SSRO

Single Source Regulations Office

Assuring value, building confidence

Contract pricing methods reported in Qualifying Defence Contracts 2015/16

13 July 2016

Defence suppliers are required by Regulation 22 of the Single Source Contract Regulations 2014 to submit reports to the Single Source Regulations Office about qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs). The types of contract reports and the data to be provided in each are prescribed in Part 5 of the Regulations.

This bulletin provides an analysis of the different regulated pricing methods used by these contracts, as reported in the contract pricing statements (CPS) or quarterly contract reports (QCR) for all 34 QDCs/QSCs entered into within the period 1 April 2015 to 31 March 2016. The Single Source Contract Regulations 2014 introduced six regulated pricing methods that single source suppliers are permitted to use when pricing contracts with the Ministry of Defence (see Table 1 for an explanation of each of these methods). The method used to price a QDC can influence the final price and profit payable, and the incentive to control costs (see Table 2 and Figure 3 for a worked example). This makes the final price adjustment an essential part of the profit control under the Single Source Regulatory Framework, in order to ensure the MOD is paying a fair and reasonable price.

A QDC/QSC can be priced using more than one pricing method in conjunction with Allowable Costs. The contract values reported are those used for contract pricing purposes, and may not reflect the final value of the contract once it is completed. Data presented in the bulletin is as submitted by the suppliers. All figures are provisional, and may be updated in future statistical releases.

Key points

- The majority of contracts agreed in 2015/16, 25 out of 34, use the firm pricing method, of which 15 QDCs/QSCs use firm pricing only and 10 use firm pricing in combination with another pricing method. Firm pricing represents 7 per cent (£0.8 billion) of the total QDC/QSC value in 2015/16.
- The highest proportion (of total value) of QDCs/QSCs in 2015/16 used the estimate-based fee pricing method, at 51 per cent (£5.6 billion), and the target pricing method, at 41 per cent (£4.5 billion).
- The profit earned on a QDC can be influenced by the pricing method used. For example, for firm and estimate-based fee pricing methods the profit is based on the costs estimated at the start of the contract.

Figure 1: Total value of QDCs/QSCs by pricing type, 2015/16

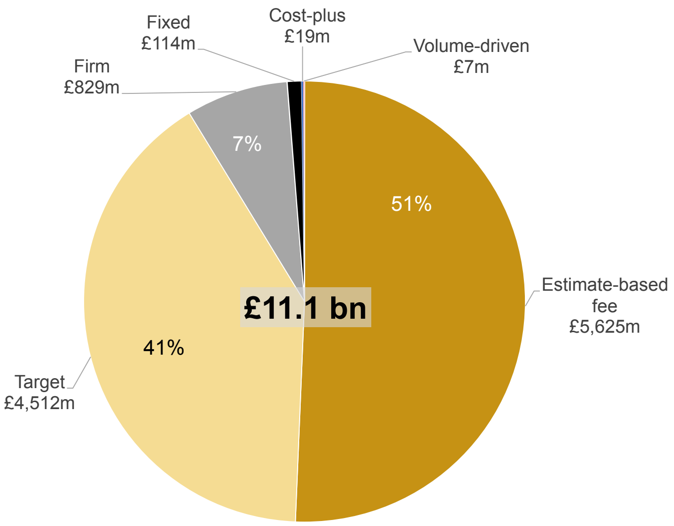
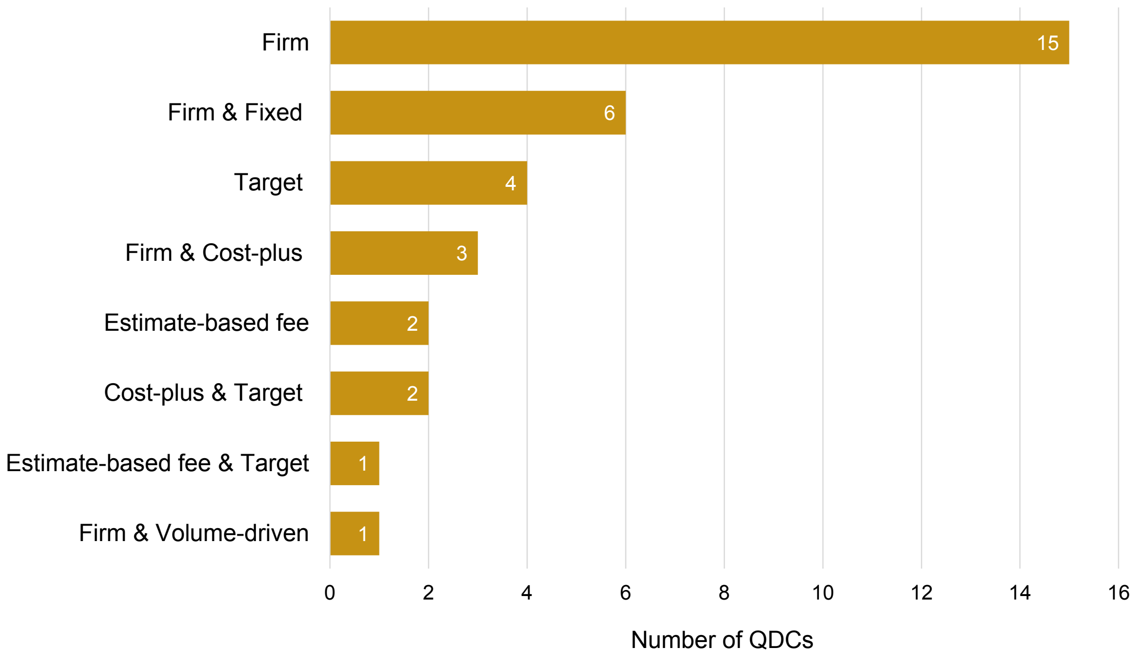


Figure 1 shows the total value of QDCs and QSCs by pricing method. Estimate-based fee pricing is used in three QDCs/QSCs, while target pricing is used in seven QDCs/QSCs (see Figure 2). These pricing methods are used in a small number of relatively higher value contracts.

Figure 2 shows the number of QDCs/QSCs that use each pricing type (and any combination of methods). The most frequently used pricing method is firm pricing, used in 25 out of the 34 QDCs. Firm pricing represents 7 per cent of the contract costs (£829 million). Firm pricing is used for a large number of relatively lower value contracts.

Figure 2: Number of QDCs/QSCs by pricing type, 2015/16



The contract pricing method affects how a cost saving (actual cost is below estimated cost) or a cost overrun (actual cost exceeds estimated costs) are apportioned between the supplier and the MOD. The apportionment arrangements for target and fixed pricing methods will be set as part of the contract negotiations, either through an explicit mechanism or linked to an index and can vary significantly. For firm price, cost plus and estimate based fee the apportionment derives from the method and cannot be altered. Volume driven pricing takes the firm price method and applies it at the unit, rather than contract level. In this case, the MOD's risk relates to the reliability of its estimate of the number of units it will require.

Table 1: Worked example of estimated and actual contract price for cost plus, firm and estimate based fee pricing methods

The worked example below and Figure 3 illustrate the impact of actual Allowable Costs varying by up to 2.5 per cent from estimated Allowable Costs of £1 billion on: supplier profit; contract price; and return on cost[1]. Figures for firm, estimate based fee and cost plus pricing methods are provided. The outcomes for target, volume driven and fixed pricing depend on additional assumptions on volumes, indexation and profit or loss sharing, and are not presented.

The worked example shows that when different pricing methods are used, the same variation between estimated and actual costs can lead to contrasting outcomes in the contract price and amount and percentage profit, even when the contract profit rate, and actual Allowable Costs are exactly the same.

	Actual cost lower than estimated cost	**Actual cost equal to estimated cost**	**Actual cost exceed estimated cost**
Actual Allowable Cost	£975.0m	£1,000.0m	£1,025.0m
Contract profit rate	10.0%		
Cost plus			
Supplier profit	£97.5m	£100.0m	£102.5m
Contract price	£1,072.5m	£1,100.0m	£1,127.5m
Actual return on cost	10.0%	10.0%	10.0%
Firm price			
Supplier profit	£125.0m	£100.0m	£75.0m
Contract price	£1,100.0m	£1,100.0m	£1,100.0m
Actual return on cost	12.8%	10.0%	7.3%
Estimate based fee			
Supplier profit	£100.0m	£100.0m	£100.0m
Contract price	£1,075.0m	£1,100.0m	£1,125.0m
Actual return on cost	10.3%	10.0%	9.8%

1 Sections 16 and 17 of the Regulations cover the final price adjustment. This example does not consider any potential final price adjustment.

Figure 3: Illustrated impact of variation between estimated and actual contract price on supplier profit, contract price and return on cost for cost plus, firm and estimate based fee pricing methods

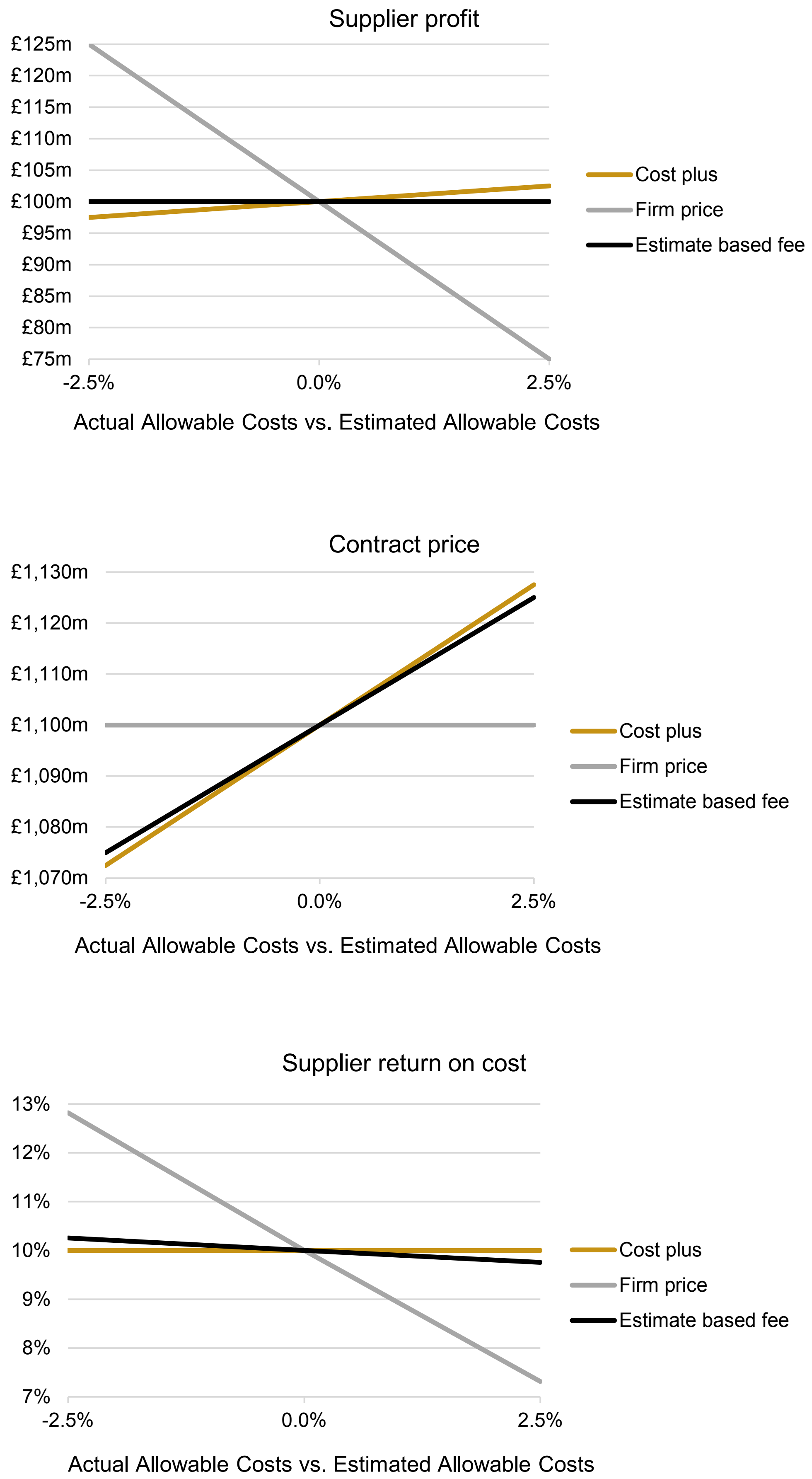


Table 2: Pricing methods explained

Regulation 10 of the Single Source Contract Regulations 2014 sets out the formula for determining the price in qualifying defence contracts and specifies how costs should be treated in each of the six regulated pricing methods that are used in pricing contracts. To assist in understanding this report, a description of each pricing method is provided below, based on the SSRO's interpretation of the Regulations.

Pricing Method	Reference in Single Source Regulations 2014	Description
Firm	*10(4)*	The Allowable Costs are the costs estimated at the start of the contract. The profit earned by the supplier is calculated by applying the profit rate to the estimated costs agreed at the start of the contract.
Fixed	*10(5)*	The Allowable Costs are the costs estimated at the start of the contract, with an adjustment in accordance with a specified index (for example RPI) at a specified time or times. The profit earned by the supplier is calculated by applying the profit rate to the Allowable Costs at the end of the contract once the index change is known.
Cost-plus	*10(6)*	The Allowable Costs are the actual costs incurred to deliver the requirement, established at the end of the contract. The profit earned by the supplier is calculated by applying the profit rate to the actual costs of completing the work.
Estimate-based fee	*10(7) and 10(8)*	The Allowable Costs are the actual costs incurred to deliver the requirement, established at the end of the contract. The profit earned by the supplier is calculated by applying the profit rate to the estimated costs agreed at the start of the contract.
Volume-driven	*10(9) and 10(10)*	The Allowable Costs are the cost per unit at the time of agreement, multiplied by the actual number of units produced by the end of the contract. The costs estimated at the time of agreement may be adjusted in accordance with a specified index (for example RPI) at a specified time or times. The profit earned by the supplier is calculated by applying the profit rate to the Allowable Costs incurred at the end of the contract, once the number of units produced are known.
Target	*10(11)*	Target pricing sets an estimated target cost and target profit. The Allowable Costs are the target costs estimated at the start of the contract. The target profit earned by the supplier is calculated by applying the profit rate to the target costs. An agreed variation mechanism is used to adjust the price payable to the supplier, should the costs change from pre-determined parameters. Cost savings or overruns against the target cost are shared between the contractor and MOD on a pre-agreed basis.

Data sources and methodology

The data in this report is sourced from either the Contract Pricing Statement (CPS), which suppliers are required to submit to the SSRO within one month of the initial reporting date for a contract (usually the date the contract is entered into, unless it becomes a QDC/QSC by amendment). It is also derived from the Quarterly Contract Report, which is required from QDCs/QSCs with a contract value over £50 million within one month of the end of each calendar quarter. The templates and user guides for both of these reports are available on the SSRO's website[2]. Data from these reports are collated in the Defence Contract Analysis and Reporting System (DefCARS).

Only QDCs/QSCs which reported a time of agreement before 1 April 2016 have been included in this release, as notified to the SSRO by the Ministry of Defence, separate to the submitted CPS reports.

Suppliers are required to submit the maximum expected value of the contract agreed for pricing purposes, including any options or incentive payments, which may not reflect the actual value at the end of the contract.

Suppliers are able to submit contract values in currencies other than pounds sterling. Where this has occurred, values are converted into pounds sterling using the exchange rates published by the Bank of England[3] as of the first day of the month in which a report was first submitted for that QDC/QSC.

Due to the commercial sensitivity of this data, the SSRO does not release any information that will enable identification of individual contracts or suppliers included within the analysis. For more information on the SSRO's handling of commercially sensitive information, see the SSRO's statement on its website[4].

Further information

The SSRO welcomes any queries or feedback you may have on this statistical release.
If you would like to get in touch, please email us at helpdesk@ssro.gov.uk.

2 https://www.gov.uk/government/collections/qualifying-defence-contracts-reporting-templates-and-user-guides
3 http://www.bankofengland.co.uk/boeapps/iadb/Rates.asp?Travel=NIxIRx&into=GBP
4 https://www.gov.uk/government/news/handling-commercially-sensitive-information