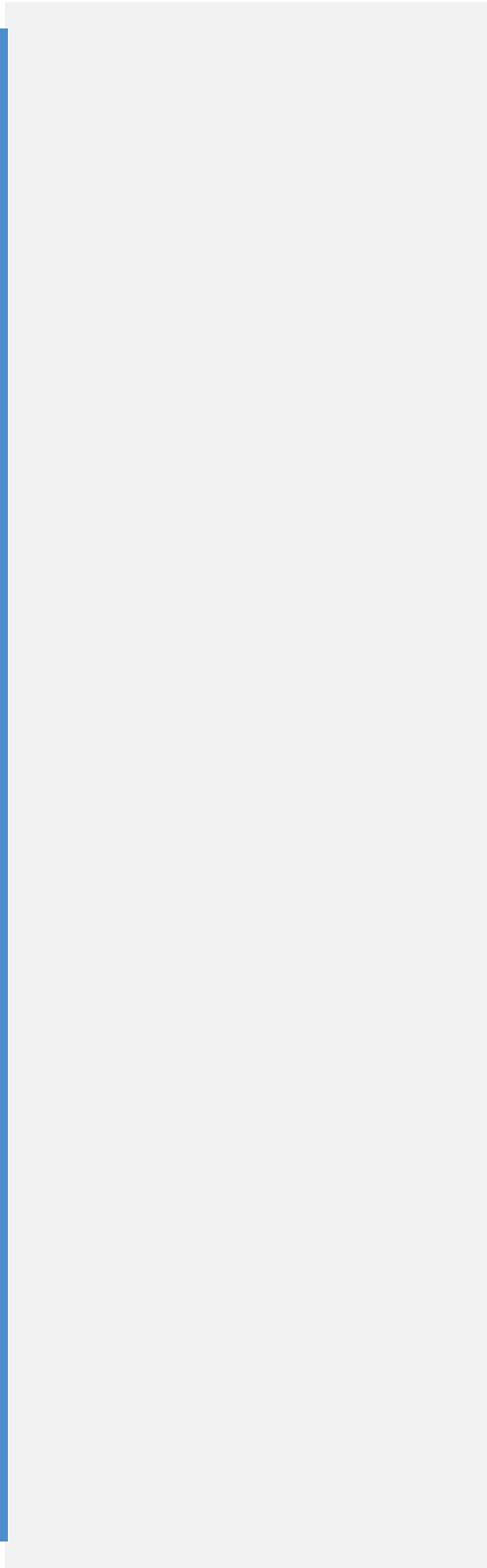
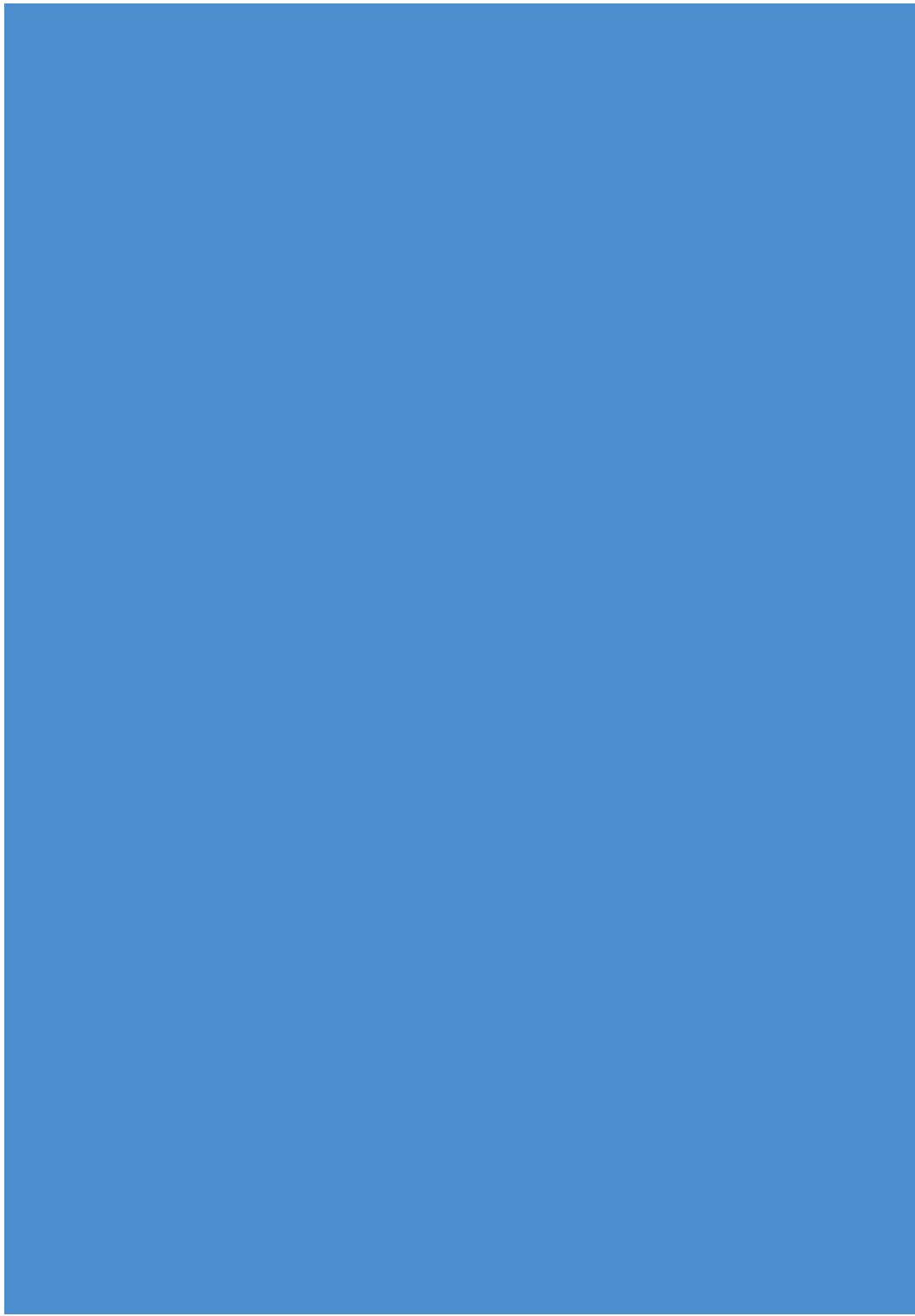
Table 1: Consultation timetable

Activity	Organisation	Date
Submit responses to consultation	Stakeholders	6 Dec 2019
Consider consultation responses and prepare final guidance	SSRO	Dec 2019 to Jan 2020
SSRO Regulatory Committee reviews and approves final guidance	SSRO	23 Jan 2020
Publish consultation response summary and new guidance (revised sections)	SSRO	31 Jan 2020
Raise awareness of changes	SSRO and stakeholders	Feb to Mar 2020
Publish version 5 of Allowable Costs guidance incorporating revised sections	SSRO	Mar 2020
Application of new guidance	Stakeholders	1 Apr 2020

- 4.4 The SSRO welcomes views on the proposed timetable for publication and application of the revised Allowable Costs guidance on these topics as part of this consultation.

5. Consultation questions

- 5.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on the following consultation questions:
- Do the proposed revisions make the guidance more or less clear?
 - Will the proposed revisions make the guidance more or less easy to apply?
 - Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?
 - Do you have any concerns regarding the proposed publication and application dates of the revised guidance?
 - What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2020?
- 5.2 A consultation response form containing these questions has been published alongside this consultation document on [the SSRO's website](#).
- 5.3 Completed response forms should be sent:
- by email to consultations@ssro.gov.uk (preferred); or
 - by post to SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB.
- 5.4 Responses to the consultation should be received by 6 December 2019. Responses received after this date will not be taken into account in finalising the guidance for 2020/21 but will inform subsequent consideration of guidance changes.
- 5.5 The SSRO also welcomes the opportunity to meet with stakeholders to discuss the proposals during the consultation period. If you wish to arrange such a meeting, please contact David Pottruff at the earliest opportunity via david.pottruff@ssro.gov.uk.
- 5.6 In the interests of transparency for all stakeholders, the SSRO's preferred practice is to publish responses to its consultations, in full or in summary form. Respondents are asked to confirm whether they consent to their response being published and to the attribution of comments made. Where consent is not provided comments will only be published in an anonymised form.
- 5.7 Stakeholders' attention is drawn to the following [SSRO policy statements](#), available on its website, setting out how it handles the confidential, commercially sensitive and personal information it receives and how it meets its obligations under the Defence Reform Act 2014, the Freedom of Information Act 2000, the General Data Protection Regulation and the Data Protection Act 2018.
- The Single Source Regulations Office: Handling of Commercially Sensitive Information;* and
 - The Single Source Regulations Office: Our Personal Information Charter.*



2. Babcock

3. Consultation responses

3.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on the following consultation questions:

a) Do the proposed revisions make the guidance more or less clear?

More clear / ~~Less clear~~ / ~~Don't know~~ (Delete as appropriate)

Comments:

Subject to our observations below, we believe the revisions makes the guidance more clear and offer the following comments against the numbered paragraphs in the 'Response to working paper' which we believe needs to be considered in conjunction with the consultation paper.

- i. Para 2.5: We confirm "principles based approach" is better suited to the wider spectrum of projects and therefore more helpful.
- ii. Para 2.10, 2.16 & 2.23: We agree with the SSRO that expected cost is not linked to the notion of central limit theorem and a mean (50%) confidence limit for pricing.
- iii. Para 2.24: Agree.
- iv. Para 2.47: We are unclear how to reconcile the statement at Para 2.47; "we do not consider the CRA should be regarded as a contingency for uncertain costs" with the aim of the CRA being an adjustment to reflect the actual allowable cost differing from its estimated allowable cost. If this is simply because the adjustment is not a contingency then we understand. However, it is fair to say there must be a correlation where the potential for unforeseen events, the nature, complexity and wider business risks logically cause the variance to prove actual allowable cost differing from its estimated allowable cost.
- v. Para 2.69 – 2.73: We welcome the forthcoming review in 2020.

b) Will the proposed revisions make the guidance more or less easy to apply?

Easier to apply / ~~Harder to apply~~ / ~~Don't know~~ (Delete as appropriate)

Comments

Subject to our observations in this consultation response, we believe the revisions makes the guidance more easy to apply save for comments in relation to:

- i. Insurance.
- ii. Language and definitions.

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- c) Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?

Yes / ~~No~~ / ~~Don't know~~ (Delete as appropriate)

Comments

Our response is offered in two parts: These first (Part A) are against the numbered paragraphs in the 'Stakeholder Responses to working paper' (which we believe should to be considered in conjunction with the consultation paper). The second (Part B) relate to the "Consultation on changes for 2020/21" table in the consultation paper.

Part A: Stakeholder responses to working paper

- i. Para 2.8: We suggest following a standard industry professional body for terminology might be helpful however understand that language has flowed from the Act through the Regulations. Perhaps a definition of the meaning in more common industry language might assist understanding.
- ii. Para 2.14: We are concerned by either the over simplification or over complication of the categorisation of the risk of occurrence. Standard Categorisation into Very Low to Very High (VL, L, M, H, VH) permits better identification of and allocation of probability to an event. The practice of allocation to one of five categories representing risk bands is much preferred to those who hope to assess to the nearest 1%. It also conveys the accuracy and evidential status of a risk.
- iii. Para 2.17: We do not support the idea of whether a project is well run or optimised as being a determinant of AAR for Actual Cost. The process of second-guessing could only be a detriment to agreement. Efficiency, transformation and other challenges are already negotiated into the price without complication the AAR further. Equally, this statement assumes that all costs in the comparator group of companies used to determine the baseline profit rate are well run and optimised. If we start to disallow costs associated with these items how will the baseline profit rate be adjusted to ensure comparability under OECD guidelines.
- iv. Para 2.39: Guidance associated with unknown unknowns requires more information including clarity that this either does or does not form part of the CRA adjustment. We believe that it should be made clearer that a cost that could be incurred but not evidentially known at the time of agreement could still be an AC. In this regard the requirements of AAR somewhat distort the picture where it was not identified in cost or risk in the original estimate. How is AAR therefore assessed in these circumstances? Perhaps the standards cannot be the same for risk contingency element and AC where evidence is not available having not been incurred before and the output is modelled?
- v. Para 2.40: We do not agree with the MOD proposition that an unknown unknown cost allocated as contingency may be allowable where there is clear evidence from historic projects. The nature of risk and their occurrence is such that they are not always incurred before and therefore are not easily evidenced. If the evidence was readily available it is more likely to be a cost. There are statistics available to show that whilst a number of risks that are identified do not occur, an equal number if not more that were not identified do indeed make it to cost.
- vi. Para 2.44: It should be noted that a risk that has happened is a cost and therefore is easier to evidence. However the point of a risk assessment is to identify risk and uncertainty for those items uncertain and not known (in probability or quantity). The contingency is therefore an allowance in cost set aside to fund the occurrence of that cost or a number of costs that may or may not happen, of unclear quantity or impact that may not have happened before.

vii. Para 2.45: It might be helpful to add guidance on options for dealing with very high impact very low probability risks. E.g. terms, provisional sums, caveats, etc.

viii. Para 2.53-2.58: We believe care is needed in relation to insurance as the guidance looks difficult to manoeuvre.

Where insurances are required by law they should be allowable (in principal) subject to the other requirements of AAR.

Where insurance is used in the normal course of business (e.g. 3rd party liability insurance) they should be allowable (in principal) as they form part of the cost of running a business and would be comparable to a company in the comparator group.

Where insurances are called for as part of the contract they should be allowable irrespective of whether they relate to a breach or not, E.g. All Risk insurance, PI.

Perhaps it would be more beneficial to identify those insurances that are not AAR. E.g. LD's , Business interruption, etc.? It might also be beneficial to add clarity on the position relative to pricing method and arrangements that benefit MOD such as co insured, waiver of subrogation etc. In this regard the guidance should perhaps look at who benefits from the insurance, is it a feature of normal business for those companies in the comparator group and the effect on the pricing method.

Certain policies are designed to de-risk the project and their absence only services to increase contingency if excluded.

ix. Para 2.77: We suggest there is more detailed guidance required in relation to the subject of damages. Whilst it might not look correct from a tax payers perspective that that an injured party is paying for its own compensation, the analogy over simplifies the situation where timescale risk, float, no blame periods, confidence level, cost of delay, pre and post mitigation time related costs, target programme, KPI's and the need for acceleration are considered. It must be remembered that LD's are a cost to the contractor if they occur and they are assessed probabilistically so full recovery is merely an allowance or contribution to the risk. To disallow LD's potentially over simplifies the contractual situation, how parties might resolve the situation in negotiation and what is fair and reasonable given the circumstances. Further guidance on this subject is definitely required noting there are possibly circumstances where it might be acceptable to add an associated risk contingency element.

x. Generic: We believe guidance required on the variant options for costing risk. E.g. quantified, qualitative, modelled, un-modelled, algorithmic etc. Not everything can or should be modelled.

xi. The whole risk section ignores the fact of the companies' responsibility for mitigating risk. This need to be addressed. For example, a company may decide in order to mitigate schedule risk that it will buy additional commissioning spares to avoid the project overrunning. In the allowable cost guidelines the additional items may not be allowable unless actually used by the project, but the project has benefitted from the risk mitigation of the schedule. Plainly this must disincentives' companies from mitigating risk. Therefore, if cost cannot be modelled then the cost of mitigation must be the determinant.

Part B: Consultation on changes for 2020/21 table

- i. H1: We suggest adding examples to 1.a.a & 1.b. as follows 1.a. E.g the occurrence and 1.b. the quantum
- ii. H1.1.1: Not all costs can be or should be modelled. Suggest replaced with 'estimated'.
- iii. H2: We suggest Risk contingency element should delete the word 'risk' as risk and contingency are two different things albeit we acknowledge language may be "lifted" from legislation. In this case perhaps add commonly used terms or definitions.
- iv. H2.1: Delete element in 3rd line and replace 'will' with 'may' in 5th line
- v. H2.2: Why not call it cost contingency? I.e.. Cost contingency for risk and uncertainty. Risk contingency element is not clear or common language (acknowledging para iii above).
- vi. H2.4 We don't see why we need the words " having due regard for economy and efficiency "
- vii. H2.6.b: Should be a competent and professional person per the standard in dispute and expert witness. A normal person will not understand such concepts.
- viii. H3.3.a&b: The guidance provides too much emphasis on cost when programme could be the priority.
- ix. H1.2: We look forward to the 2020 CRA review.
- x. E5: This is an area that is still ambiguous and could benefit from further guidance in our opinion. Employers liability, buildings, public liability etc. are all insurances the comparator group and responsible businesses adopt by law or best practice. Builders Risk / All Risk policies are designed to de-risk the project and their absence only services to increase contingency if excluded. It is notable that if the risks were permitted for a risk register why wouldn't they be AAR for an insurance policy? Furthermore many insurances are called up because of the nature of actual cost pricing where the benefit is conveyed to MOD by terms. It therefore in our opinion warrants further clearer explanation. In this regard the guidance at E5.2 is not helpful where the insurance E.g. PI is enacted to safeguard the taxpayer as the beneficiary.

NB: Part A para viii above also refers.

- d) Do you have any concerns regarding the proposed publication and application dates of the revised guidance?

~~Yes~~ / No / ~~Don't know~~ (Delete as appropriate)

Comments

No, subject to the issues we have raised being addressed.

- e) What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2020?

Comments

We are content with the subjects raised in the SSRO's Corporate Plan.

3. Leonardo MW Ltd

3. Consultation responses

- 3.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on the following consultation questions:

a) Do the proposed revisions make the guidance more or less clear?

~~More clear~~ / Less clear / ~~Don't know~~ (Delete as appropriate)

Comments

Many of the changes we see as being helpful. However, we have answered “less clear” as elements of the expanded text could be problematic when agreeing estimated Allowable costs as representing actual Allowable costs.

Sections that we see as problematic to agreeing estimated Allowable costs:

- **H.1.4.** explains the full range of costs to be considered as Allowable Costs: those costs already incurred, known future costs, uncertain costs and the effects of any actions agreed to mitigate uncertainty and then includes consideration of the terms and condition of the contract. As this sub-section is discussing contract costs in total we presume “terms and conditions”, in this instance, incorporates both the requirement itself and the commercial terms and conditions associated with the contract. We would welcome clarity on this point.
- **H.2.6.b.** In a discussion of Allowable Costs for uncertainty and risk, we think this subsection could be used in a way that will mean that estimated Allowable costs do not fully represent actual Allowable Costs. Limiting consideration of risk by reference to history may result in valid risks being excluded and contractual agreement hindered. Just because a risk has not previously materialised does not mean it will not in the future. By means of example:
 - A driver may not have had an accident before, but that is not to say it could not happen. Legally you must still have insurance.
 - A property, that in 100 years had never flooded, then did so two years consecutively.
 - A change to environmental regulation may make chemicals used, for many years, unusable.
 - A subcontractor who has IP, or critical parts approval, may go out of business or decide to no longer make the component.
- **H.3.3** We believe you are explaining the test for AAR regarding costs of mitigation is at the point of commitment, when the mitigation costs and benefits are all estimates. That being the case we think inclusion of your second bullet on page 6 “Clarifies, particularly for contracts priced on actual allowable costs, that it is the estimated effect of mitigating actions that is relevant, not what actually occurs”.

Also could guidance be simplified by reliance on section 3 (the AAR principles):

- **H.2** explains costs must satisfy section 3. Section 3 includes the requirement under 3.13.d to demonstrate “...due regard for economy and efficiency...”
Therefore, do the various sub-sections of H and E need to repeat this requirement for “due regard for economy and efficiency” (e.g.H.1.3, H.2.4, H.2.5, H.3.a, E.5.3)?

b) Will the proposed revisions make the guidance more or less easy to apply?

Easier to apply / Harder to apply / Don't know (Delete as appropriate)

Comments

See responses to section 3.1.a

c) Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?

Yes / ~~No~~ / ~~Don't know~~ (Delete as appropriate)

Comments

In your response to consultation 2.47 you explain all types of cost risk are included in cost (subject to AAR tests) and that the CRA is not to be regarded as a contingency for uncertain costs, as to do so would imply that an element of profit is in fact an element of cost. "Accordingly, all risk must be considered in forming that estimate (*of Allowable costs*)." This does not appear to have been included in your final guidance.

We recognise the SSRO's response in section 2.44 of the "Allowable cost guidance review 2019 – stakeholder's responses to a working paper on uncertainty and risk October 2019" – explaining both parties take a proportionate approach to evidence for uncertain costs. However, we remain of the opinion that without some outline guidance how estimates, management reserves and contingencies might be considered for AAR compliance, then agreements may be problematic and protracted.

Practical experience is confusion exists regarding risks within costs and the purpose of the CRA. MOD Commercial officers do not seem to share the same interpretation as explained in 2.47 (Allowable Cost guidance review 2019). Therefore we propose further work is required to improve guidance.

- d) Do you have any concerns regarding the proposed publication and application dates of the revised guidance?

Yes / No / ~~Don't know~~ (Delete as appropriate)

Comments

- e) What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2020?

Comments

- Clarity and alignment of guidance for Allowable Costs for “uncertainty and risk” and guidance for the Cost Risk Adjustment.

4. Metasums

3. Consultation response

I believe that this is a marked improvement in the guidance on these topics, particularly in respect of Insurance E.5

My contribution therefor only relates to those sections of 'Uncertainty and risk' where I believe that guidance could be improved. These are:

H.1.5. The first sentence is unclear to me.

I understand what is meant by '.... the relevant parties should consider the *estimated amount* of the uncertain costs.' however this element of the sentence is clearly axiomatic with the topic under review.

I do not understand what is meant by either, '.... the relevant parties should consider the *type* of the uncertain costs.' or, '.... the relevant parties should consider the *purpose* of the uncertain costs.'

H.2.4 The phrase in this section H.2.4 and in H.1.3 of '*aim to anticipate the actual Allowable Costs the contractor will incur*' lacks clarity. The most likely value (the mode) is not the same as the average value derived from the probability of each outcome multiplied by the value of that outcome (the mean) nor is either the same as the 50th percentile outcome in a ranked listing (the median).

The guidance should be based on the mean expected cost outturn whereby *the aim is to arrive at an agreed cost estimate whereby the quantification of risk of overspend is equal to the quantification of risk of underspend.*

H.2.8 Your reference to separate guidance on the reporting of data on any element of risk contingency in Allowable Costs needs to be complete so that it is accessible. The document referenced in the footer is 144 pages long.

H.4.1 I cannot make sense of the first sentence '*In determining the price of a QDC or QSC, cost risk is the possibility that the actual amount of costs which are determined to be Allowable Costs will differ from the estimated amount of those costs.*' Costs, unless they have already been incurred, will have a distribution of potential outcomes. Paragraph 1.5 states that the cost estimate should be consistent with the expectation of cost outturn. It should not be an option to estimate costs lower/higher than that expected, and the profit allowance increased/decreased to compensate. If this is an option then 1.5 needs a complete rewrite.

What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2020?

Comments

There needs to be statutory guidance on the calculation and composition of 'Cost of Production'. The guidance is necessary to ensure that the value Cost of Production used is derived from and reconcilable to statutory accounts.

Cost of Production is not = operating revenue (turnover) – operating profit/loss [EBIT].

The following elements of the pricing formula should be anchored and reconciled to 'Cost of Production'.

Calculation of Step 6 of the contract profit allowance for the legal entity

Actual and estimated rate claim reports, and actual and estimated cost analysis reports for QBUs.

Contractor's allowable costs under the contract

5. MOD

SSRO ALLOWABLE COSTS GUIDANCE REVIEW 2019

CONSULTATION ON CHANGES FOR 2020/21.

The following is the CAAS response to the SSRO Consultation paper on Allowable Costs Guidance Review 2019, Consultation on changes for 2020/21 (October 2019).

This is the MOD responses to the SSRO Consultation papers on the Allowable Costs (14 October 2019).

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/838353/Allowable_Costs_guidance_review_2019_-_Consultation_on_changes_2020-21_-_October_2019.pdf

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/838354/Allowable_Costs_guidance_review_2019_-_Response_to_working_paper_October_2019.pdf

General

While the changes proposed address some problems with the previous versions, this section of the guidance remains unfit for purpose. This is for two main reasons: it does not use the language that is used by the MOD and contractors in this area; and it therefore contains little concrete guidance for delivery teams on what is or is not allowable. This is compounded by the lack of a clear set of overarching criteria by which to assess the allowability of costs.

We also believe the proposition that "risk should lie with the party best able to manage it" should be included in the SSRO's AC Guidance, as an important principle. It is a VFM issue and given Defence Reform Act 2014 Section 13(2)(a), there is a good case for its inclusion.

a. Do the proposed revisions make the guidance more, or less clear?

Although the intention to explain the distinction between Risk and Uncertainty is welcomed, we believe that the proposed changes do not provide sufficient clarity. Extant definitions of risk and uncertainty that are used in the pricing of single source contracts have been replaced with descriptions that are unclear, and lose an important distinction that determines how costs should be estimated. We have previously provided the SSRO with a suggested taxonomy, based on current practice

In particular:

H1.1 The first subsection risk, the second is uncertainty. These require to be treated differently. The first requires a description of how it should be valued in terms of its likelihood and probability. The second requires guidance on how the outcome of cost modelling techniques such as Monte Carlo simulations should be used, including whether the most likely or mean figure

should be used. In both instances, the treatment needs to be clear for both estimated and actual costs, including the relationship to the final price adjustment.

H1.3 and throughout. The use of 'uncertainty' to cover both risk and uncertainty make this unclear.

H1.1.6 This section needs to make it clear that there must be an evidence-based rationale for inclusion of any contingency.

H1.1.7 If the commonly used definition of uncertainty is used, there may be evidence that costs that are not identified in the modelling or risk register frequently arise, and that these can be covered by an amount for contingency.

H3.7 and H4.3 The term 'having due regard to economy and efficiency' does not represent a clear test that can be applied. We have previously suggested words along the lines of 'a well run company seeking to maximise efficiency'.

H4.3 and H2.4 The word 'anticipate' gives no indication about how such costs should be calculated. The word 'expected' does in this context, and commonly used costs modelling tools will also produce a 'most likely' figure, as well as a 'P50'. Which should be used?

H4.7 This needs to make it clear that evidence needs to be given for any contingency figure, and preferably give some indication of what would be acceptable.

E6. This need to make it clear how these cost would be estimated, and their treatment as actuals under various pricing types.

b. Will the proposed revisions make the guidance more or less easy to apply?

Less easy. We have concerns that the application of the proposed guidance may be open to misinterpretation, deliberate or otherwise, and defence contractors may take advantage in negotiations. This is of particular concern with regard to the introduction of "Risk Contingency". If contractors can include contingency, they should provide robust justification for any contingency claim. We believe being able to claim for contingency will lead to contractors taking shortcuts with respect to the assessment of risks.

c. Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?

Yes, see above

d. Do you have any concerns regarding the proposed publication and application dates of the revised guidance?

No, providing there is sufficient time to make the very significant changes we think are required

e. What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2020?

We have previously said that the whole of the pricing guidance needs to be reviewed against a set of clear underlying principles.

ENT

MOD

6. Thales

Allowable Costs guidance review 2019: Consultation response form

2.3 In the interests of transparency for all stakeholders, the SSRO's preferred practice is to publish responses to its consultations, in full or in summary form. Respondents are asked to confirm below whether they consent to their response being published and to the attribution of comments made. Where consent is not provided comments will only be published in an anonymised summary form.

a) Do you consent to the SSRO publishing this consultation response?

Yes

b) Do you consent to the SSRO attributing comments made by you in this response in a public summary of consultation responses?

Yes

3. Consultation responses

- 3.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on the following consultation questions:

Allowable Costs guidance review 2019: Consultation response form

a) Do the proposed revisions make the guidance more or less clear?

More clear

Comments

Thales is now comfortable that the revisions make it clearer that costs, risks and uncertainty associated with costs and risk are now recoverable within the cost base. Risks are specific events or issues that can be incurred, avoided, transferred, mitigated or retired. These are referred to as Project Contingencies

Uncertainty is volatility around costs to be incurred, either uncertainty in estimates, or uncertainty around events not yet known or fully known. These are referred to as Management Contingencies.

The confidence level applied to the probability of uncertainty occurring that resides within the cost base should be referred to as the PContracted position. Any residual Confidence against the uncertainty occurring is considered as part of the Cost Risk Adjustment.

The effect of any financial imposition against the contract such as LDs, whilst not clear as a recoverable cost, the cost incurred by the contractor in applying specific mitigations to avoid or reduce the probability of those financial impositions being incurred should be an allowable cost and the guidance should make this clear. Any residual risk of incurring a financial imposition should be considered within the Contract Risk Adjustment.

Internally these are referred to as Financial Contingencies.

b) Will the proposed revisions make the guidance more or less easy to apply?

Easier to apply

Allowable Costs guidance review 2019: Consultation response form

Comments

Thales believes that with training and examples of the elements that sit under each of the categories and a worked example, examples of applying the guidance practically to a contract would be beneficial to all parties.

Thales would be pleased to assist in developing examples for inclusion

'Where there are no uncertain costs there should be no requirement for a risk contingency'

This above comment is an example of ambiguity. It should say

'Where there are no uncertain costs there should be no requirement for an **uncertainty** contingency'.

There may still be specific risks which could be incurred even though there isn't uncertainty. There would be Project Contingencies but no Management Reserve

Contractors may use slightly different terminology so there should be definitions .

Allowable Costs guidance review 2019: Consultation response form

- c) Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?

Don't know (Delete as appropriate)

Comments

Thales is pleased that the purpose of the CRA in line with the legislation to cover the potential variation in costs included in the estimate for Allowable costs.

All costs should first and foremost be in the anticipated costs.

Insurance

Contacting companies do not incur as a general rule unnecessary cost . Insurance premiums with multi cover are often cheaper than individual policies .

Please delete the sentence below :

Insurance cover is partly for a purpose for which the costs are not Allowable, then the whole of the insurance costs should not be Allowable. A part of the costs may be Allowable if the contractor demonstrates what the cost would be with any inappropriate, non-attributable or unreasonable cover excluded.

General

Please ignore references to a reasonable man in the street as I am sure they don't understand this topic !

A general recommendation would be to reduce the number of words and where possible replace with practical examples - then this can focus the reader on the relevant areas.

OPEN

Allowable Costs guidance review 2019: Consultation response form

- d) Do you have any concerns regarding the proposed publication and application dates of the revised guidance?

Yes

Comments

The general comment that the guidance supersedes all previous guidance should be noted as at times individuals think old guidance is relevant for contracts that were previously provisionally priced. Thales does not consider provisional priced contracts to conform to the legislation

OPEN

Allowable Costs guidance review 2019: Consultation response form

- e) What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2020?

Comments

The priority should be for the examples for adequate evidence , product and off the shelf items that we could normally sell to another man in the street and recovery of previously incurred but not recovered private venture and bid costs.

I am still concerned that the BPR calculation considers all cost incurred by Companies and there is no alignment to adjust for any cost that is not allowed – eg pension , insurance etc

There is also a concern re the practicality of multiple profit rates on one contract .