SSRO

Single Source
Regulations Office

Pricing guidance review 2018

Consultation responses

January 2019

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1. Introduction

1.1. Section 18 of the Defence Reform Act 2014 ("the Act") requires that the Secretary of State, or an authorised person, and primary contractors have regard to guidance issued by the SSRO in relation to any of the six steps for determining the contract profit rate for a qualifying defence contract (QDC) or qualifying sub-contract (QSC). Section 20 of the Act states that the SSRO must issue guidance about determining whether costs are Allowable Costs under QDCs and 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 pricing guidance was published in spring 2018. It includes guidance on:

a. Allowable Costs[1] (Allowable Costs guidance); and

b. the application of the six-step process to calculate the contract profit rate[2] (profit rate guidance).

1.3. Following engagement with key stakeholders during summer 2018, the SSRO conducted an eight-week public consultation[3] on proposed changes to its pricing guidance in three areas:

a. the requirements of Allowable Costs (the AAR test);

b. research and development costs (R&D); and

c. capital servicing adjustment (CSA).

1.4. During the consultation period, the SSRO:

a. held group and individual meetings with members of the SSRO's Operational Working Group[4] and other interested parties;

b. received written responses to the working papers from 13 stakeholders, including the MOD, ADS, ten defence contractors and one consultant.[5]

1.5. The SSRO would like to take this opportunity to thank all those who responded to the consultation for sharing their views with us. The majority of respondents gave permission for their responses to be published in full and they are presented in the remainder of this document.

1.6. A summary of the views and evidence provided by all consultation respondents, together with the SSRO's commentary on how these responses have informed the final guidance in the areas on which we consulted has been published in SSRO (2019) *Pricing Guidance Review 2018: Summary of Consultation Responses*.

1.7. The final guidance resulting from the consideration of consultation responses has been published in SSRO (2019) *Pricing Guidance Review 2018: Changes for 2019/20*.

[1] SSRO (2018) *Allowable Costs Guidance*.

[2] SSRO (2018) *Guidance on the Baseline Profit Rate and its Adjustment 2018/19*.

[3] From 15 October to 7 December 2018. See SSRO (2018) *Pricing Guidance Review 2018: Consultation on Changes for 2019/20*.

[4] Comprising the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors.

[5] The ADS response was explicitly supported by four of the defence contractors that responded to the consultation.

2. ADS Group 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

Comments

On balance the Single Source Cost Standards (SSCSs) have improved in each year and the guidance has become progressively clearer, however some significant issues remain to be addressed which are highlighted in this response.

The principle of general business overhead needs to be included in the guidance on "Attributable", which would make other specific classes of cost clearer and more logical to treat.

Proposed Guidance (PG) 2.2 *'requires **both parties** to be satisfied that particular costs meet the requirements of Allowable Costs'*. It is unclear in the case of a QSC who are the relevant parties; the Statutory Guidance (SG) should state that in this case it would be the Secretary of State (SoS) and the sub-contractor.

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

Members advise that in their view, the revisions to the PG are unlikely to make a significant difference in their ease of use. A major improvement in ease of use would be to address "Attributable" and the issue of general business overheads as suggested in this response.

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

General Business Overheads & Attributable

The principle of "Attributable" as defined in the SG requires that costs *'enable the performance of the contract'* and occurs in several places (e.g. paragraphs 3.1, 3.5, 3.6, 3.7b, 3.8, 3.9a). For many types of cost this is adequate, however this causal relationship between cost and a contract is too strict a requirement for the recovery of overhead costs. This has caused many problems when Members have negotiated prices with MOD, and results in illogical reasoning with respect to certain cost types (e.g. for research).

Some costs that would be fair and reasonable to permit cannot meet this test. The SSRO should consider how costs for items such as research, selling and marketing; lean initiatives, business transformation initiatives, green initiatives (beyond legal requirements) and redundancy meet this test (some of which are addressed in the SG as potentially allowable). None of these costs can "enable" a contract (unless it is a contract to undertake research). Research ensures that the business is viable and competitive in the future; the argument that the SG sets out in D1.3 is somewhat tenuous and unnecessary if general business overheads are allowable. Similarly, whilst selling and marketing costs lower the cost base for MoD contracts through spreading overhead, they do not enable performance; redundancy keeps the cost base competitive, it does not enable performance.

An additional criterion of "Attributable" is required (e.g. as allowed by the US DoD) for general business overhead or overheads incurred in the normal course of business **without** the qualification of **enabling**. General business overhead would still be required to meet the criterion of Appropriate, therefore only relevant overheads would be permitted. Refer FAR 31.201-3 Determinising reasonableness (b)(1) 'Whether it is the type of cost generally recognised as ordinarily and necessary for the conduct of a contractor's business or the contract performance. Refer FAR 31.201.4 Determining allocability (c) Is necessary for the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown. Refer FAR 31.205-28 for examples of general business costs that are allowable. Adding this criterion would simplify the logic throughout the SG.

Public Scrutiny/Regularity/Parliament

ADS believes the "public scrutiny" test given in paragraphs 3.4, 3.8 is inappropriate. The criterion is an artificial construct and should not be a factor in determining allowable costs as it is subjective and there can be no reliable evidence on which to assess the extent to which it has been met. If a cost satisfies the Allowable Cost criteria i.e. it is "Appropriate", "Attributable" and "Reasonable", then it should not be possible to challenge or set this assessment aside with a "public interest" test. Public scrutiny (and Value for Money) is an output-based measure that addresses price rather than cost. ADS believes that if a price has been estimated or incurred in accordance with the SSCSs, it is for MOD to defend that price against the contract requirements.

Equally, references that attempt to interpret "public scrutiny" by relating the criterion to "a reasonable person, informed of the facts" are inappropriate for the task (paragraphs 3.4, 3.5.a, 3.8, 3.9). MOD contracts are rarely for consumer goods and services to which a "reasonable person" could relate. The majority, by value and volume, are for complex technical goods and services which only a person with skills comparable to the supplier; an awareness of the requirement and the economic environment in which the contract is being performed; and the resources could have a fair-minded view of a cost. Even then it is possible that different experts will arrive at different views on the same price.

MOD introduced a concept of public scrutiny in the labelling of spares from July 1987 until April 2003. This enabled store and service personnel to observe the price of spares shown on the packaging and to raise a post-pricing challenge if they felt that the price was not value for money. This exercise produced no significant challenges or benefit to any party.

References to standards of "regularity" and "prudence" expected by Parliament and MOD create uncertainty and self-serving outcomes (paragraphs 3.5.b, 3.9.b). It is for the SSRO to define those standards in the SSCSs rather than refer to external sources that are subject to political whim and for which no objective evidence can be evinced. Concepts of "regularity" and "prudence" are irrelevant in situation where significant uncertainty and risk arises from the contract programme.

Value For Money

ADS does not support the criterion of "Value for Money" (paragraph 3.3). This can only be assessed on the whole price MOD will pay for the requirement(s) delivered in accordance with the contract, not on elements of cost. If the contract price was calculated and agreed in accordance with SSCSs, then it is for MOD to defend it in relation to the requirements of the contract. There have been occasions when requirements have been over-specified which can lead to a price not being value for money, however, that does not detract from the allowability of costs.

Other Issues

Verification (2.2)

PG 2.2 states that *'the Secretary of State and the contractor must be able* ***to verify****, to their satisfaction'* that costs are AAR and this has caused uncertainty and contention. The legislation requires that the parties are satisfied: there is no requirement to "verify", only to "show" compliance with the AAR test by reference to the statutory guidance or otherwise. Introducing an additional verification criterion in the statutory guidance places an unnecessary additional burden on both MoD and the contractor. ADS believes the last sentence should be deleted. Further, the reference in that column to Regulation 20 and verifying is incorrect; it is section 23 of the DRA that requires these records. There is no requirement for the parties to verify costs, only for the contractor to keep sufficient records to enable the verification of costs and for the MoD to be entitled to examine the records.

It would be helpful for the SG to develop criteria for when evidence is not sufficient, and what evidence should be available.

Quality of evidence (2.4)

The guidance has been improved by the addition of *'a proportionate approach'* to evidence, however, ADS believes it should go further. Several members have reported that MoD has on occasions been intransigent and rejected evidence as "inadequate" without explaining in what way it is defective or what it requires or would be considered "adequate". ADS suggest adding the word *'pragmatic'* before *'proportionate'* and including an expectation that MoD, when rejecting evidence as inadequate, would state what it requires to be satisfied.

Reasonable (3.9)

PG 3.9d introduces comparison in costs with *'by third parties in similar circumstances*.' Contractors will rarely, if ever have information about other contractors' costs, this requirement should be deleted.

PG 3.9e extends the reach of the guidance into improving business performance. This paragraph should be deleted and dealt with in the contract by KPIs or via step 5 of the profit make up.

Reasonable (3.10d)
This SG applies to both estimated and actual costs and the relevance of *'events which were not anticipated at the time of agreement'* is unclear. Defence contracts are often to do new things with new technology, in an uncertain political and technological environment. Many cost outcomes may not have been 'anticipated', however, that should not affect their reasonableness. ADS believes this sub-para should be deleted.

Research and development
This section of the SG has been improved but requires further polishing. The SG should make clear it applies only to Private Venture Research and Development where the contractor is funding the entire programme from its own resources. Where MOD is funding the R&D programme the expenditure will constitute direct costs and this guidance will be irrelevant. Industry and the MoD to agree to this approach to the treatment of R&D costs. In summary this position is:

- Research and Development are separate issues and should be addressed individually.
- Research may be allowable as a general business overhead through the rates as a period expense (not D1.3's argument).
- Development may be allowable, and its treatment through the rates as a period expense **or** recovered against specific outputs agreed with the MoD.

Contractors often have choices in the accounting treatment of Development costs e.g. capitalisation/amortisation or period expense and this is irrelevant for recovery under MoD contracts. The key factor is that the recovery method is discussed and agreed with MoD.

D1.1 is attempting to define GAAP and is unnecessary and should be removed.

D1.2. Research (in year) cannot enable a contract being priced; its use and success is uncertain (see previous comments). This should be deleted.

D1.3 This logic is tortuous and unnecessary if general business overheads are considered "Attributable". The tests a-d may not be appropriate and with this change are no longer required:

a. *'Consistent with historical levels'* - this has no relevance.
b. Research, to be appropriate, should be agreed to have relevance for defence. It has no relevance to *'the contract being delivered'*.

D2.1 Is attempting to define GAAP and is unnecessary and should be deleted.

D2.3 As stated, the accounting treatment of development expenditure is irrelevant and may give inappropriate results for either the MoD or the contractor. The MoD and industry agree the decision the contractor makes to account for development is irrelevant; the specific development project's treatment in costing and pricing MoD contracts requires agreement between the parties.

D1.5 The term "abortive research" is meaningless: research into a material may or may not find new possible applications. Even where no use is found, the research has provided that knowledge and it is useful as no further investigation into that material is necessary and other materials may need to be investigated in future. Research should always be treated as a period expense. ADS would recommend that the reference to research in this paragraph is deleted.

D1.6 This change is welcomed as it clarifies government policy of rewarding companies that undertake qualifying research. Further, it resolves the issue that pricing of contracts including R&D tax credits is unrealistically complex, as the qualification criteria often change each year (and could be curtailed by any budget).

Penalties
E4.4 Civil Penalties. These costs are always inappropriate and does not require the elaboration past the first sentence.

Capital Servicing Adjustment
The redefinition of FCSA and WSCA seek to simplify the calculation to that presented in the 2018-19 SSRO Guidance on the baseline profit rate and its adjustment. This is welcomed, however, certain specifics have been deleted, and a line by line review of the adjustments in section 20 of the quoted document is required. For example:

a. 20.5 (f) *'Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as a source of capital and is not deducted from assets.'* To not treat in this manner penalises the contractor potentially twice (excess cash – disallowed, contract liability – deducted from assets), this may place him in a counter intuitive commercial position. Similarly, for 20.6 (g) this treatment should be included in the SG.

G2.1 (and 17.1, 18.3, 19.4) Further to previous comments, *'capital they employ to enable the performance'*. This is too close a test, capital supports the business unit in general, use on a particular contract is not considered and is unhelpful. A business unit may have many assets, considering the use of each asset and confirming that it enabled performance of a contract, would be a time-consuming activity and generate volatile and spurious rates. Capital is taken in the round at a business unit level. It would be difficult, if not impossible for the contractor to evidence each asset that would be or had been employed during performance of the contract. Guidance in 18.4 and 18.5 are pragmatic and useful and should replace the above references.

19.5 Considers the exclusion of items from the CSA, ADS have the following comments on the specifics:

a) i) Why are intangible assets with an indefinite useful life excluded? If the MoD is benefitting from the use of the asset, then the asset should qualify for CSAs. Contractors rarely benefit from the impairment in allowable cost, and neither the CSA meaning the MoD benefits at no cost. The treatment of indefinite life intangible assets/costs (largely goodwill and fair-values on business combinations is inconsistent between the BPR, CSAs and allowable costs, all to the disadvantage of industry:

BPR:

- Profits are stated after goodwill impairment
- CSA is computed including goodwill assets, therefore lowering what is 'left' for the BPR

Allowable Costs:

- Impairment of goodwill is only allowed with the Secretary of State's agreement (however, he has stated he never intends to allow this cost)

CSA:

- Goodwill is not allowed in the calculation.

As a result, the reference group profit is reduced for goodwill, its BPR is reduced by the CRAs of goodwill, and then contractors cannot price goodwill or get a return on the assets. This is illogical and inequitable.

a) ii) *'fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets'*. GAAP requires fair value adjustments, to values that better represent the assets being used in the business in certain situations. This

updates the balance sheet to a more relevant value and may change EBIT through additional depreciation/fair value charge. Disallowing CSAs on a fair valuation means that the CSAs allowed are at a historical and out of date value. The contractor suffers an opportunity cost of the use of that asset, for example, a landlord sets his rental yield at the current value of the property, the historical purchase cost of the property is of no relevance. The input of additional capital is irrelevant, the opportunity cost of either the sale (contractor) or use (benefitting the MoD) is the relevant value.

a) vi) Exclude cash in excess of the amount required for normal operations. This is an area of repeated disagreement, and further definition would assist both parties. The definition should be extended to cash that is required to complete MoD contracts and settle TCIF/PEPL payments and for customer advances to unwind (if not removed form liabilities).

c. 'Items generally not relevant for single source MOD contracting.' This is a new requirement and is not understood; and should be explained and agreed before inclusion in the SG. The reference should be wider to include items not relevant for defence purposes.

19.6 The draft SG states that in a cash pooling arrangement that the cash required for normal operations **may** be included as an element of capital. **May** should be changed to **must**.

19.7 States that further adjustments may be required if they can be **reliably** estimated. This test is too harsh and should be changed to **reasonably** estimated, otherwise some reasonable adjustments could be disallowed. Further, 19.7 a. permits adjustment where there is a **pervasive** change, again too harsh, it should be a **significant** change. Many changes to the balance sheet may be required, for instance revaluing inventory to MoD rates from accounting rates.

20.2 Requires *'Adequate justification should be provided to support the calculation of both fixed and working capital.'* Tests as harsh as **adequate** are causing delays in the agreement of contracts as the MoD are rejecting proposals where they consider evidence as inadequate without providing reason or possible remedy, this criterion needs changing to **reasonably adequate** and the MoD should be required to state why they consider justification is inadequate and what would be reasonable to satisfy them.

21.2 Requires the data to be **annualised**, the SG should explain the meaning of annualised.

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

e) What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2019?

Comments
ADS would like to work with the SSRO after the publication of the 2019 SSCSs to prioritise changes required. Only after this guidance is published future change requirements will be understood.

3. Babcock International Group PLC

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

The proposed revisions generally make the guidance clearer. The changes to simplify and provide clarity in many areas is a positive change to the guidance.

There remain some areas where the guidance remains weak on clarity (see (c) below)

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

The proposed revisions generally make the guidance easier to apply due to improved clarity.

There remain some areas where the guidance remains weak on ease of application (see (c) below)

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

We don't believe industry's concern regarding ability to treat general business costs as AAR has been adequately dealt with. The guidance still appears to require a strong link between the cost and the performance of the contract which is not possible for general business costs (para's 3.1, 3.5, 3.6, 3.7b, 3.8, 3.9a for example).

Research and selling and marketing are clear examples of this, but they are both reasonable costs associated with running a business, but cannot meet the criteria for enabling a contract.

For example, selling and marketing costs lower the cost base to MoD contracts through spreading overhead, it does not enable performance.

We believe the SSRO need to address this point to ensure industry is not penalised by not being able to recover necessary, general business costs.

An additional criterion of Attributable is required for general business overhead or overheads incurred in the normal course of business without the qualification of enabling. General business overhead would still be required to meet the criterion of Appropriate, therefore only relevant overheads would be permitted. Adding this criterion would simplify the logic throughout the Guidance.

We do not support the criterion of "public scrutiny" [3.4, 3.8]. This criterion is a construct of the SSRO and should not be a factor in determining allowable costs. It is subjective and there can be no reliable evidence on which to assess the criterion. If a cost meets all other criteria, then this criterion should not cause the cost to be inappropriate. If the SSCSs have established reasonable cost criteria, on which a contract price is based, then it is for MOD to defend that price against the requirement that MOD established for the contract. Public scrutiny, just as Value for Money, is an output-based matter addressing price rather than cost, which are matters for MOD to justify in any public scrutiny, whether Parliamentary or otherwise.

Equally, references that attempt to interpret "public scrutiny" by relating the criterion to "a reasonable person, informed of the facts" are ill-founded [3.4, 3.5.a, 3.8, 3.9]. MOD contracts are rarely dealing with consumer goods and services to which a reasonable person can relate. Only an expert having skills comparable to the supplier and awareness of the requirement, the resources available and the economic environment could have a fair-minded view of a cost.

In para 19.6 the draft Guidance states that in a cash pooling arrangement that the cash required for normal operations may be included as an element of capital. 'May' should be changed to 'must'.

We still have the general concern regarding the inconsistency between allowability of costs and the failure to adjust for disallowed costs in generating the BPR from the Comparator Group. This means that, ceteris paribus, single source contractors will always earn lower profits than the median of the Comparator Group for equivalent performance as costs are disallowed in single source contracts, but the same costs are charged to profits of the Comparator Group in arriving at the BPR. This cannot be equitable and goes against the principles of comparability.

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 2019?

Comments
We would like to work with Industry, ADS, MOD and the SSRO after the publication of the 2019 SSCSs to prioritise changes required. Only after this guidance is published future change requirements will be understood.

4. Boeing Defence UK 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

On balance the Single Source Cost Standards (SSCSs) have improved in each year and the guidance has become progressively clearer, however some significant issues remain to be addressed which are highlighted in this response.

The principle of general business overhead needs to be included in the guidance on "Attributable", which would make other specific classes of cost clearer and more logical to treat.

Proposed Guidance (PG) 2.2 '*requires **both parties** to be satisfied that particular costs meet the requirements of Allowable Costs*'. It is unclear in the case of a QSC who are the relevant parties; the Statutory Guidance (SG) should state that in this case it would be the Secretary of State (SoS) and the sub-contractor.

BDUK fully supports and has contributed to the ADS consultation submission and Pricing Guidance mark-up – embedded here for ease of reference.

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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

It is considered that the revisions to the PG are unlikely to make a significant difference in their ease of use.

A major improvement in ease of use would be to address "Attributable" and the issue of general business overheads as suggested in this response.

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

General Business Overheads & Attributable
The principle of "Attributable" as defined in the SG requires that costs *'enable the performance of the contract'* and occurs in several places (e.g. paragraphs 3.1, 3.5, 3.6, 3.7b, 3.8, 3.9a). For many types of cost this is adequate, however this causal relationship between cost and a contract is too strict a requirement for the recovery of overhead costs. This has caused many problems when Members have negotiated prices with MOD, and results in illogical reasoning with respect to certain cost types (e.g. for research).

Some costs that would be fair and reasonable to permit cannot meet this test. The SSRO should consider how costs for items such as research, selling and marketing; lean initiatives, business transformation initiatives, green initiatives (beyond legal requirements) and redundancy meet this test (some of which are addressed in the SG as potentially allowable). None of these costs can "enable" a contract (unless it is a contract to undertake research). Research ensures that the business is viable and competitive in the future; the argument that the SG sets out in D1.3 is somewhat tenuous and unnecessary if general business overheads are allowable. Similarly, whilst selling and marketing costs lower the cost base for MoD contracts through spreading overhead, they do not enable performance; redundancy keeps the cost base competitive, it does not enable performance.

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BDUK believes the "public scrutiny" test given in paragraphs 3.4, 3.8 is inappropriate. The criterion is an artificial construct and should not be a factor in determining allowable costs as it is subjective and there can be no reliable evidence on which to assess the extent to which it has been met. If a cost satisfies the Allowable Cost criteria i.e. it is "Appropriate", "Attributable" and "Reasonable", then it should not be possible to challenge or set this assessment aside with a "public interest" test. Public scrutiny (and Value for Money) is an output-based measure that addresses price rather than cost. BDUK believes that if a price has been estimated or incurred in accordance with the SSCSs, it is for MOD to defend that price against the contract requirements.

Equally, references that attempt to interpret "public scrutiny" by relating the criterion to "a reasonable person, informed of the facts" are inappropriate for the task (paragraphs 3.4, 3.5.a, 3.8, 3.9). MOD contracts are rarely for consumer goods and services to which a "reasonable person" could relate. The majority, by value and volume, are for complex technical goods and services which only a person with skills comparable to the supplier; an

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Value For Money

BDUK does not support the criterion of "Value for Money" (paragraph 3.3). This can only be assessed on the whole price MOD will pay for the requirement(s) delivered in accordance with the contract, not on elements of cost. If the contract price was calculated and agreed in accordance with SSCSs, then it is for MOD to defend it in relation to the requirements of the contract. There have been occasions when requirements have been over-specified which can lead to a price not being value for money, however, that does not detract from the allowability of costs.

Other Issues

Verification (2.2)

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It would be helpful for the SG to develop criteria for when evidence is not sufficient, and what evidence should be available.

Quality of evidence (2.4)

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including an expectation that MoD, when rejecting evidence as inadequate, would state what it requires to be satisfied.

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- Research may be allowable as a general business overhead through the rates as a period expense (not D1.3's argument).
- Development may be allowable, and its treatment through the rates as a period expense **or** recovered against specific outputs agreed with the MoD.

Contractors often have choices in the accounting treatment of Development costs e.g. capitalisation/amortisation or period expense and this is irrelevant for recovery under MoD contracts. The key factor is that the recovery method is discussed and agreed with MoD.

D1.1 is attempting to define GAAP and is unnecessary and should be removed.

D1.2. Research (in year) cannot enable a contract being priced; its use and success is uncertain (see previous comments). This should be deleted.

D1.3 This logic is tortuous and unnecessary if general business overheads are considered "Attributable". The tests a-d may not be appropriate and with this change are no longer

required:

a. *'Consistent with historical levels'* - this has no relevance.

b. Research, to be appropriate, should be agreed to have relevance for defence. It has no relevance to *'the contract being delivered'*.

D2.1 Is attempting to define GAAP and is unnecessary and should be deleted.

D2.3 As stated, the accounting treatment of development expenditure is irrelevant and may give inappropriate results for either the MoD or the contractor. The MoD and industry agree the decision the contractor makes to account for development is irrelevant; the specific development project's treatment in costing and pricing MoD contracts requires agreement between the parties.

D1.5 The term "abortive research" is meaningless: research into a material may or may not find new possible applications. Even where no use is found, the research has provided that knowledge and it is useful as no further investigation into that material is necessary and other materials may need to be investigated in future. Research should always be treated as a period expense. BDUK would recommend that the reference to research in this paragraph is deleted.

D1.6 This change is welcomed as it clarifies government policy of rewarding companies that undertake qualifying research. Further, it resolves the issue that pricing of contracts including R&D tax credits is unrealistically complex, as the qualification criteria often change each year (and could be curtailed by any budget).

Penalties
E4.4 Civil Penalties. These costs are always inappropriate and does not require the elaboration past the first sentence.

Capital Servicing Adjustment
The redefinition of FCSA and WSCA seek to simplify the calculation to that presented in the 2018-19 SSRO Guidance on the baseline profit rate and its adjustment. This is welcomed, however, certain specifics have been deleted, and a line by line review of the adjustments in section 20 of the quoted document is required. For example:

a. 20.5 (f) *'Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as a source of capital and is not deducted from assets.'* To not treat in this manner penalises the contractor potentially twice (excess cash – disallowed, contract liability – deducted from assets), this may place him in a counter intuitive commercial position. Similarly, for 20.6 (g) this treatment should be included in the SG.

G2.1 (and 17.1, 18.3, 19.4) Further to previous comments, *'capital they employ to enable*

the performance'. This is too close a test, capital supports the business unit in general, use on a particular contract is not considered and is unhelpful. A business unit may have many assets, considering the use of each asset and confirming that it enabled performance of a contract, would be a time-consuming activity and generate volatile and spurious rates. Capital is taken in the round at a business unit level. It would be difficult, if not impossible for the contractor to evidence each asset that would be or had been employed during performance of the contract. Guidance in 18.4 and 18.5 are pragmatic and useful and should replace the above references.

19.5 Considers the exclusion of items from the CSA, BDUK has the following comments on the specifics:

a) i) Why are intangible assets with an indefinite useful life excluded? If the MoD is benefitting from the use of the asset, then the asset should qualify for CSAs. Contractors rarely benefit from the impairment in allowable cost, and neither the CSA meaning the MoD benefits at no cost.

The treatment of indefinite life intangible assets/costs (largely goodwill and fair-values on business combinations is inconsistent between the BPR, CSAs and allowable costs, all to the disadvantage of industry:

BPR:

- Profits are stated after goodwill impairment
- CSA is computed including goodwill assets, therefore lowering what is 'left' for the BPR

Allowable Costs:

- Impairment of goodwill is only allowed with the Secretary of State's agreement (however, he has stated he never intends to allow this cost)

CSA:

- Goodwill is not allowed in the calculation.

As a result, the reference group profit is reduced for goodwill, its BPR is reduced by the CRAs of goodwill, and then contractors cannot price goodwill or get a return on the assets. This is illogical and inequitable.

a) ii) *'fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets'*. GAAP requires fair value adjustments, to values that better represent the assets being used in the business in certain situations. This updates the balance sheet to a more relevant value and may change EBIT through additional depreciation/fair value charge. Disallowing CSAs on a fair valuation means that the CSAs allowed are at a historical and out of date value. The contractor suffers an opportunity cost of the use of that asset, for example, a landlord sets his rental yield at the current value of the property, the historical purchase cost of the property is of no relevance. The input of additional capital is irrelevant, the opportunity cost of either the sale (contractor) or use (benefitting the MoD) is the relevant value.

a) vi) Exclude cash in excess of the amount required for normal operations. This is an area of repeated disagreement, and further definition would assist both parties. The definition should be extended to cash that is required to complete MoD contracts and

settle TCIF/PEPL payments and for customer advances to unwind (if not removed form liabilities).

c. 'Items generally not relevant for single source MOD contracting.' This is a new requirement and is not understood; and should be explained and agreed before inclusion in the SG. The reference should be wider to include items not relevant for defence purposes.

19.6 The draft SG states that in a cash pooling arrangement that the cash required for normal operations **may** be included as an element of capital. **May** should be changed to **must**.

19.7 States that further adjustments may be required if they can be **reliably** estimated. This test is too harsh and should be changed to **reasonably** estimated, otherwise some reasonable adjustments could be disallowed. Further, 19.7 a. permits adjustment where there is a **pervasive** change, again too harsh, it should be a **significant** change. Many changes to the balance sheet may be required, for instance revaluing inventory to MoD rates from accounting rates.

20.2 Requires *'Adequate justification should be provided to support the calculation of both fixed and working capital.'* Tests as harsh as **adequate** are causing delays in the agreement of contracts as the MoD are rejecting proposals where they consider evidence as inadequate without providing reason or possible remedy, this criterion needs changing to **reasonably adequate** and the MoD should be required to state why they consider justification is inadequate and what would be reasonable to satisfy them.

21.2 Requires the data to be **annualised**, the SG should explain the meaning of annualised.

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 2019?

Comments
BDUK with Industry with ADS would like to work with SSRO after the publication of the 2019 SSCS' to prioritise required changes. Only after the guidance is published will further change requirements be understood.

5. CGI IT UK 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

CGI welcomes the considerable clarifications proposed to the Allowable Costs guidance and, in our view, the majority of the proposed changes do make the guidance clearer.

We note in particular the changes to the sections giving guidance on "Reasonable" and the new section 3.10 which provides much clearer guidance on how the particular circumstances of a QDC might inform the determination of whether costs are "Reasonable".

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

There are many helpful revisions proposed and these will make some of the guidance a little easier to apply, however the guidance around determining whether a cost is AAR and the evidence required to support that remains very generic.

While we understand the desire to establish overarching principles and avoid a prescriptive approach, some of the guidance is still very difficult to apply.

As an example, the proposed section 3.9 requires that consideration is given to "whether a reasonable person informed of the facts, would consider the cost congruent with the performance of the contract". This remains a very subjective principle and in the event of a dispute, is unlikely to provide any helpful clarity.

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

We are concerned that the SSRO is reluctant to accept industry's proposal that AAR costs should include the general costs of doing business as well as those incurred directly or indirectly to enable the performance of the contract.

There are a number of legitimate costs necessary to maintain a healthy business which are not attributable to particular customers or contracts and these are allocated across the business in line with Corporate policies. Every customer bears their share proportionately and, in our view, it is not reasonable to expect businesses to allow one contract or customer to opt out of such costs.

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
We have no comments to make on this aspect.

e) What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2019?

Comments

We would request that the next review considers the appropriateness of applying a single Baseline Profit Rate to all companies, regardless of size, location, nature of work and normal margins in the sector. We further question the appropriateness of the selection of comparator group companies, the majority of whom are neither based in the UK nor involved in Defence activities.

With respect to our specific line of business which is in the CIS sector we do not believe that the current indices areas considered and comparator companies used are representative or reflective of the realities of the CIS market.

There are considerable differences in the margins the markets expect companies of differing types to deliver and, for some, accepting work at margins well below the market expectation would be potentially share price affecting. Where this is the case, the Authority may find that the only contractor able to deliver essential work or services cannot take the contract because the proposed margin is unacceptable under its Governance regime. It is unclear what the Authority would do in such circumstances.

6. Leonardo MW Ltd

LEONARDO

Direct Line: [redacted]
Fax: [redacted]
Box No: [redacted]

Ref: [redacted]
Date: 7th December 2018

[redacted]
Head of Strategy and Policy
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London EC4A 1AB

Dear [redacted]

SSRO's Pricing guidance review 2018: Allowable Costs, R&D and Capital Servicing Adjustment

Thank you for inviting Leonardo's input to this review, we remain at your disposal to discuss any of the matters below which are structured in line with your paper of proposed changes. Section reference numbers relate to your proposed guidance numbering unless otherwise stated.

With regard to your questions regarding publication and attribution:

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

Yes / ~~No~~ (Delete as appropriate)

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

Yes / ~~No~~ (Delete as appropriate)

Below is our response to your paper with suggested amendments in *italics.*

2 Requirements of Allowable Costs (AAR test)

2.2 *"For the purposes of pricing QDC's and QSC's the Act requires, having regard to this guidance, both parties to be satisfied that particular costs meet the requirements of Allowable Costs***.** *The burden of proof rests with the contractor. The Secretary of State, where it finds evidence does not satisfy the Allowable Costs test, may explain what further evidence, reasonable in the circumstances, they require."*

This emphasises the requirement to "satisfy" and the onus is on the contractor, but also facilitates speedy, reasoned agreement by saying the Secretary of State can be expected to advise what further evidence it seeks to meet the AAR they are applying.

3 The AAR principles

3.1 *"Costs are Allowable to the extent they are appropriate, attributable and reasonable in the circumstances. These three requirements apply to all costs of a QDC or QSC, whether estimated or actual and whether incurred directly or indirectly to the contract."*

The change included in the above proposal is to still say all costs must be AAR as they apply to a QDC or QSC by direct allocation or indirect allocation through such as an hourly rate or material uplift, but avoids the chance of someone excluding an AAR cost because they say an indirect cost has not specifically enabled the performance of the contract. Examples as discussed at 13th November review included indirect business costs being excluded as they were argued not to specifically facilitate current contracts eg. STEM costs, research etc.

3.3 A comment on this section: the MOD requirement/specification can equally affect an assessment of value for money in government expenditure. Is the specification more than needed to meet the capability requirement?

3.4 *"A cost is appropriate if by its character, it is a cost a reasonable person, informed of the facts, would consider ought to have been incurred, by a contractor, directly or indirectly, in the conduct of its business that enables the performance of the QDC or QSC."*

The intent again here is to have an informed reasonableness test capturing the costs that may be directly attributed to a contract whilst also recognising that the cost of operating a company in the defence business is also appropriate, the latter costs being charges to contract by indirect method.

3.5 We believe 3.4 covers the subject and the proposed 3.5 may be removed.

3.6 The last sentence of the proposed 3.6 could be removed and rely on the proposed 3.7d, or vice versa. But we think 3.7d probably explains the intent more clearly.

3.8 *"A cost is reasonable in the circumstances if it is of an amount that is consistent with that a reasonable person, informed of the facts, would consider ought to have been incurred by a contractor**,** directly or indirectly, in the conduct of its business that enables the performance of the QDC or QSC."*

Reason for this proposal is as explained in 3.4.

3.9 3.9a We question whether this a test of reasonableness?
3.9b We are not sure of the practicalities of this test. It sounds more an objective of the test, the objective being "reasonableness"?
3.9d It is unlikely a contractor would have evidence of other contractors costs for performing the same activities, so we think this requirement should be removed as it cannot be satisfied.

3.9e we think this will be hard to agree and question its application in post costing. Indeed, the contract pricing type (other than cost plus) will deal with this issue. We therefore recommend this paragraph is removed.

3.10 These tests seem similar to those of 3.9? We are unclear of the intent of 3.10.d. and believe 3.10.g. is not a test that suits post costing.

Research and Development

D.1 Research

D.1.2 Research, unless specifically customer funded (which is then a contract in its own right), does not have a direct link to existing or currently being priced contracts. Therefore, for some readers, the proposed paragraph could lead to all research costs being disallowed from pricing rates. We suggest this paragraph is removed.

D.1.3 *"The period's cost of research, not specifically funded by a customer, may be an allowable cost. Such indirect research costs are applied to the contract on a basis that is consistent with the contractors overarching cost accounting practices or using a methodology agreed with the Secretary of State. For research costs to be considered allowable they must be of interest to the Secretary of State, be it through: the development of specialists and technical knowledge providing a capability the Secretary of State may enjoy, specific areas of research that are of interest, or, the beneficial effect the volume of such work may have in the dilution of the contractors pricing rates the Secretary of State is charged."*

The above is suggested as an alternative to that proposed. It does not reference historic cost as the pursuit of new knowledge may have no link to past expenditure levels. A new technology may need increasing investment to realise it, the constraint in such cases being access to cash and investor views on future potential.

D.2 Development

D.2.1 We recommend removal of the word "substantially" to avoid subjective argument.

D.3 Other matters

D.3.1 *"Abortive development expenditure should be treated in the same way as any other research and development expenditure and may be an allowable cost. Costs should only be recovered once. Any costs recovered as a direct cost of any contract should not also be recovered as an indirect cost."*

The above removes the reference to faulty workmanship and the specific contract. Capitalised development will be impaired because the intended development and or its market is no longer forecast to be realised, in full, or in part. The amount impaired will not relate to a specific contract, but is a period expense. Hopefully, impairment is rare, but realising a new product and or size of market is a risk with any development. During the period of capitalisation the Secretary of State has enjoyed the dilution of pricing rates by deed of the hours incurred capitalised, at pricing rates.

E.4 Reimbursements, notional transactions and penalties

E.4.2 In support of your proposal that non-ring fenced grants and incentives/adjustments made though the tax system are not Allowable Costs.

R&D Tax Credit

The R&D tax credit is not a "grant", it is an non-ring-fenced incentive through the tax system.

Background:
In 2000 the government introduced a tax incentive scheme to encourage scientific and technological innovation within the United Kingdom. This scheme saw amendment to RDEC in 2013, fully enacted in 2016. Whilst the basis of calculation remained the same the change to RDEC included potential to treat the tax credit as an "above the line" entry in the profit and loss account. The intent of this treatment was to encourage large companies to invest more R&D by making the benefits "more visible and certain".

This desire to increase the country's investment in R&D is explained in a recent House of Commons Committee of Public Accounts report "Research and Development funding across government" (28th March 2018). The report explains Government aims to increase total UK investment in research from 1.68% in 2015 to 2.4% of GDP in 2027. It also makes clear the Government may need to address a big shortfall and that BEIS does not appear to have a clear plan for achieving the 2.4% target. Among its recommendations are;

- BEIS to develop a clear strategy for increased total UK investment to 2.4%, and
- UKRI should publish a strategy showing how decision makers will work across the new organisation and with other parts of government.

KPMG advice is RDEC does not specifically fall within either IAS 12 (tax) or IAS 20 (grants), since it is assistance given through the tax system. They advise treatment could be below or above the line depending on circumstances, but in all cases application of either standard is only by analogy. Whilst not a technical consideration, there was also a Treasury and industry desire to make visible the gross tax payable.

Your proposal rightly recognises the intentions of this incentive. Indeed, if such incentives were to be included in Allowable Costs it would not only work against the Government's aim of growing R&D but it would mean they have created a system where one part of government implements an industry incentive (R&D tax credit), in the expectation of another part of government clawing that incentive back (in part, or in whole). This would be no incentive at all and for a business significantly MOD based there would be little purpose for a contractor incurring costs and effort making RDEC claims.

Part D – Capital Servicing Adjustment

18. Calculating the capital servicing adjustment

18.5 This section should be amended to remove the term "Qualifying" as the business unit may or may not be a Qualifying business unit in the period concerned, it will depend on the volume of activity on QDC's/QSC's meeting the set threshold.

19 Calculation of capital employed

19.2 *"The capital funding adjustment provides funding for the fixed and working capital employed by the unit of business, capital employed being the sum of fixed and working capital"*

To simplify the statement and reflect that there are two funding types: one for fixed assets and one for working capital (positive and negative).

19.3 *"Capital employed may be the average over the same period used to determine the cost of production."*

Change is to recognise the regulation does not mandate an average capital employed is used.

19.4 "*The capital employed is adjusted to remove elements that are not applicable to single source procurement as detailed below"*

19.5 "*The following items should generally be excluded from capital employed:*

a. *Items not representing capital employed for single source purposes:*
    a. *Goodwill- unless the MOD was party to the business combination/goodwill generation*
    b. *Investment in shares and securities*
    c. *Loans to and from other companies, including non-trading balances with group entities, unless they represent a cash balance pooled with the group company.*
        i. *This includes finance lease creditors*
    d. *Assets held for sale and idle assets*
    e. *Asset and Liability values that relate to the "pass through" element of collaborative programmes, where the contractor is simply flowing cash to collaborator contractors.*

b. *Items that are indirect ways of raising money that should be treated as debt equivalents:*
    a. *Current and deferred tax assets or liabilities*
    b. *Declared dividends*
    c. *Retirement benefit surpluses or obligations*

c. *Adjustments made for Allowable Costs through the agreement of rates should also be reflected in capital employed (and cost of production) as relevant.*
    a. *Inventories may be adjusted from the values included in the statutory accounts to:*
        i. *Include those overheads agreed in pricing.*
        ii. *To exclude provisions if the contractor only includes costs as incurred, not as anticipated (through provision).*
        iii. *Net carrying values associated with spreading of costs, as agreed with the MOD."*

The above amends your proposed guidance to ensure symmetry between Allowable Cost and Balance Sheet treatment.

- Fair value adjustments.
    - Related to goodwill, unless involving MOD, would be excluded, as Goodwill is excluded.
    - Other fair value adjustments should not be excluded. For instance, impaired development costs (abortive) are an allowable cost and so the balance sheet movement should also be included. Any, subsequent review that reinstates the balance sheet carrying value would also be a credit in the periods Allowable Costs.
- Inventories as with current guidance:
    - To reinstate overheads as agreed in pricing rates
    - To remove provisions where they are not included as an allowable cost (i.e. costs are recognised when actual cost is incurred).

- Cash.
    - As the SSRO's proposed approach has moved to Net Assets, with customer advances no longer being recognised as a source of capital, then equally **ALL** cash, whether held locally or under group pooling, should be included as an asset.

An alternative for customer advances and cash would be to return to the original wording in 20.5.f. In such a case the following would be included in the proposal:

"19.5.a.f. Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract the advance payment(s) received is treated as a source of capital and is not deducted from assets.

19.5.a.g Cash held in excess of normal operating requirements, be that cash held by the unit in a discrete bank account or through group treasury "pooling" arrangements."

Agreement on guidance as to what is viewed as "normal operating requirements" would also be helpful (current payroll, supplier payments, due, etc. depending on the definitions you may include for 19.5.a.f).

Cost of Production

21.3 "Cost of production should be constructed recognising the Allowable Cost guidance and that for capital employed"

21.4 "The following items should generally be excluded from the definition of Operating revenue less Operating profit/loss:

a. the cost of raising and servicing capital
b. cost of production relating to the "pass through" element of collaborative programmes, where the contractor is simply flowing cash to collaborator contractors.
c. costs related to items excluded from capital employed"

21.5 "The following items should generally be included in the definition of Operating revenue less Operating profit/loss:

a. Values associated with spreading of costs, as agreed with the MOD."

SSRO welcomes views on the proposed timetable

We agree with the timetable

Do the Proposed revisions make the guidance more or less clear?

Generally, improvements have been made over the last year or so.
However, in the case of your proposed changes to CSA we are troubled by what might be the unintended consequences of "simplification" and would suggest this is rethought. If there is not enough time to reconsider proposals we would recommend guidance remains as current other than the constructive clarification regarding cash which should include that in "group pooling" arrangements.

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

Yes in relation to the current CSA proposals. If CSA is resolved, no.

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

CSA as per your current proposal is a material issue.
Also making sure a reader of the guidance appreciates that the cost of operating a defence business meets AAR even if it is not a specific task that delivers a contract (in such a case the cost would be a direct cost)

What, if any, aspects of the SSRO pricing guidance should the SSRO prioritise for review in 2019?

It will somewhat depend on the output of this review and conclusions regarding Cost Risk Adjustment.

We hope these proposals provide helpful to your review and welcome the opportunity to discuss them further.

Yours sincerely

[redacted]
VP Finance

cc: [redacted]

7. Lockheed Martin UK

SSRO Consultation on Pricing Guidance Review 2018

Lockheed Martin UK is pleased to be able to contribute to the ongoing consultation process applicable to the Pricing Guidance (2018) review and in particular the document issued in October 2018 under cover of SSRO letter dated 15th October 2018.

General comments

While we note some attempts to broaden the application of beneficial allocation of cost indirectly incurred to a contract the guidance still predominantly focuses on a direct correlation between a cost and a contract before it can be considered 'Appropriate, Attributable and Reasonable'. As part of our review LMUK believes that there should be more allowance made for costs which are reasonably incurred in the operation of the business or which enable the performance of a contract, but which cannot be directly tied to a contract; typically utilising a company's standard accounting standards as the basis for the assessment. Whilst MOD often allows these costs to be treated as general business expenses and included in the cost base, they would fail a strict application of the test as currently prescribed in guidance. Examples of these costs are: redundancy and restructuring costs, preventative maintenance on buildings, apprentice training, patent costs, training indirect staff, research, etc.

Part of the consideration should be the sustainability of a defence contractor and its capability. To meet the demanding quality requirements, state of the art technology and future developments a defence contractor will incur costs associated with maintain ISO standards, security requirements, research and maintaining suitably qualified and experience personnel (SQEP). These are generally indirect costs and usually get apportioned across the business to recover fairly. In this context they are an enabler cost and maintain the credibility and relevance of the business in the Defence domain. Therefore, they should be considered as appropriate and reasonable, with the apportionment being deemed attributable. The guidance does not go far enough to embrace this principle in many areas, as defined in our specific comments below.

The inclusion of themes relating to Public scrutiny, informed person and independent 3rd party which continues to appear in several places (despite previous requests to remove it on the grounds that it is not a requirement of either the Act or Regulations) introduces a factor of proof or clarity that is not required for the standards that the contractor must reach to satisfy the requirement. The introduction of numerous qualifying 3rd Parties detracts from the purpose of agreeing the costs. Where these have been referenced in the new wording comments have been provided to explain why they would be inappropriate.

In addition, it is important to note that only a Government Department is subject to Public Scrutiny and has always had to "write-up" justifications for reaching agreement on a contract price to accommodate such scrutiny. Contractors are not subject to the same level of scrutiny, even when called to give evidence at either the Public Accounts Committee or the National Audit Office (where they are called as witnesses). This subtle difference seems to have been mixed up with the shift in the onus of proof now required, where the Contract has the onus of proof rather than the Government Department. The two levels of responsibility are mutually exclusive; while the contract must provide sufficient evidence to justify its cost, this is not the same as the Department being subject to public scrutiny. The concept of such scrutiny, or exposure to 3rd party assessment should be removed from the guidance as it has no relationship to the legislation.

There is a distinct difference between 'Research' and 'Development' which does not appear to have been properly clarified in the guidance. Research would be undertaken to maintain credibility of the SQEP and for future sustainment of the business, while Development is likely to be directly related to a product or contract requirement. In the case of research, the wording chosen in the guidance would make the cost of research in most cases unallowable, yet it is a genuine cost of doing business and an enabler to maintaining the necessary skills and know how that relates to contact performance and sustainment of the business.

In the section considering Research and Development (R&D), a number of clarifications are necessary. By its very nature R and D in most cases represent investment decisions by a contractor, even if such investments are recovered through indirect charging in the overhead. As the requirement to supply a SICR report on an annual basis is fundamental to the Regulations, there could be some level of reference to the SICR in relations to the declared long-term investment plans (i.e. if investment plans are in the SICR report and has not been challenged at a strategic level then the apportionment of those costs should automatically be considered allowable (unless they are related solely to non-defence markets)). Otherwise the guidance does not connect up with the other related elements of the regulations.

Pricing Guidance

Para 2.2 and 2.4 – In the proposed guidance column, third line, reference to "parties" should be defined. It may not always be the case that "parties" refer to the contracting parties in the case of a QSC for instance where the parties are S of S Defence and the QSC.

Para 2.2 – The words "must be able to verify" are used in both existing and proposed language – legislation says that there is only a need to "show" compliance with AAR. Verification adds another layer of proof that is not clearly determined. It would be better if the guidance included better clarity over what happens when MoD are not satisfied. For instance, experience has shown that in a number of cases a contractor will face the "bring me another rock" syndrome, often to unreasonable degrees, to avoid making an decision based on what would normally be, in the commercial world, acceptable levels of proof. It would be helpful if the guidance was able to balance the onus of proof with the onus of setting out satisfactory evidence around either why the AAR test has not been met and/or what would be considered satisfactory.

Para 2.4 – this is linked to the comment at para 2.2. If it is for MoD to be satisfied then there should be some obligation on MoD to indicate at the outset, or during the process of agreement, what is required to be satisfied when the information provided by the contractor is considered to insufficient. If this is not possible then the contractor should not be at a disadvantage by trying to meet an open-ended requirement. There should be some consideration included in the assessment guidance for accepting the cost of doing business. The use of the word proportionate is helpful in this context, but the proportionality is not linked to the value of the contract. Perhaps this could be more explicit, with the addition of a pragmatic approach as well.

Para 3.1 – under "Purpose of Change" column, at bullet 2, reference to allowable costs being "those which enable the performance of the contract" which is helpful, but could be expanded to include reference to "…performance of the contract, which is incurred as a result of normal business activity". For instance, the cost of doing business, the costs associated with future sustainability and those costs which enable the continue operation of the business are all relevant costs even if not directly linked to the contract itself other than being enablers to performance. A contractor that recovers only those costs directly identifiable to a contract and nothing else associated with the

business as a whole will soon be unable to perform if it loses key skills, future business, ongoing research and development as well as administrative burdens for just being a legal entity. Those costs are usually apportioned over the business as a whole. It would be better if the purpose of the change recognised and reflected costs as allowable where they enable the contractor to operate and sustain its business and perform the contract.

Para 3.2 & 3.3 – the revised text relies on "public scrutiny" as a test. It should be for MoD and the Contractor to determine and agreed what is an appropriate cost given the circumstances relevant at the time of the agreement and the context within which the agreement was made. If "public scrutiny" is to remain it needs to be qualified to the extent that such scrutiny would be applied to a Government Department. For instance, public scrutiny would naturally include a Government agency acting in the public interest (i.e. the NAO) or a Parliamentary body (such as the Public Accounts Committee) who was acting from a political context. It is not for a contractor to address the needs to satisfy such scrutiny, but rather it is for the MoD to provide sufficient justification for the conclusion of an agreement that would then be used by the public scrutiny process. This should not detract from the usual process of reaching agreement because this same responsibility existed before SSCR. However, the shift of onus of proof may have set a mindset that assumed relief from this public scrutiny responsibility where the guidance places the contractor in the position of a Government Department in this respect. For instance, a Government Department would have access to far more reference material to satisfy public scrutiny that was available to a contractor. Further, under the process of public scrutiny a contractor would be called to give evidence as a witness.

Para 3.3 – the link in the proposed guidance to allowable costs supporting contract price that delivers good value for money is not a valid consideration. The guidance is mixing costs, which may well be reasonable against the scope and specifications, with a price, which may not be judged value for money where the scope and specifications were too ambitious. It is recognised that the principle of value for money in Government expenditure and a fair and reasonable price for the contractor is the right balance, but it should not confuse how the value for money should be measured. In addition, there needs to be more dialogue around how "fair and reasonable in the course of normal business" is defined. Would that be by comparison to the comparator group, although they may not be representative of the cost structure applicable to a regulated defence contract, or by reference to the contractor's standard accounting standards.

Para 3.3, page 4 – reference to "contract price that delivers good value for money" is not an appropriate term. Value for money is the assessment of the scope/requirements rather than the price itself. For instance, a contract price may reflect a number of necessary activities but that provide no value add (such as reporting functions, addressing administrative requirements or applying specific terms of the contract to the outcome of the programme. These may be considered counter to value for money, but they are necessary according to the framework within the contract. It is better to say that "the contract price provides a fair and reasonable return to the contractor while providing the required capability". Value for money has more than one moving part so should not be subject to a single item.

Para 3.3 (b), page 5 – rather than "costs being suitable for the purposed of the QDC/QSC" a more appropriate reference would be whether a cost is of a type that is consistent with generally accepted accounting principles, is part of the contractor's normal cost of doing business and generally considered to be consistent with standards of propriety of British business. There should also be a reference to an assessment of the resilience of a legal entity when considering the suitability of costs. This relates again to the general cost of doing business.

Para 3.4 & 3.8 – The term “informed person” or “reasonable person” is used as a “benchmark” for consideration of appropriate costs. Given the complexity of many Defence programmes reference to an “informed expert” would be a better reference than an “informed person” or “a reasonable person” (which has no recognised standard) who would likely react in a subjective way with little or no correlation to the context in which the measurement was being made.

Para 3.4 – reference is made to “public scrutiny” again. We refer you to our early statement about public scrutiny and re-emphasised that public scrutiny is an internal matter for MoD in regards to how it “writes-up” its justification for reaching agreement.

Para 3.4 – the current wording would benefit from a small addition to avoid the potential to interpret the guidance as referencing only direct cost. LMUK suggests something along the following lines: “A cost, normally incurred to enable the business, is appropriate if, by its character, it is a direct or indirect cost that an informed expert would consider…”

Para 3.5 (a), page 5 – reference to “a reasonable person, informed of the facts” detracts from the basis of agreement of the contract. The agreement is between the contracting parties without interference from 3rd parties. The use of informed persons, reasonable person, public scrutiny and independent 3rd party, which remains undefined by a recognised standard, undermines the integrity of the agreement once struck. This does not have any link to the legislation and is unhelpful in providing clearer guidance, see early comments on this theme where we have offered alternative references.

Para 3.6 – Assessment of indirect cost should not be done on a contract by contract basis. By their nature an indirect cost would typically be those costs which enable to business perform and maintain its capability. Normal accounting practice, and a fair and reasonable approach to charging for it, is to apportion those costs across the business. The assessment should be against the normal accounting practice of the business and reference to its QMAC or equivalent agreed disclosure statement.

Para 3.6 and 3.9 (a) – Attributable costs should not only be related directly to the contract. A contract is performed because the contractor has a “wrapper” that allows it to accept defence contracts, guarantee specific standards of quality and maintains suitably qualified and experienced personnel (SQEP) that can meet the exacting requirements of defence contracts. Therefore, attributable costs need to include those costs that enable the contractor to operate its business and to meet the Industry standards appropriate to the quality of outputs and performance expected of a QDC/QSC. We would suggest that costs are reasonable if they enable the operation of the contractor’s business and performance of the contract. See also above comment against 3.6 and reference to QMAC or equivalent disclosure statement.

Para 3.7 (b) – Assessing only costs that have a causal relationship with the performance of the contract will not cover general business overheads. It would be more appropriate to remove this sub paragraph from the guidance.

Para 3.9 © – while the reference to “empirical evidence” is qualified by being “reasonably expected to be available” it is not clear how the person following the guidance would handle costs where there is no evidence because it has not been done before, or where the assessment of whether something is available becomes a subjective issue. The underlying principle should be that “costs are assessed against the balance of strong possibilities where evidence is not available” and to acknowledge that in some cases evidence may not be available.

Para 3.9 (d) – the statement against this paragraph should be deleted. It is better to rely on the QMAC or equivalent disclosure statement given that the legislation permits the use of the contractor's standard accounting structure. Using the criteria as defined in the sub paragraph is ambiguous because it is not clear how the parties would use parametric assessment or ignoring how a contract has its own unique cost profile based on the specific requirements of the contract, risk profile, how it would be performed within a contractor's own business and the processes adopted by individual contractors ("the secret sauce"). Besides which the contractor would not have access to costs of performance of similar contracts if this relates to general benchmarking and as the onus of proof is on the contractor it would be unreasonable to place this obligation of proof on to the contractor. Such details would not be in the public domain. Further, if the contract was indeed sole source then there would be no direct comparison otherwise the contract could be competed.

Para 3.9 (e) – It is not clear how a contractor would prove this requirement nor how it would be judged and so should be deleted. This should be a mechanic of the contract type; so for fixed and firm priced contracts the contractor is incentivised to be efficient and economic. Whereas if it was a cost reimbursable contract the contractor would be largely subject to direction of the Authority in setting priorities of work and risk ownership. Besides which if the outturn of the contract resulted in 100% of the estimated costs would this then imply that the contractor had not executed it in an economic or efficient manner.

3.10 (d) – This can only relate to the cost assessment and adjustment stage of the contract at the end of the performance. This should be made clear in the guidance otherwise it would be unreasonable to make this assessment for future events.

Para D.1.2 – The term "directly or indirectly enables the performance of the contract" helps to include the cost of doing business, however, it probably does not go far enough to recognise the broader aspects of the "cost of doing business" when it relates to Research and Development (R&D). To clarify and avoid ambiguity in the guidance R&D generates new knowledge and therefore, contributes to the future sustainability of the contractor. This should be an important consideration in the guidance to determine allowability. Research costs, as distinct from development, by their definition are general in nature but serve to maintain the necessary skills and experience of the business. Therefore, while they are not incurred for the fulfilment of the QDC/QSC, unless the objective of the contract is to undertake research, they are an essential cost of doing business that should be an allowable cost.

Para D.1.3 – several general observations apply to this section of the guidance. Research is a period expense for the development of the contractor's capability into the future and should be treated as such through the normal accounting standards applied by the contractor.

Para D.1.3 (b) – the term "consideration of the specific circumstances of the contract being delivered" would negate all indirect research making it unallowable. There should be an allowance for the sustainment of a business and the benefit of maintaining skills, experience and expertise. It is not clear how this sub paragraph differs from Para D.1.3 (c). Do we need it if it is covered by (c). Also, if (b) is to stay then this could be where the SICR report comes into play. Otherwise the assumption is that the Authority at the programme level knows what the wider department wants for the longer term which is not the case at that level. Therefore, genuine allowable costs, when assessed against the broader picture could end up being disallowed on the grounds of parochial interest.

Para 19.5 (c) & 21.3 (c) – the statement " items generally not relevant for single source MoD contracting" is not understood. This needs further qualification, context or it should be deleted as it does not make sense.

Capital Servicing Adjustment

Para 19.5 (a) (i) – it is not clear why intangible assets with an indefinite useful life should be excluded? If the MoD is receiving benefit from the use of the asset, then the asset should qualify for CSA. Contractors rarely benefit from the impairment in allowable cost – the MoD benefits at no cost.

Para 19.5 (a) (ii) – this is at odds with GAAP which requires fair value adjustments to values that better represent the assets being used in the business in certain situations. For instance, the balance sheet would be updated to a more relevant value and may change EBIT through additional depreciation/fair value charge. Disallowing CSAs on a fair valuation means that the CSAs allowed are at a historical and out of date value. The input of additional capital is no relevant, what is more relevant is the opportunity of either a sale (by the contractor) or use (by MoD).

Para 19.5 (a) (vi) – It is not clear how you would evaluate cash that was in excess of the amount required for normal operations. There will always be enterprise risks that need to be accommodated, liabilities that have no limitation (typical for an MoD contract) and the need to hold cash to settle TCIF/PEPL payments.

Para 19.5 (c) – This is noted as a new requirement which is not understood. This should be the subject of proper consultation as it is not clear that we have had the opportunity to comment on this new requirement to date.

Para 19.7 (a) – rather than pervasive changes we believe that it should be linked to a material change. Otherwise this could include regular changes needed to the balance sheet for revaluing inventory.

Para 20.2 - The reference to "adequate justification" is too vague to be objective – in a similar way to that mentioned above under Pricing Guidance. Where MoD rejects proposals where they consider evidence is inadequate without providing reason or possible alternative justification is a cause of unnecessary delay. Either this should be changed to reasonably adequate and available or MoD should be required under the guidance to state why they consider justification is inadequate and further clarify what the remedy should be.

Para 20.5 (f) – The disallowing of excess cash and the treatment of contract liability being deducted appears to penalise the contractor unfairly as it has a double impact.

Para 21.2 – What does "Annualised" mean in this context. Company financial year, calendar year, Government financial year, contract financial year?

Consultation Questions

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?

   While effort has been made to simplify the guidance, for which we are grateful, there is still a number of significant issues that remain to be addressed and covered herein.

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

While the guidance has been made clearer, the application of it is still complex. As addressed herein addressing the issue of the cost of doing business within the Attributable category would go a long way to a logical application.

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?

General cost of doing business goes beyond the current Attributable category which is limited only to costs that enable the performance of the contract. While this may cover most costs, there is a direct link defined within the revised guidance making a causal relationship between cost and the contract. Some costs that are fair and reasonable to permit cannot meet this test. The guidance should consider how costs for items such as research, selling and marketing and redundancy could be accommodated (all potentially allowable within the guidance), but none of these costs would necessarily enable a contract while they would sustain the business for the longer term and increase its resilience to fulfil the contract overall.

General business overheads that may not directly enable the contract, but are incurred in the normal course of business should be permitted (as they are under FAR/DFAR contracts let by the US DoD). Again, this has as much to do with the resilience of the business which enables it to undertake contracts and so should be included in the logic around what would be Attributable.

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

We have no concerns

e) What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2019?

We believe that ADS are suggesting that Industry work with you during 2019 to prioritise the changes required. We defer to that engagement.

8. MBDA UK

MBDA UK Response to SSRO 'Pricing Guidance Review 2018 Consultation on Changes for 2019/20 – October 2018

MBDA UK welcomes the consultation on the above paper and the pre-consultation engagement; we found it helpful to be able to participate in discussion prior to written inputs.

The SSRO consultation asks the following questions, against which we have structured our response.

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

On balance the Single Source Cost Standards (SSCSs) have improved in each year: the guidance has become progressively clearer, however some significant issues remain to be addressed which are highlighted in this response.

The principle of general business overhead needs to be included in the guidance on "Attributable", which would make other specific classes of cost clearer and more logical to treat.

Proposed Guidance (PG) 2.2 *'requires **both parties** to be satisfied that particular costs meet the requirements of Allowable Costs'*. It is unclear in the case of a QSC who the relevant parties are; the Statutory Guidance (SG) should state that in this case it would be the Secretary of State (SoS) and the sub-contractor.

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

No significant change in the ease of application has been identified. As above, addressing Attribution and the issue of general business overheads would make the SG easier to apply (and logical to apply/challenge if required).

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

General Business Overheads & Attributable
The principle of Attributable as defined in the SG requires that costs *'enable the performance of the contract'* and is pervasive within the SG (3.1, 3.5, 3.6, 3.7b, 3.8, 3.9a for example). For many types of cost this is adequate, however this causal relationship between cost and a contract is too strict a requirement for the recovery of overhead costs.

Some costs that it is fair and reasonable to permit, cannot meet this test. The SSRO should consider how costs for items such as research, selling and marketing, and redundancy meet this test (all specifically addressed in the SG as potentially allowable). None of these costs can enable a contract (unless it is a contract to undertake research). Research ensures that the business is viable, competitive in the future and in a position to present innovative requirement solutions to the MoD; the argument that the SG sets out in D1.3 is tenuous at best, and unnecessary if general business overheads are allowable. Similarly selling and marketing costs lower the cost base to MoD contracts through spreading overhead, it does not enable performance; redundancy keeps the cost base competitive, it does not enable performance.

An additional criterion of Attributable is required (e.g. as allowed by the US DoD) for general business overhead or overheads incurred in the normal course of business **without** the qualification of **enabling**. General business overhead would still be required to meet the criterion of Appropriate, therefore only relevant overheads would be permitted. Adding this criterion would simplify the logic throughout the SG.

Public Scrutiny/Regularity/Parliament

We do not support the criterion of "public scrutiny" [3.4, 3.8]. This criterion is a construct outside of the original legislation in determining allowable costs. It is subjective and there can be no reliable evidence on which to assess the criterion. If a cost meets all other criteria, then this criterion should not cause the cost to be inappropriate. If the SSCSs have established reasonable cost criteria, on which a contract price is based, then it is for MoD to defend that price against the requirement that MoD established for the contract. Public scrutiny, just as Value for Money, is an output-based matter addressing price rather than cost, which are matters for MoD to justify in any public scrutiny, whether Parliamentary or otherwise.

Equally, references that attempt to interpret "public scrutiny" by relating the criterion to "a reasonable person, informed of the facts" are ill-founded [3.4, 3.5.a, 3.8, 3.9]. MoD contracts are rarely dealing with consumer goods and services to which a reasonable person can relate. Only an expert having skills comparable to the supplier and awareness of the requirement, the resources available and the economic environment could have a fair-minded view of a cost. However, even expert witnesses in court proceedings can take a contrary view on the same information.

MoD introduced a concept of public scrutiny, but only as a post-pricing challenge, when it introduced price labelling of spares from July 1987 until April 2003. This enabled store and service personnel to observe the price of spares shown on the packaging and to raise a challenge if they felt that the price was not value for money. This exercise produced no significant challenges or benefit to any party, and was discontinued.

References to standards of "regularity" and "prudence" expected by Parliament and MoD create uncertainty [3.5.b, 3.9.b]. It is for the SSRO to define what those standards are in the SSCSs rather than refer to external sources that are subject to political whim and for which no objective evidence can be evinced. Concepts of "regularity" and "prudence" are not relevant where significant uncertainty and risk arises from the contract programme.

Value For Money

We do not support the criterion of "Value for Money" [3.3] in determining the allowability of an individual cost element. This is not a relevant judgement in this context, nor should it apply in a retrospective manner to costs if the resultant price is considered not to be value for money. Value for Money should be assessed on the whole price that MoD pays for the requirement it established in the contract, not on elements of cost. If the SSCSs have established reasonable cost criteria on which a contract price was based, then it is for MoD to defend that price against the requirement that it established for the contract. There have been occasions when MoD has over-specified the requirement for a contract which can lead to a price not being value for money – but that does not detract from the allowability of costs; it relates to the specified requirement.

Other Issues

Verification (2.2)

PG 2.2 states that *'the Secretary of State and the contractor must be able **to verify**, to their satisfaction'* that costs are AAR and this has caused uncertainty and contention. The legislation refers to the parties being satisfied, there is no requirement to "verify", only to "show" compliance with the AAR test by reference to the statutory guidance or otherwise. For the statutory guidance to imply an addition criterion of verification places an unnecessary additional burden on both MoD and the contractor. The last sentence should be deleted. Further, the reference in that column to Regulation 20 and verifying is incorrect; it is section 23 of the DRA that requires these records. There is no requirement for the parties to verify costs, only for the contractor to keep sufficient records to enable the verification of costs and for the MoD to be entitled to examine the records.

It would be helpful for the SG to develop criteria of when evidence is not sufficient, and what evidence should be available.

Quality of evidence (2.4)
The guidance has been improved by the addition of *'a proportionate approach'* to evidence, however this does not go far enough. During the pre-consultation discussions we heard from a number of organisations that areas of MoD have, at times, rejected evidence as inadequate without explaining why it is inadequate, or what would form adequate evidence. We are aware that there may be a suggestion of adding the word *'pragmatic'* before *'proportionate'* and placing an expectation for the MoD, when rejecting evidence as inadequate, to state what evidence it requires to be satisfied, which appears to us to be a suitable addition.

Reasonable (3.9)

PG 3.9d introduces comparison in costs with *'by third parties in similar circumstances*.' Contractors will rarely, if ever, have information about other contractors' costs, this requirement should be deleted.

PG 3.9e extends the reach of the guidance into improving business performance. This paragraph should be deleted and dealt with in the contract by KPIs or via step 5 of the profit make up.

Reasonable (3.10d)
This SG applies to both estimated and actual costs and the relevance of *'events which were not anticipated at the time of agreement'* is unclear. Defence contracts are often intended to undertake novel activities with new technology, in an uncertain political and technological environment. Many cost outcomes may not have been 'anticipated', however, that should not affect their reasonableness. This sub-para should be deleted.

Research and development
This section of the SG has been improved but still requires further changes. Industry and the MoD appear to agree over the treatment. In summary this position is:

Research and Development are separate issues and should be addressed individually. Research not undertaken against specific contracts should be allowable (general business overhead not D1.3's argument), through the rates as a period expense. Development should be allowable, and its treatment (through the rates as a period expense **or** recovered against specific outputs), agreed with the MoD.

The contractor's accounting for Development (there is often a choice of capitalisation/amortisation or period expense) is irrelevant for recovery under MoD contracts. A contractor's decision may not be the best match of cost, hence the discussion and agreement with the MoD is vital.

D1.1 Is attempting to define GAAP, this is not required.

D1.2. Research (in year) cannot enable a contract being priced; its use and success is uncertain (see previous comments). This requires deletion.

D1.3 This logic is tortuous and not required if general business overheads are allowed as Attributable. The tests a-d may not be appropriate and with this change are no longer required:

a. *'Consistent with historical levels.'* This has no relevance.
b. Research, to be appropriate, should be agreed to have relevance for defence. It has no relevance to *'the contract being delivered'*.

D2.1 Is attempting to define GAAP, this is not required.

D2.3 As stated, the accounting treatment of development expenditure is irrelevant and may give inappropriate results for either the MoD or the contractor. It is our understanding that MoD agrees with industry that the decision the contractor makes to account for development

is irrelevant, the specific development project's treatment in costing and pricing MoD contracts requires agreement between the parties.

D1.5 Abortive research has no meaning, and research is always a period expense, the reference to research can therefore be deleted.

D1.6 Treatment of R&D tax credits, this is a welcome change that effects government policy of rewarding companies that undertake qualifying research. Further, it resolves the issue that pricing of contracts including R&D tax credits is unrealistically complex, as the qualification criteria often change each year (and could be curtailed by any budget).

Penalties
E4.4 Civil Penalties. These costs are always inappropriate and does not require the elaboration past the first sentence.

Capital Servicing Adjustment
The redefinition of FCSA and WSCA seek to simplify the calculation to that presented in the 2018-19 SSRO Guidance on the baseline profit rate and its adjustment. This is welcomed, however, certain specifics have been deleted and a line by line review of the adjustments in section 20 of the quoted document is required. For example:

a. 20.5 (f) *'Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as a source of capital and is not deducted from assets.'* To not treat in this manner penalises the contractor potentially twice (excess cash – disallowed, contract liability – deducted from assets), this may place him in a counter intuitive commercial position.

G2.1 (and 17.1, 18.3, 19.4) Further to previous comments, *'capital they employ to enable the performance'*. This is too close a test, capital supports the business unit in general, use on a particular contract is not considered and is unhelpful. A business unit may have many assets, considering the use of each asset and confirming that it enabled performance of a contract, would be a time-consuming activity and generate volatile and spurious rates. Capital is taken in the round at a business unit level. It would be difficult, if not impossible for the contractor to evidence each asset that would be or had been employed during performance of the contract. Guidance in 18.4 and 18.5 are pragmatic and useful and should replace the above references.

19.5 Considers the exclusion of items from the CSA, and we have the following comments on the specifics:

a) i) Why are intangible assets with an indefinite useful life excluded? If the MoD is benefitting from the use of the asset, then the asset should qualify for CSAs. Contractors rarely benefit from the impairment in allowable cost, and neither the CSA. The MoD benefits at no cost.

a) ii) *'fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets'*. GAAP requires fair value adjustments, to values that better represent the assets being used in the business in certain situations. This updates the balance sheet to a more relevant value and may change EBIT through additional depreciation/fair value charge. Disallowing CSAs on a fair valuation means that the CSAs allowed are at a historical and out of date value. The input of additional capital is irrelevant, the opportunity cost of either the sale (contractor) or use (benefitting the MoD) is the relevant value.

a) vi) Exclude cash in excess of the amount required for normal operations. This is an area of repeated disagreement, and further definition would assist both parties. The

definition should be extended to cash that is required to complete MoD contracts and settle TCIF/PEPL payments.

c. 'Items generally not relevant for single source MOD contracting.' This is a new requirement and is not understood. This requirement should be explained and agreed before inclusion in the SG.

19.6 The draft SG states that in a cash pooling arrangement that the cash required for normal operations **may** be included as an element of capital. **May** should be changed to **must**.

19.7 States that further adjustments may be required if they can be **reliably** estimated. This test is too harsh and should be changed to **reasonably** estimated, otherwise some reasonable adjustments could be disallowed. Further, 19.7 a. permits adjustment where there is a **pervasive** change, again too harsh, it should be a **material** change.

20.2 Requires *'Adequate justification should be provided to support the calculation of both fixed and working capital.'* Tests as harsh as **adequate** can cause delays in the agreement of contracts as the MoD are rejecting proposals where they consider evidence as inadequate without providing reason or possible remedy, this criterion needs changing to **reasonably adequate** and the MoD should be required to state why they consider justification is inadequate and what would be reasonable to satisfy them.

21.2 Requires the data to be **annualised**, the SG should explain the meaning of annualised.

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

No

What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2019?

As in previous, we would welcome any opportunity to work with the SSRO after the publication of the 2019 SSCSs to prioritise changes required. Only after this guidance is published will future change requirements be understood.

9. Metasums

Overall comments

Introduction

The SSRO's draft is in many areas a marked improvement of the existing statutory guidance but I believe that there remain significant corrections that need to be made to the draft guidance and material issues that need to be addressed. I have spent a great number of hours writing this paper and would welcome further engagement to explain why I believe the changes I suggest are necessary to improve for (a) defence contractors, the delivery of fair and reasonable prices, and a level playing field, and (b) the Secretary of State a better framework under which it achieves VfM.

I generally work with contractors that are smaller, and/or, have limited background in pricing single source contracts for MoD by reference to cost, and/or are based overseas, and/or are sub-contractors. SSRO will appreciate that MoD is applying, and requires contractors to warrant, that statutory guidance issued by SSRO is also used on single source contracts and sub-contracts that are outside of the scope of the legal framework because of value and/or exclusion.

I found the SSRO's paper on stakeholder responses helpful. There are areas where I believe that SSRO should reconsider or include such considerations within statutory guidance (the SSRO's paper does not constitute statutory guidance and it is unclear if content has any bearing on subsequent reading of the published statutory guidance. If I am correct in believing that the utility of the content of this document expires as soon as the statutory guidance is updated, then I believe that some content should be carried through to be included within the statutory guidance. If I'm incorrect then SSRO's opine needs to be updated and included within the published statutory guidance.

My response is in two parts:

Part 1 Limited comments on SSRO's *Response and proposed change* sections included within the accompanying document

Part 2 My contribution to the SSRO's draft changes to statutory guidance on allowable cost

My comments in Part 2 are made on a stand-alone basis i.e. as if the draft statutory guidance was to be read without inclusion of the greater depth from SSRO's comments on pre-consultation inputs.

The 25th October 2017 NAO report on 'Improving value for money in non-competitive procurement of defence equipment'

This report talked to the acute shortage of Commercial Officers and CAAS accountants within DE&S. Commercial officers are increasingly required to undertake activities that require accounting skills, experience and judgement.

The quality of SSRO guidance needs to reflect the increasing usage and interpretation by MoD's commercial officers acting without appropriate accounting expertise.

Of notable concern within the NAO report I draw the following to SSRO's attention

386 unfilled commercial posts (24% of total)

5.12 Specialist staff, traditionally within the Cost Analysis and Assurance Service (CAAS), provide crucial expert technical advice on costs and prices submitted by the supplier to project teams within DE&S, and determine whether costs are allowable under the Regulations. Lord Currie's review in 2011 identified that CAAS staff

numbers had nearly halved in the previous decade. Around 77 staff will carry out price investigations on non-competitive procurements in 2017-18. In addition a core group of five specialists provide expert advice on the Regulations. Project teams told us that they are very reliant on the support of these staff. Direct support from CAAS is only available as a matter of course on the relatively small proportion of contracts worth more than £50 million, since these account for a large proportion of total contract values. Support for other contracts (with a total value of £6.5 billion) is dependent on CAAS having available capacity when requested by project teams. <u>One of the objectives of the additional training being delivered to commercial staff is for them to be able to carry out some costing analysis in their own right.</u>

Change in the role of CAAS accounting resource

The change places greater reliance on MoD's commercial officers understanding of industry and accounting. SSRO's statutory guidance on allowable costs needs to be of a quality that supports the change in responsibilities within DE&S

Divergent Financial Accounting Standards

In order to achieve establishment and subsequent maintenance of a level playing field is established for allowable costs between contractors the SSRO must align allowable costs to a single set of accounting standards that underpin the guidance.

To this end I commend EU adopted IFRS as that framework.

By way of example, I give 2 examples:

The allowable costs of Defined Benefit Pension costs significantly differ between IFRS, and FRS 102 to the significant advantage of:

- those PLC groups that use FRS 102 for its associated undertakings but adopt IFRS for the group accounts
- Companies that are not listed or associated undertaking of listed companies that adopt FRS 102

and significant disadvantage of those companies that use IFRS

The assessment of allowable costs for QBUs that are not legal entities needs to have a clear and consistent accounting framework under which costs can be assessed as allowable on a consistent basis. Alignment to IFRS would provide such a consistent framework whereby some key aspects of the quantification of cost and thereby allowability can be treated consistently between contractors.

Part 1

Requirements of Allowable Costs (the AAR test)

General comments

3.11 See my comments included within introduction above. SSRO should make clear the final sentence within the published statutory guidance.

Applying the guidance

3.17 I agree

3.18 a. For the benefit of doubt and improvement in consistency of application I believe that there is benefit in including words to this effect within the statutory guidance. It should not need to be said but I fear, for some, it has to be said.

3.18 b. and c. I agree.

3.20 Whilst I agree it is also the case that this issue often sits within the gap between SSRO's obligations to provide a framework that simultaneously delivers VfM for government and a fair and reasonable price to contractors. SSRO should include within comments in discussion in its obligations to the Secretary of State to deliver VfM. VfM is not part of statutory guidance on allowable costs but can, in the minds of MoD, be seen to be. See paragraph 3.3 of your draft where you talk to 'good value for money'.

Evidential standards

No comments

Value for money and fair and reasonable prices

3.33 See comments made under 3.20 above

Public scrutiny

No comments

Costs not allowable

3.48 I've discussed at length in Part 2. I am concerned to ensure that SSRO understands my reading of the guidance, it will be the version that I train, and I'm happy to engage further as necessary.

3.52 I agree.

Other changes

3.58 I agree, though I suspect that the SSRO misses this point in its draft update for E.4.2

Research and Development

4.4 The issue of differing accounting standards is, I believe a significant issue for assessing allowable costs of defined benefit pension plans.

4.6 The issue of capitalising or not capitalising should not be an issue. The issue is only exposed if the timing of costs being taken to the income statement are at the heart of the consideration. There is no other cost type nor evaluated activity where allowability of costs is assessed on the value falling to the income statement. All other costs, including depreciation, are assessed on the basis of 'cost of production' and not 'cost of sales'. Cost of sales is a feature of the requirement that the income statement is based upon matching the timing of revenues with the recognition of costs incurred in the same. To this end private venture research and development should be recognised on a cost of production basis and not a cost of sales basis. Another reason that this is necessary and appropriate is that the cost recovery rates used to evaluate private venture research/development are established on a cost of production basis. Inventory is held in the balance sheet on the same basis and one would never propose that (1) rate numerators could or should should be developed on the volumes credited to inventory and debited to the income statement, or (2) that rate denominators could or should be similarly evaluated. The intangible asset accounting standards on internally generated intangible assets does not restrict capitalisation to private venture expenditure but rather tests if the entity has control over the asset (intellectual property) developed. I believe SSRO needs to rethink use of amortisation of development assets as an allowable cost. See also IAS 39.44

4.9 I hope I have given in Part 2 sufficient evidence that lack of 'necessary for the business at large' is a problem that needs to be addressed within the AAR guidance.

4.10 I hope I have given in Part 2 sufficient evidence that for a definition of 'abortive development'. The term has existed for decades, I accept that its meaning is not immediately apparent. It would be helpful if SSRO addressed where quantities sold exceed or fall short of those estimated for the purpose of establishing recovery rate based upon expected usage. See your discussion of costs paid only once in 4.12

4.12 I've covered above

4.14 and 4.15 I agree

4.18 Conversion of contracts to become a QDC requires that parties use the pricing formula. The parties can agree not to comply with the legal framework; but the law remains the law and can be subsequently enforced. Better if the Secretary of State changed the legal framework!

4.21 through 4.24. I've addressed in my Part 2

4.37 through 4.39 **I wholly disagree with SSRO's analysis of RDEC**. RDEC is a grant that contributes to certain R&D activities and cost types. I have discussed further within my Part 2. SSRO's guidance says costs should be recovered more than once. I can't see how RDEC differs from statutory maternity pay which is repaid to employers by HMIT (see

https://www.gov.uk/recover-statutory-payments). Happy to discuss further. I suspect that many contractors will just smile wryly.

5.34 They should if (a) accounting standards for production of the Group accounts differ from that of the trading entities under review, or (2) the valuation derived from the standard adopted causes a material difference to the assessment of allowable costs that would have arisen if EU adopted IFRS had been used (e.g. there are material difference for assessment of current year service costs of defined benefit pension plans).

Part 2

Requirements of allowable costs (the AAR tests)

2.2 I have no comments to make.
2.3 I have no comments to make.
2.4 I have no comments to make.
2.5 I have no comments to make.

3.1 I suggest you change 'and whether incurred directly or indirectly to enable the performance of the contract' to read 'and whether allocated directly or indirectly'.
Costs are not incurred directly or indirectly but rather; costs are incurred, and the costs are either allocated to end cost objects (direct costs) or apportioned, through use of cost drivers to end cost objects (indirect costs).
'to enable the performance of a contract' needs to be excluded as it is either addressed earlier in the sentence 'of a QDC or QSC' and therefor a tautology; or it is an erroneous and unnecessary restriction. Inclusion of 'to enable the performance of the contract' would result allowable costs being restricted to consideration of only costs without which the contract could not reasonably be expected to be able to be performed i.e. those costs that enable the performance of the contract. If it is the SSRO's intention to restrict allowable costs to only those direct and indirect costs that enable the contract to be performed, then this should be addressed in detail within paragraphs 3.4 through 3.10
3.2 §20 states that the Secretary of State and the contractor must:

- Be satisfied that a cost passes the test of being appropriate, and attributable to the contract, and reasonable in the circumstances.
- Have regard to SSRO's issued guidance

SSRO statutory guidance includes separate sections called 'The AAR principles' and 'Guidance on specific cost types. There should be no conflict between the two sets of guidance and I believe that as the AAR test is the requirement of the Act that it logically follows that the SSRO's guidance in 'The AAR principles' section has higher precedence than 'Guidance on specific cost types' section. Costs that are given within the statutory guidance as not allowable should be consistent with the SSRO's guidance included within the 'AAR principles'.
The parties to pricing of a qualifying contract need to have regard to SSRO's statutory guidance (i.e. if it being followed would result in a perverse outcome then the SSRO's statutory guidance can be set aside). I believe that the regulation is clear that the AAR test itself cannot be set aside, and it remains a firm requirement. In the event that the parties disagree then the matter can be referred to SSRO for a binding determination or an opinion (dependent upon the circumstances).
It would be helpful if wording to this effect were included within paragraph 3.2 and for either those paragraphs 3.4 through 3.10 to point to examples within the 'Guidance on specific cost types' or (probably easier) for that topical guidance to include reference back to why such costs are or are not AAR e.g. notional costs are not actually incurred by the corporation and therefore fail tests of appropriate, attributable to the contract and reasonable in the circumstances. You will see that I have further developed this later.
3.3 'that delivers good value for money in government expenditure' sits awkwardly within the sentence and should therefore be removed. Good VFM in government

expenditure, if it is not tautologous with the AAR test, is about the scope and construct of qualifying contracts. I see nothing in the SSRO's statutory guidance about either scope or construct of such contracts and would consider SSRO ill placed to give such guidance.
It could be that the requirement in the Act was intended, as Lord Currie proposed, that the SSRO's role was to oversee VFM in MoD's procurement process. As I severely doubt that MoD has this reading, I'm left with a belief that §13(2)(a) has no meat on the bone whatsoever as a requirement for contractors over and above the tests for AAR.

Appropriate

3.4 The test of 'appropriate' ought to be better differentiated from 'attributable' and reasonable'.

I would argue that a cost type is not 'appropriate' if the cost incurred, or expected to be incurred, is of a type that either (a) should be wholly borne by the shareholders (e.g. entertaining, political donations, charitable contributions), or (b) should not be expected to be incurred (e.g. fines), or (c) is not incurred or expected to be incurred (e.g. notional transactions).

I would also argue that the SSRO should also give consideration some activities as not 'appropriate'.i.e. cost allowability appropriate test should not only be considered for the cost type (e.g. wages, subsidised canteen, correction to assessments/judgements (truing up) made in prior years on costs of defined benefit pension plans) but also for the activity (e.g. bids and proposals, lobbying, private venture research and development, business combination and/or divestment activity). Costs that are inappropriate are not restricted to cost types. Some activities are inappropriate, and this requires activities to separately considered and be evaluated. All cost is incurred by type e.g. wages, travel, office accommodation but activity also needs to be prosecuted as allowable or not allowable after the activity has been evaluated .

The valuation basis of activities that are not contract end cost objects need to be considered within the statutory guidance i.e. the disallowance applied to (a) prime cost, or (b) prime costs plus overhead costs that would not be incurred 'but for' the undertaking of the unallowable cost activity, (c) prime cost, plus factory overhead, or (d) prime cost plus fully absorbed overheads. If any activities are sanctioned as unallowable then a level playing field is only achieved if there is a reasonably consistent basis for evaluation of the cost to be excluded. Not all businesses have a QMAC where these matters have been agreed with MoD.

I would construct guidance for 'appropriate' by use of negative criteria rather than positive criteria and thus avoid conflating appropriate with attributable and reasonable. SSRO should link to its guidance on specific cost types.

Industry engagement in government lead public events may pass public scrutiny but this does not make the cost appropriate to be borne by the taxpayer through increased contract prices. Consideration of 'enable the performance' should be a consideration within the applicable test; I have concerns that an 'enables the performance' test is anyway massively overly simplistic (see below 3.7 where I have listed a small number of examples that quickly came to mind that would be problematic under such an ill-considered criterion).

3.5 I like the 'a reasonable person informed of the facts' but then covers matters that should be covered in 'applicable. The US FAR sets out costs types or activities that it does not want to be paid for out of the public purse; the costs are expressly unallowable as for inclusion in contract prices. Much of what is unallowable are expenditures that owners or employees would enjoy (e.g. alcohol, entertaining, lobbying). The section covers the same ground as 3.4 above and therefore the same comments apply.

Attributable to the contract

3.6 'Attributable to the contract' are the words that are used in §20 so I agree with the title change.

I've never been wholly comfortable with a lack of clear definition for the term 'attributable', the dictionary tells me that 'attributable' means 'regarded as being caused by'. I won't suggest a change to the legislation to use the US FAR 'allocable' and the 3 criteria they set out, but the SSRO guidance ought to write its guidance to make clear the foundation it wants to rest its guidance upon.

In the draft paragraph 3.6 SSRO looks to have two tests that need to be satisfied:

a) The cost is incurred by the contractor to 'enable the performance' 'of the QDC or QSC in question', and
b) The treatment of the cost is allocated or apportioned to the contract is on a basis consistent with either (1) the contractor's overarching cost accounting practices, or, (2) using a methodology agreed with the Secretary of State

My major concerns lay with the first test of 'enable the performance' 'of the QDC or QSC in question'.

The phrase 'enable the performance of the contract', when applied to indirect costs, is too harsh and an unreasonably restrictive test. I believe that there are areas where costs that do not 'enable the performance should also be classified as being 'attributable. Such costs are those of a type or purpose that are for good social responsibility or for sustainment of the business beyond the completion period of any qualifying contract being priced. More at the end of this section.

The phrase 'of the QDC or QSC in question' when applied to indirect costs is also too harsh and an unreasonably restrictive when applied to 'enable the performance'. SSRO's draft looks to exclude apportionment of any cost that is incurred but does not enable the performance of the contract in question. At the same time indirect costs that are incurred to enable the performance of the contract in question need to be apportioned in accordance with test 2 i.e. typically across all evaluated activity. An example or two may help to illustrate my concern:

- A production machine shop facility comprises various machine tools. These machine tools are depreciated over their useful life of 10 years and the depreciation for each of the machine tools is apportioned to the cost of manufactured items using the cost driver of productive machine shop labour hours. The evaluated cost of manufactured items is allocated to contract on the basis of actual prime costs and indirect overhead recovery. Say a particular article manufactured for a contract does not use a milling machine but does use a deep honing machine. SSRO's test 1 guidance as currently written says that no portion of the depreciation of the milling machine is attributable i.e. unallowable. However, SSRO's test 2 says that the contractor will cost account for cost that is apportioned in a consistent way. If all Machine Shop overheads (e.g. machine tool depreciation) are apportioned on the basis of machine shop labour hours, then (a) the depreciation of the milling machine is allocated on the basis of all machine shop labour hours and the cost allocation to the subject contract is consequentially diluted, and (b) the depreciation of the deep honing machine is an unallowable contract cost as the deep honing machine is not necessary for the performance of the contract. It is impactable and unreasonable to issue statutory guidance that requires contractors establish a separate hourly rate denominator each piece of property, plant and equipment.

- The stress engineering office roof needs to be repaired. The maintenance of building fabric is treated as an indirect cost and the cost is included within the hourly engineering overhead rate. The repair cost is incurred during a period when there is no stress engineering activity being undertaken for the subject contract. The business has only one engineering overhead rate and this cover all engineering activity including stress. SSRO guidance above suggests that the cost would not be allowable. Similarly, if there was work undertaken in the stress office for the subject contract then the rate denominator would be all engineering hours throughout the business and the rate would be diluted.

A cost that is allowable as attributable could be either 'direct' or 'indirect'. However, I believe that the guidance should alter the 'is' to become 'is, was or will be'; the criteria applies not only to costs in the process of being incurred but also to forecast costs, deferred costs (e.g. PV product development incurred in prior periods).

I worry greatly about 'or using a methodology agreed with the Secretary of State'. The US framework requires application of 48 CFR Part 9904.401 and 9904.402. I commend these principles to the SSRO. Whatever the methodology is that a contractor uses for the allocation and or apportionment of costs the criteria should be consistently applied whereby:

- Like costs incurred for similar purposes should be treated in the same way
- Costs are estimated, reported and accounted for in that same consistent manner.

The Q-MAC is an open book disclosure by the contractor of the consistent basis it employs in accounting for costs. Any agreement MoD has with the contractor should only apply to the prosecution of costs, relevant to the pricing or reporting of qualifying contracts. to the extent that the costs in question pass the AAR requirement. The SSRO's draft wording looks to invert the test whereby an agreement with MoD has superior authority than the Act.

SSRO needs urgently to consider including guidance as to what 'to the contract' means. The guidance as presently written e.g. 3.7(b) 'whether the cost has a causal relationship with the performance of the contract' is similar to the 3.6 'incurred …. to enable the performance of the QDC or QSC in question'. There are many costs that are of a type or nature that would not pass such a narrow test.

Examples of such costs that do not or may not enable the performance of pre-existing contracts or contracts in the process of acquisition but place the company in an improved position longer term to service needs of future contracts include:

- Apprenticeship programmes. As apprentices will not be licenced to perform contract work during the period of their training as they will not have requisite licences or permits to work and are therefor not necessary to perform any contract
- Compassionate paid leave at the discretion of the company. Not part of their term of employment but a good employer would exercise judgement.
- Green initiatives that are not contractually required but are expected by stakeholders
- Research undertaken that is not required or expected to be used during the performance of a contract. MoD expects its contractors to perform sufficient research to stay enhance its core technical capability e.g. basic and applied research into theoretical investigation of new materials, techniques and processes.
- Replacement of inefficient process that are still functional
- Some preventive maintenance and replacement of plant and equipment
- Mass redundancy as it will not enable the performance of a contract

- Insurance costs in excess of those required by law or terms of contract
- Membership of trade associations and trade bodies
- Development and implementation of strategic business and operational systems e.g. ERP, CAD, CAE, FEA

3.7 I've far less concerns for paragraph 3.7 than I have for paragraph 3.6. I make my comments by sub-paragraph

a. I can't see any utility for this here. The statutory guidance should make clear what is the purpose of the consideration of this aspect. How does it make any difference whether the cost is anticipated to be incurred or has already been incurred? Is the SSRO talking to the reasonableness of a cost estimate, if so this should be in section 3.8 through 3.10. If not then the utility should be crystal.

b. This is far too close to 'required to enable the performance of the contract'. See comments in 3.6 above. If SSRO means that indirect costs are required to be distributed by use of appropriate cost drivers then they should say so.

c. See may comments in 3.6 above

d. I suggest '…. to ensure that indirect costs are only included in rate numerators once and that direct costs are only allocated once to a final end cost object. I have spelled out what I believe you mean by the overly simplistic term 'recovered'.

Reasonable in the circumstances

3.8 'reasonable in the circumstances' are the words that are used in §20 so I agree with the title change.

Otherwise section 3.8 needs work:

- A cost is reasonable in the circumstances" is fine.
- "if it is of an amount that is consistent with what a reasonable person would consider ought to be or have been incurred"
    - 'informed of the facts' should be added after reasonable person. I have to say that I'd prefer to see what I consider to be a hasher test of 'prudent person undertaking commercial work' which say much the same without recourse to 'man in the street' imagery.
- "to enable the performance of the QDC or QSC in question"
    - This at best talks to the applicable test and not a sub-set of 'reasonable'. Indirect costs are incurred in support of current or future work, there are 3 tests that need to be met, they are and need to be distinct tests and severally applied. I have discussed this intensively in paragraphs above
- "and which would withstand public scrutiny".
    - This is unnecessary here. It at best talks to the appropriate test and not a sub-set of 'reasonable'. You use words elsewhere that moves away from opinions that may be attributed to an ill-informed public.

3.9 Needs to be reviewed in accordance with my comments in 3.8 comments above

a. Surely this is a test of 'attributable'. Also, use of the word 'congruent' does little to impart understanding of the intended test
b. I'm happy
c. Happy as far as it goes. Although I left to wonder when it is reasonable for any significant cost not to be able to be supported by empirical evidence i.e. if the estimate has to be based upon management judgement rather than empirical evidence then anyone else would have a perfectly reasonable lower or higher estimate. The contractor has to have some meat on the bone (supported) for an estimate to be considered reasonable. An estimate should comprise a mix of facts (empirical evidence) and judgement (applied to those facts). The US framework does not provide such flexibility to use management judgement at the expense of use of cost history for analogous transactions.
d. OK save I can't see consistency with 3rd parties (other contractors) as a test where relevant and auditable evidence of consistency of circumstance or SoW will be available.
e. Statutory guidance based upon a term of art is not a good idea. Beauty lies in the eye of the beholder. For most contractors and their customers, it is effectiveness that is the most important attribute that need to develop. Efficiency is a measure of outputs over inputs. Effectiveness is a measure of the extent to which objectives are achieved. Efficiency without effectiveness is useless.

I'm content with Section 3.10 save I would add 'or the business overall' to the end of sub-paragraph d. Indirect costs are largely driven by the requirements of contracts rather than an individual contract.

Research and Development

The title of Section 3 is not "Private Venture Research and Development" but rather "Research and Development". This breath of scope, to include contracted work was not expected and is poorly addressed. It is not a bad idea, it is rather that it has been badly done.

D1 Research

The statutory guidance on research should address the following sets:

(a) research independently undertaken by the contractor where continuance of the research is not required to complete the performance of any contract and the activity is wholly financed by use own private venture funding.
(b) research undertaken by the contractor which is partially funded by government or supra government grant aid e.g. EU FP7. Here the grant aid should be deducted before consideration of allowability of the residue within overheads as private venture contribution. The funded proportion is just a contribution towards costs.
(c) research activity necessary to discharge a contractual obligation should be treated as a direct cost of that contract unless (b) applies

D.1.1 As these words are taken directly from IASB IAS 38 I am content.

D.1.2 This is very muddled. For (a) above the cost may be allowable if the research has potential for reducing risk or enhancing understanding when addressing future MoD requirements; (b) same as (a) but the grant aid needs to be deducted else the costs are recovered more than once; (c) costs should be allowable cost to the contract that first obligates the contractor to perform the research

D.1.3 For private venture expenditures it will not be 'the contractor's method for allocating and apportioning research costs that makes it is not possible or cost effective to show what amount of historic indirect research costs meet the requirements of Allowable Costs' but rather the nature of research itself. Even if a business could establish the quantum for the numerator the quantum of the denominator would always be unavailable. The definition of research (see D.1.1) means that you don't have units of usage. Research needs to be treated as a period expense included indirect costs incurred during the period of the contract. Costs should be evaluated on fully absorbed basis. Costs may be Allowable Costs provided that:

1. the estimated private venture research costs incurred during the period of the contract are evaluated on a fully recovered cost basis and the quantum is consistent with empirical evidence (e.g. historic levels);
2. the parties agree that the indirect research undertaken, using private venture funding, during the period of the contract has potential long-term interest to the Secretary of State e.g. improving the knowledge base of the company to undertake future work for the Secretary of State;
3. indirect research costs are apportioned to contracts (final end cost objects) on a basis using a methodology agreed with the Secretary of State; I have removed 'that

is consistent with the contractor's overarching cost accounting practices or' as the contractor should treat the private venture research as a period expense and grant aid as a reduction to PBIT i.e. the contractor will not have a practice to disclose that is of any application to distribution of cost to final cost objects.

4. 'costs are only recovered once' is correct but I would add 'and must be evaluated on fully absorbed basis and exclude all unallowable cost types'. Grant aid has to be deducted.

D2 Development

The statutory guidance on development should address the following sets:

(a) Development independently undertaken by the contractor where continuance of the development is not required to complete the performance of any contract and the activity is financed by use own private venture funding
(b) Development activity that is required to enable the performance of a contract of supply
(c) Development activity that commenced under case (a) but the activity has since become, or expected to become, necessary to enable the performance of a contract.
(d) Development activity undertaken that was financed by private venture funding and that did not fully achieve the sales volumes of the business case for whatever reason e.g. technological or market

Statutory guidance should also consider non-typical defence contractors. Where the contractor has limited, or no, prior business exposure to the pricing of single source contracts entered into to satisfy MoD requirements then where contract prices have been determined by other than (a) competition, or (b) price by reference limited either previously priced

D.2.1 As these words are taken directly from IASB IAS 38 I am content save I would add 'costs must only be recovered once, costs must be evaluated on a fully absorbed basis and exclude all unallowable cost types.'

D.2.2 The sentence "Development costs that directly or indirectly enable the performance of the contract may be Allowable Costs." Is just too simplistic. Furthermore, the phrase 'that directly or indirectly enable' lacks clarity e.g. (a) all background IPR that is brought into use in discharge of the contract obligations fits within the scope of 'directly', (b) prior performance or experience of development costs on analogous contracts may indirectly enable the performance as may maintenance of strategic capability across a range of contracts whereby development capability is maintained. Indirectly should be restricted to aspects contained with the scope of D.2.1.

Also as the City does not like to see Statement of Financial Position loaded with large carrying value of internally generated intangible assets; consequently, there is a predilection to (a) impair, or (b) treat as a period expense by failing to segregate research from Development (see IFRS 38), or (c) use of excessively prudent lives (3 years is not untypical a write down period). Use of amortisation would unnecessarily load the cost recovery to the initial sales of the product and consequential bias/distortion to single source prices.

I'd look to my list of sets at the head of this section and describe each the criteria for each e.g.:

> (a)(1) Where the item being developed will be allocated to contract on a unit basis (i.e. the quantity actually sold can be established), then the Secretary of State may agree that the evaluated development cost is accumulated at completion may be allowable as an overhead (the numerator) and be recovered over the sales volumes

included in the business case. Cumulative development costs incurred less cumulative overhead allocated to contracts will be carried forward to future periods. For the benefit of clarity, if MoD do not anticipate future interest in the outcome of the development then none of the overhead will fall to be included in the allowable cost of qualifying contracts. Statutory guidance for this set should also consider non-typical defence contractors. Where the contractor has limited, or no, prior business exposure to the pricing of single source contracts entered into to satisfy MoD requirements then there will often be problems in establishing historic documents that set out the volume of articles included in the business case and the fully absorbed actual allowable cost of that development. The contractor may have previously priced articles at market prices as proprietary items (see guidance on ASG that shows that this remains a valid basis for non QSC single source sub-contracts) or priced by reference to previous competitive prices. A proxy for this calculation needs to be established else these non-typical defence contractors will not achieve a fair and reasonable price that reflects their investment in intellectual property. Current expenditure incurred (or expected to be incurred) during the period of the contract needs to be used as a proxy alternative methodology for assessment of allowable costs for inclusion within business overheads. A 'provided that ;needs to be added:

a. Need to alter 'research costs' to become 'private venture development costs '.
b. Paragraph D.1.3.b. is not needed as the costs will only fall to the contract as allowable costs in the proportion that that contract is to the overall levels of business activity/
c. indirect research costs are applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State;
d. this is not appropriate as it is a proxy methodology

(a) (2) Where the item being developed cannot be allocated to contract on a unit basis (i.e. the quantity actually sold will not be able to be established), then the Secretary of State may agree that the evaluated development cost incurred in the period is an allowable overhead. D.2.3 I suggest that this says 'Development costs will be accounted for on a cost of production basis. Amortisation of internally generated intangible development expenditure is not an allowable cost.'
(b) This is cost to the contract and allowable if AAR tests in Section 2 and 3 are met
(c) In accordance with case (a) above where the development SoW remains unchanged from the pre-existing business case, else in accordance with (b)
(d) I've moved the section on abortive development to here. There can't be abortive research as the definition of research renders inclusion illogical. I'd use the following wording: Abortive development is that part of the actual expenditure of case (a)(1) above that is unrecovered to contract when the product developed, or attempted to be developed, by use of private venture funds is ceased to be marketed. These unrecovered costs may be an Allowable Cost for inclusion with overheads where there was reasonable expectation by the business that MoD had interest in that development. Also. for aborted work the

assessment of what is a reasonable level will depend on the information available and the specific circumstances of the development being undertaken, similar to the guidance on reworks, wastage and faulty workmanship (E.2).

D.2.4 This paragraph should not be here. It deals with capital employed and not allowability of costs.

D.2.5 I've deleted much of this paragraph as it too glib and I've covered those aspects above. Development costs are an evaluation of an activity and not a cost type. Development costs should be evaluated for application to contracts or held awaiting allocation/prosecution on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State. Development costs should only be recovered once and must be evaluated on fully absorbed basis and exclude all unallowable cost types; specifically grant aid must be deducted e.g. RDEC.'

D3 Other matters

D.3.1 I've deleted, altered and moved to Development section above where it better fits. See comments on 2.5 above.

D.3.2 I've moved this to Sections D.1 and D.2 above. As the guidance applies to all costs e.g. manufacturing costs. It should sit boldly within one of the AAR sections. Then again one could argue that the Fraud Act 2006 makes it clear enough. This final sentence should clearly sit within the AAR section. I'd like to go further than 'Any costs recovered as a direct cost of any contract should not also be allocated and apportioned as an indirect cost." and include the requirements of US CFR 9903.401 and 402. They are good and effective constraints on contractors.

E.4 Reimbursements, notional transactions and penalties

E.4.1 Allowable Costs should be net of any reimbursements, credits, grants or refunds received by contractors that directly reduce a particular cost for the contractor. The current D.I.6 should be restored and given as an example of such a credit that needs to reduce costs that are otherwise allowable. Any benefits or credits gained by contractors through the taxation system as a result of research and development expenditure should be offset against Allowable Costs. This can include tax reductions or cash offsets that reduce the tax liability. The costs associated with making such claims should generally be Allowable. Considering RDEC the following GOV.UK websites make clear that the grant is for costs incurred on projects that satisfy the requirements:

https://www.gov.uk/guidance/corporation-tax-research-and-development-rd-relief

https://www.gov.uk/guidance/corporation-tax-research-and-development-tax-relief-for-large-companies

E.4.2 I have no idea what SSRO means by “grants that are not ringfenced” means.

I have no idea what SSRO means by “adjustments made through company income tax regimes.

I have no idea what SSRO means by “because they are not given with a view to directly reduce particular costs.”

RDEC is significant to contractors and if the above should be taken to read that RDEC should not be deducted from costs incurred then I strongly suspect that contractors will be pleased to increase their reported profits as a consequence of having the exact same cost recovered more than once. A Christmas gift that will keep giving. Again, for RDEC I believe that the SSRO’s proposal will cause an unexpected misuse of taxpayer’s funds. It is plain wrong to treat RDEC as other than a government grant that reduces an otherwise allowable cost of payroll costs and directly related expenditure. Whilst the grant is not made as a payment of money into the company’s bank account but rather made through the taxation system the grant is available to be offset against payment that have to be otherwise paid. I understand that examples of where deduction can be used to reduce amounts otherwise payable include National Insurance contributions, VAT, and others in addition to Corporation Tax. SSRO’s statutory guidance for RDEC provides contractors with a reduced cost of undertaking research and development activity that would in a competitive environment lead to either (1) greater investment (for the same net cost outlay) or (2) reduced prices as a consequence of competitive forces, or (3) increased operating profit for contractors. Market forces would tend to suggest (1) or (2) is the long-term outcome. I suspect that international treaties on government aid caused the RDEC grant to be framed as a reduction in payments that would otherwise be due to government. I am truly staggered to think that SSRO guidance could be that RDEC is not to be deducted.

E.4.3 Delete ‘generally’. I can’t see how a notional transaction could ever become an allowable cost. It is not, by definition, a cost that is incurred. By simple arithmetic the cost if it were notional and allowed would be recovered more than once.

E.4.4 Replace ‘third parties’ by less expansive wording. Under UK law, this is the basis of these regulations, only institutions of government can impose a penalty or fines. SSRO should separately consider agreed damages payable to 3rd parties and when these are

allowable e.g. settlement of a breach of IPR by agreement of licence/easement and payment of royalty.

Capital servicing adjustment: Allowable Costs guidance

G.2.1 Fine

17 Basis of the capital servicing adjustment

17.1 Fine but I can't see why this is statutory guidance

17.2 Fine but I can't see why this is statutory guidance

17.3 Fine but I can't see why this is statutory guidance

17.4 Fine

17.5 In the calculation of the baseline profit rate (Step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2018) *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology*.

18 Calculating the capital servicing adjustment

18.1 Fine

18.2 Fine

18.3 The CSA calculation compensates for an appropriate and reasonable return on all capital employed by the contractor for the purposes of enabling the contractor to perform the contract. On this basis financing costs should not form part of Allowable Costs.

18.4 The CSA calculation assumes that the capital intensity of the unit of business is equivalent to the capital intensity of the performance of the contract. This assumption is a reasonable estimate because a unit of business will normally perform many contracts of a similar nature under similar conditions and it is therefore reasonable to expect that the QDC or QSC will be performed on the same basis with equivalent capital requirements.

18.5 The contractor must use the information of the unit of business most relevant to the contract, which may be a subsidiary company, division, Qualifying business unit (QBU), or site location, and is selected based upon professional judgement. If reliable information cannot reasonably be isolated to a unit of business the information of the contractor's business as a whole may be used.

19 calculation of capital employed

19.1 I believe that you need to make changes to the first sentence; (1) add, 'long term liabilities' to the scope of capital employed for the purpose of calculating working capital and fixed capital (2) delete 'investment' after 'equity' as it is completely inappropriate as equity is the shareholder's funds that are invested i.e. one would never say debt investment for the same reason that the loan is only an investment by the lender. Capital employed is the debt together with other long-term liabilities and equity i~~nvestment~~ necessary for a unit of business to function.

The next sentence contains the word 'may' twice. The SSRO cannot be seriously giving option to use assessment of debt and equity as a basis for assessment of relevant capital employed. The only part of this section that has any virtue is the final sentence. Even then it is better just to say that 'Capital employed for the purpose of establishing fixed and working capital servicing allowances is by reference to non-current assets, current assets and current liabilities reported in the statement of financial position. Even here it is close to a duplication the following paragraph.

19.2 Alter to reflect IFRS wording. Capital employed should be computed by reference to non-current assets, current assets and current liabilities reported in the statement of financial position. Business unit calculations that are not for a single legal entity should be reconciled to statutory accounts that they form a part of. Also the values must be in accordance with EU adopted IFRS unless the valuation difference is agreed as immaterial.

19.3 Capital employed is the average capital employed over the same period used to determine cost of production. At a minimum this is the average of the opening and closing position.

19.4 Proposed changes are in red and ~~strikethrough~~. The capital employed is adjusted to remove elements that are not part of normal operations~~, are equivalent to debt,~~ or irrelevant for single source procurement. These adjustments seek to achieve a result that, when taken with the cost of production as a ratio, approximates the capital intensity of the performance of the contract as closely as is practicable.

19.5 The following items should generally be excluded from the general definition of total assets less total current liabilities, except for interest bearing current liabilities:

a. items not representing capital employed in normal operations, for example:
    i. intangible assets with an indefinite useful life (does SSRO mean anything other than goodwill?) I believe that 'intangible assets with an indefinite useful life' should be replaced by 'all intangible assets, including goodwill, that result from business combination together with all internally generated development' assets should be excluded (see also my d. below) ;
    ii. fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets and derivative financial instruments and values deriving from OCI
    iii. investments including those in shares and securities;

iv. loans to or from other companies, including non-trading balances with group entities;
v. assets held for sale ~~and idle assets not required for the normal operation of the business~~; or (I have struck through the idle assets section as the carrying value of any asset is required to be the lower of cost or net realisable value; assets held for sale are by definition expected to be sold within the period establish as the period used for current assets).
vi. cash in excess of the amount required for normal operations;

b. items that are indirect ways of raising money that should be treated as debt equivalents, for example:
   i. deferred tax assets or liabilities (this is nonsense, deferred tax is the impact of timing difference between the basis of calculating tax paid/payable and the basis of calculation of the comprehensive income statement. It is not an indirect way of raising money; or
   ii. retirement benefit surpluses or obligations (this is a non-current liability and should be excluded for the reason that it is not anything to do with normal operations; and
c. items generally not relevant for single source MOD contracting. Was there anything you had in mind or should contractors continue to use the items included within the retired Government Accounting Conventions?
d. Items representing capital employed in normal operations should include cumulative Development expenditure for which recovery rates based upon usage have been agreed with the Secretary of State but for which recoveries are yet to be secured. For non-typical defence contractors that do not have recovery rates agreed for private venture funded products a reasonable alternative method of valuation can be agreed for inclusion within capital employed.

19.6 Fine

19.7 Fine

20 Fixed and working capital

20.1 I'd very much prefer that SSRO statutory guidance was firmly anchored to the IFRS accounting standard IAS 1. Long term assets comprise both Property, Plant and Equipment, and Intangible assets. The SSRO should make clear that intangible assets, to the extent that they are allowable, are to be included within fixed capital. IAS 1.66 requires assets that are expected to be realised in the entity's normal operating cycle, held for the purposes of trading, and are expected to be realised within 12 months of the reporting period; to be treated as current assets. Similar arrangements are set out for current liabilities within IAS 1.69. Rather than the spongy descriptive framework set out within the draft of the statutory guidance I'd refer to IAS 1 and in particular paragraphs 1.60 through 1.75. I'd also require each line of the balance sheet to be prosecuted between 'fixed' and 'working'. This 'fixed capital value' figure is subtracted from the capital employed and the balance is the 'working capital value', which may be positive of negative.

20.2 I agree.

21 Calculation of cost of production

21.1 I'm fine with "Cost of production is the cost incurred by the functioning of a business" but that is as far as I am content. Cost of production is not congruent with cost of sales plus period expenditure as the balance sheet is where all the timing differences are taken. Accrual accounting is, I believe, a universally accepted accounting concept. It may be that revenue less operating profit plus/minus movement in inventory over the period gives a good enough approximation of cost of production for calculation of CSAs. An accurate valuation would also need to look at income and expenditures included between operating profit and profit after discontinued operations but before tax. SSRO's phrase 'the general definition being operating revenue less operating profit/loss' is both incorrect and reads to be wholly optional in its usage.

21.2 Agreed

21.3 I just had to correct. "The following items should ~~generally~~ be excluded from ~~the general definition of Operating revenue less Operating profit/loss~~ cost of production:"
a. the cost of raising and servicing capital;
b. costs related to items excluded from capital employed; and
c. costs generally not relevant for single source MOD contracting.

21.4 Where exceptional adjustments have been made to capital employed in accordance with paragraph 19.5, a corresponding adjustment to cost of production may be required.

10. Ministry of Defence

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

HMG approves of aligning the language between the guidance and the Act, and the consistency this brings. Defining key terms in the guidance also improves its clarity.

Importantly, the guidance makes explicit the link between determining Allowable Costs, and proving value for money, as well as the need for the type and amount of costs to withstand public scrutiny.

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

The changes to the guidance proposed in the consultation bring a welcome emphasis on 'reasonableness' in determining a range of criteria in the calculation of Allowable Costs. We believe this will encourage all parties to reach agreements that safeguard both contractor investment and value for money for the taxpayer.

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

Please see separate sheet with detailed comments

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
Nil return

e) What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2019?

Comments
The MOD have separately engaged with the SSRO on further areas to prioritise. We are happy for these to be made public.

Comments on the SSRO Consultation Document		
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
2. Application of the guidance		
2.1 It is a legal requirement to have regard to this guidance in determining whether costs are Allowable under a QDC or QSC. This guidance applies to QDCs or QSCs entered into or amended on or after 1 April 2018 and replaces the version of the guidance published on 1 July 2016. Where a change in guidance occurs during contract negotiations, the contractor must report an agreed deviation from the statutory guidance if the previous guidance has informed the majority of the negotiation.	2.1 It is a legal requirement to have regard to this guidance in determining whether costs are Allowable under a QDC or QSC. This guidance applies to QDCs or QSCs entered into or amended on or after 1 April 2018 and replaces the version of the guidance published on 1 July 2016. Where a change in guidance occurs during contract negotiations, the contractor must report an agreed deviation from the statutory guidance if the previous guidance has informed the majority of the negotiation.	No comment
2.2 Section 20(4) of the Act places the onus upon the primary contractor of a QDC to demonstrate to the Secretary of State (if required) that costs meet those requirements set out in this guidance as being Allowable. The burden of proof rests with the contractor and it is essential that the MOD has the ability to verify, challenge and agree the material costings that are submitted as being Allowable.	2.2 For the purpose of pricing QDCs and QSCs the Act requires both the parties to be satisfied that particular costs meet the requirements of Allowable Costs, having regard to this guidance. To facilitate this, the Secretary of State may require the contractor to show that the requirements are met (with reference to this guidance or otherwise). In such cases, the burden of proof rests with the contractor. Whether or not the Secretary of State requires the contractor to show that the requirements of Allowable Costs are met, the Secretary of State and the contractor must be able to verify, to their satisfaction, that the costs are Allowable Costs.	We believe this would be clearer if it specified that the parties concerned are the contractor (whether prime or sub) and SofS. Similar clarification required in subsequent sentences. The addition of the final sentence is welcomed
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018**	**Comments**

Text deleted	*Text revised/moved* *Text added*	
	2.3 In relation to a QDC or QSC, and associated reports required under Part 5 of the Regulations, Regulation 20 places a duty on the primary contractor or sub-contractor to keep 'relevant records'. Section 23 of the Act defines relevant records as accounting and other records (whether in hard or electronic form) which the primary contractor or sub-contractor 'may reasonably be expected to keep' and 'which are sufficiently up-to-date and accurate' for use by the Secretary of State or an authorised person for verifying certain matters relating to the price payable under a QDC or QSC, including whether a cost is an Allowable Cost.	Understand the intent of this but believe it would be better served by giving a simple reference to Records in the Primary and Secondary legislation e.g. "Requirements and definitions relating to records are given in the DRA S.23 and SSCRs Reg 20"
	2.4 The Act and Regulations do not specify what, if any, other information related to facts, assumptions or calculations is to be provided by a contractor (if required by the Secretary of State), or what standard of information is needed, to show that a cost in a QDC or QSC is an Allowable Cost to the satisfaction of both parties. In determining what type and standard of information is required, the parties should take a proportionate approach considering: a. the specific requirements and circumstances of the contract; b. the materiality of particular costs; and c. what it is reasonable to expect would be available.	We support this addition.
Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
	2.5 The information used to show that costs are Allowable Costs should make sufficiently clear	We would welcome the addition of "to both parties" after "sufficiently clear".

	how the costs meet the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.	
2.3 If the primary contractor has entered into sub-contracts to a QDC (including any QSC), then the prices of those sub-contracts will be costs in the QDC. The Secretary of State and the primary contractor will need to be satisfied that the prices are Allowable Costs (section 20(2)). The Secretary of State may require the primary contractor to demonstrate this is the case (section 20(4)). The legislation does not prescribe how this may be demonstrated, or what would be sufficient evidence that a sub-contract price satisfies the AAR test. It may be that the price of a sub-contract may be demonstrated to be Allowable without the need to demonstrate that all the component costs are Allowable.	2.6 If the primary contractor has entered into sub-contracts to a QDC (including any QSC), then the prices of those sub-contracts will be costs in the QDC. The Secretary of State and the primary contractor will need to be satisfied that the prices are Allowable Costs (section 20(2)). The Secretary of State may require the primary contractor to demonstrate this is the case (section 20(4)). The legislation does not prescribe how this may be demonstrated, or what would be sufficient evidence that a sub-contract price satisfies the AAR test. It may be that the price of a sub-contract may be demonstrated to be Allowable without the need to demonstrate that all the component costs are Allowable.	We support this change.

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
2.4 In the case of a sub-contract that is also a QSC, the contract price must conform to the price formula and the costs must be Allowable. In	2.7 In the case of a sub-contract that is also a QSC, the contract price must conform to the price formula and the costs must be Allowable. In	We support this change.

terms of whether a cost in a QSC is Allowable, the application of section 20(2) and (4) is modified by section 30(1) of the Act. The Secretary of State and the sub-contractor must be satisfied that the costs are Allowable. The obligation to demonstrate to the Secretary of State that a cost included in the price of a QSC is Allowable sits with the sub-contractor. The price of any sub-contract to the QSC will need to be an Allowable Cost in the QSC and the guidance given at paragraph 2.3 will apply equally.	terms of whether a cost in a QSC is Allowable, the application of section 20(2) and (4) is modified by section 30(1) of the Act. The Secretary of State and the sub-contractor must be satisfied that the costs are Allowable. The obligation to demonstrate to the Secretary of State that a cost included in the price of a QSC is Allowable sits with the sub-contractor. The price of any sub-contract to the QSC will need to be an Allowable Cost in the QSC and the guidance given at paragraph 2.3 will apply equally.	
Further clarification		
2.5 Any general enquiries related to this guidance should be addressed to the SSRO helpdesk[3]. The SSRO responds as quickly as possible to such requests, provided they are matters of general guidance and not contract-specific.	2.8 Any general enquiries related to this guidance should be addressed to the SSRO helpdesk[3]. The SSRO responds as quickly as possible to such requests, provided they are matters of general guidance and not contract-specific.	No comment
2.6 If the parties to a QDC or QSC, in advance of entering into the contract, would like a view as to whether costs under the contract may be Allowable Costs, then a referral may be made to the SSRO for an opinion. The SSRO has published guidance[4] as to how it will deal with such referrals for an opinion.	2.9 If the parties to a QDC or QSC, in advance of entering into the contract, would like a view as to whether costs under the contract may be Allowable Costs, then a referral may be made to the SSRO for an opinion. The SSRO has published guidance[4] as to how it will deal with such referrals for an opinion.	No comment
Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
2.7 Following contract award, the parties to a QDC or QSC may apply to the SSRO to determine the extent to which costs are Allowable Costs. If such a referral is made, the SSRO will make a determination as to the extent to which costs are Allowable Costs (section 20(5) and 20(6)). The final determination has legal consequences for the parties. The SSRO has published guidance as	2.10 Following contract award, the parties to a QDC or QSC may apply to the SSRO to determine the extent to which costs are Allowable Costs. If such a referral is made, the SSRO will make a determination as to the extent to which costs are Allowable Costs (section 20(5) and 20(6)). The final determination has legal consequences for the parties. The SSRO has published guidance as	No comment Need additional paragraph to show Statutory Guidance starts at Section 3 NOT Section 2

to how it will deal with such referrals for a determination.	to how it will deal with such referrals for a determination. 2.10	
3. The AAR principles		
3.1 Costs are Allowable to the extent they are Appropriate, Attributable to the contract and Reasonable in the circumstances. These criteria apply to all costs (estimated and actual) of a QDC or QSC. This guidance sets out the principles to be followed. The subsequent paragraphs set out a non-exhaustive list that parties should consider when assessing whether a cost might meet the Appropriate, Attributable and Reasonable criteria and are therefore Allowable.	3.1 Costs are Allowable to the extent they are appropriate, attributable to the contract and reasonable in the circumstances. These three requirements apply to all costs of a QDC or QSC, whether estimated or actual, and whether incurred directly or indirectly to enable the performance of the contract.	This needs to be checked in the context of the text against Attributable**

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
This guidance sets out the principles to be followed. The subsequent paragraphs set out a non-exhaustive list that parties should consider when assessing whether a cost might meet the Appropriate, Attributable and Reasonable criteria and are therefore Allowable.	3.2 This guidance sets out the principles underpinning each requirement and a non-exhaustive list of related factors that the parties should consider when assessing whether particular costs meet the requirements and are, therefore, Allowable Costs. Assessing whether the factors are true requires judgement to be applied by the parties. The	We support the intent, but we believe that the drafting could be clearer, particularly as to when a deviation needs to be reported in the CPS etc

	relative importance of each factor to the particular costs under consideration, and the level of information required by the parties to be satisfied that the factors are true, are matters for the parties to decide taking account of the circumstances of the case. However, it is unlikely that a requirement will be met where the parties judge none of the underpinning factors to be true.	
	3.3 The overarching principle is that for costs to be determined Allowable Costs they must support a contract price that delivers good value for money in government expenditure and is fair and reasonable to the contractor.	This isn't a requirement stemming from S.20(2) but rather a statement of one of the aims of the SSRO; therefore not convinced that it should be introduced in to the Statutory Guidance

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Appropriate		
3.2 Guidance on Appropriate Costs A cost is Appropriate if, by its character and nature, it represents a cost that is expected to be incurred in the conduct of delivering the QDC or QSC in question. Appropriate costs are those which should be able to withstand public scrutiny	3.4 A cost is appropriate if, by its character, it is a cost that a reasonable person would consider ought to be or have been incurred to enable the performance of the QDC or QSC in question and which would withstand public scrutiny.	"has" not "have" Is there a difference between the "reasonable person" here and the "reasonable person, informed of the facts" in the next para? What is the difference between a reasonable person and public scrutiny?

and which can be supported by sufficient justification.		Should the reasonable person be suitably qualified?
3.3 In order to assess whether a cost is Appropriate, consideration should be given to the following: a. whether a cost might be expected to be incurred in the delivery of the QDC or QSC; b. whether the cost is suitable for the purpose of the QDC or QSC; c. whether the inclusion of the cost would withstand public scrutiny; and d. whether the inclusion of the cost is fair and equitable.	3.5 In order to assess whether a cost is appropriate, consideration should be given to the following: a. whether a reasonable person, informed of the facts, would consider the cost suitable and necessary to enable the performance of the contract; and b. whether the cost is of a type that is consistent with the standards of regularity, propriety and prudence expected by Parliament of the Ministry of Defence.	We believe 3.5b is more applicable to the 'appropriateness' test.

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Attributable	**Attributable to the contract**	
3.4 Guidance on Attributable costs: A cost is Attributable if it is incurred directly or indirectly for the fulfilment of the QDC or QSC in question and it is necessary to fulfil the requirements of that contract. All costs should be incurred by the contractor and applied to the QDC or QSC on a basis that is consistent with the contracting company's overarching cost accounting practices. The costs should be costs	3.6 A cost is attributable to the contract if it is incurred by the contractor directly or indirectly to enable the performance of the QDC or QSC in question and is applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State. Costs which are attributable to the	We suggest changing the word 'attributable' in the last sentence to 'attrinuted'.

not recovered in any way from another contract, whether past, existing or proposed.	contract should not be recovered in any way from another contract, whether past, existing or proposed.	
3.5 In order to assess whether a cost is Attributable, consideration should be given to the following: a. whether the treatment is consistent with generally accepted accounting principles; b. whether the cost is borne by the contractor; c. whether the cost has a causal relationship with the contract, in the sense of being required for its delivery; d. whether the cost is identifiable; e. whether the cost is incurred in fulfilling the requirements of the QDC or QSC; and f. whether it can be evidenced that the cost has not already been recovered.	3.7 In order to assess whether a cost is attributable to the contract, consideration should be given to the following: a. whether the cost has been or is anticipated to be incurred by the contractor; b. whether the cost has a causal relationship with the performance of the contract; c. whether the allocation and apportionment of the cost to the contract is consistent with the contractor's overarching cost accounting practices or uses a methodology that is agreed with the Secretary of State; and d. whether the contractor has effective controls in place to ensure that costs are only recovered once.	We support this change.
Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Reasonable	**Reasonable in the circumstances**	
3.6 Guidance on Reasonable costs: A cost is Reasonable if by its nature it does not exceed what might be expected to be incurred in the normal delivery of the QDC or QSC in question, whether under competitive tendering conditions or as a single source contract. Indicators of whether costs are Reasonable include, but are not limited to, the level of competitiveness and/or market testing undertaken in the supply chain, any particular specification and performance requirements, any uncertainty involved, the economic environment,	3.8 A cost is reasonable in the circumstances if it is of an amount that is consistent with what a reasonable person would consider ought to be or have been incurred to enable the performance of the QDC or QSC in question and which would withstand public scrutiny.	This section seems unnecessary, and potentially has unintended consequences. For example, a reasonable person might consider that costs arising from a crane accident 'ought' not to be incurred. But if the MOD has agreed a cost plus or EBF pricing method, it's effectively taken on this risk.

the statutory provisions in place at the time of contracting, the expected benefits provided and any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'.		

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Reasonable	**Reasonable in the circumstances**	
3.7 In order to assess whether a cost is Reasonable, consideration should be given to the following: a. whether it is congruent with meeting the contract requirements; b. whether the cost would withstand public scrutiny; c. whether cost estimates are based on empirical evidence, where this is possible;	3.9 In order to assess whether a cost is reasonable in the circumstances, consideration should be given to the following: a. whether a reasonable person, informed of the facts, would consider the cost congruent with the performance of the contract; b. whether the cost is of an amount that is consistent with the standards of regularity, propriety and prudence expected by Parliament of the Ministry of Defence;	a) reasonable person should be suitably qualified. c) We don't believe that the word 'empirical' is useful here, and it use raises more questions than it answers. e) We suggest replacing with 'whether cost estimates assume that the contractor has taken reasonable steps to enhance economy and efficiency in the use of resources.'

d. whether the cost is consistent with any available sector/market benchmarks; e. whether the quantum of the cost is consistent with good business practice; and f. whether the costs deliver value for money for the UK taxpayer.	c. whether the cost is supported by relevant empirical evidence, where it is reasonable to expect this would be available; d. whether the cost is consistent with costs of a similar nature that were or are anticipated to be incurred by the contractor in the performance of other contracts or by third parties in similar circumstances; and e. whether the contractor has taken adequate steps to enhance economy and efficiency in the use of resources.	

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Reasonable	**Reasonable in the circumstances**	
(see 3.6)	3.10 Consideration must be given to the circumstances of the case when determining whether costs are reasonable. Circumstances which may influence costs and which may, therefore, be considered when determining if a cost is reasonable in the circumstances include, but are not limited to: a. the level of competitiveness and/or market testing undertaken in the supply chain; b. the particular specification and performance	We suggest removing sub paras d) and e)

	requirements of the contract; c. uncertainty and risk affecting costs; d. events which were not anticipated at the time of agreement; e. the economic environment; f. the statutory provisions in place at the time of contracting; and g. any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'.	

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Research and development		
D.1.1 Contractors will account for private venture research and development expenditure in accordance with the relevant Generally Accepted Accounting Principles. Where it is realistic and suitable to do so, any expenditure of this nature must be allocated as closely as possible to those product groups that the expenditure is designed to benefit. Product groupings already established for the contractor's own purposes will normally be adopted and only revised when this is a	(See D.2.3)	

necessity to achieve a fair allocation of the expenditure.		
D.1.2 When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing principles, the following guidelines to assess it as Allowable will normally apply:	(See D.2.3)	
a. Any costs relating to projects where the research and development activity has already been funded via other routes should not be an Allowable Cost. In a case of a joint venture between the Secretary of State and other customers, a proportion of costs relevant to the Secretary of State's take up could be Allowable provided these costs have not been recovered elsewhere.	(See D.3.2)	
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Research and development		
b. Research and development costs should not be allowed where there has been no discernible benefit provided to the QDC or QSC as a whole or where sufficient evidence is not available to support the research and development costs.		
	D.1 Research D.1.1 Research means original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.	We support this change, assuming that it is consistent with the relevant accounting definition
	D.1.2 The costs of research undertaken before or during the contract that directly or indirectly enables its performance may be Allowable costs.	Suggest adding 'if they have not already been recovered elsewhere'

Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Research and development		
	D.1.3 Where the contractor's method for allocating and apportioning research costs means it is not possible or cost effective to show what amount of historic indirect research costs meet the requirements of Allowable Costs, indirect research costs incurred during the period of the contract may be used to determine the historic indirect research costs that are Allowable Costs provided that: a. the research costs incurred during the period of the contract are consistent with historic levels; b. the parties agree that the indirect research undertaken during the period of the contract is of potential interest to the Secretary of State when considering the specific circumstances of the contract being delivered;	We suggest rewriting to show PV Research is recoverable through overheads provided that: 1) MOD has interest in potential outcome 2) it is only recovered once 3) paras c and d apply 4) There is evidence to support level of spend.

	c. indirect research costs are applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State; and d. costs are only recovered once.	

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Research and development		
	D.2 Development D.2.1 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.	We support this change, assuming that it is consistent with the relevant accounting definition
	D.2.2 Development costs that directly or indirectly enable the performance of the contract may be Allowable Costs.	We support this change.
(See D.1.1 to D.1.2)	D.2.3 Accounting standards allow contractors to account for development costs in different ways. They will either recognise an intangible asset arising from development expenditure and amortise this over time or will write off the costs as they are incurred. Development costs may be Allowable Costs under either approach and the treatment already established for the contractor's own purposes should normally be adopted.	We would like this to include a statement that product development costs should be recovered as direct costs through the costs of the relevant products when they are sold. The methodology should be agreed by both parties

	D.2.4 Development costs that are recognised as an intangible asset and amortised are dealt with in section G.1 of this guidance.	
c. In the case of a product or service under development, the nature of which is such that it will be possible to ascertain the utilisation of the product or service developed, the recovery should be by direct charge to the product or service concerned.	D.2.5 Development costs that are written off as they are incurred should be applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State	

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Research and development		
d. In the case of private venture research and development, the nature of which is such that it is not possible to ascertain the utilisation of the product or service developed, the costs should be recovered by a charge to the current total output of the product or service group. D.1.3 Development expenditure that gives rise to an intangible asset should be attributed to the relevant product or products of the contractor. The intangible asset generated should fulfil the criteria set out in the relevant accounting standard and such expenditure will be charged direct to the products being developed. The costs of this research expenditure would be recovered through the costs of the relevant products when they are sold.		Final sentence of D.1.3 should effectively be moved to new para D.2.3

D.1.4 Due to the timeframes that research and development programmes can span, there may be circumstances where the parties may agree to carry forward a decision on whether costs are		

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Research and development		
D.1.5 Abortive research and development expenditure should be treated in the same way as any other research and development expenditure and may be an Allowable Cost.	**D.3 Other Matters** D.3.1 Abortive research or development expenditure should be treated in the same way as any other research and development expenditure and may be an Allowable Cost. This recognises that trial and error is normal and inevitable given the nature of such work. The assessment of what is a reasonable level of aborted work will depend on the information available and the specific circumstances of the contract being delivered, similar to the guidance on reworks, wastage and faulty workmanship (E.2).	Suggest removing. Development expenditure that does not result in a product should not be recoverable from the MOD. As stated above, research expenditure is recoverable through the overheads if the MOD has an interest in its *potential* outcome. This implies that it will be recovered whether it results in a product or not.
(See D.1.2a)	D.3.2 Costs should only be recovered once. Any costs recovered as a direct cost of any contract should not also be allocated and apportioned as an indirect cost.	Move to further up?

D.1.6 Any benefits or credits gained by contractors through the taxation system as a result of research and development expenditure should be offset against Allowable Costs. This can include tax reductions or cash offsets that reduce the tax liability. The costs associated with making such claims should generally be Allowable.	(See E.4.2)	

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
We propose to replace Part E.4 in the current Allowable Costs guidance with the guidance below. This is not part of the specific research and development guidance, but the change is introduced here because previous specific guidance on benefits and credits gained by contractors through the taxation system as a result of research and development expenditure have been merged with the current guidance on refunds, penalties and notional transactions.		
E.4 Refunds, penalties and notional transactions E.4.1 Where reimbursements, credits, grants or refunds are received by contractors and cannot be identified to a particular contract then these should be apportioned to individual contracts to reduce Allowable Costs.	**E.4 Reimbursements, notional transactions and penalties** E.4.1 Allowable Costs should be net of any reimbursements, credits, grants or refunds received by contractors that directly reduce a particular cost for the contractor.	
	E.4.2 Grants that are not ringfenced and adjustments made through company income tax regimes are not relevant to the determination of Allowable Costs because they are not given with a view to directly reduce particular costs.	Some of adjustments made through company income tax are given with a view to directly reducing particular costs. This applies to R&D tax credits. We will respond in more depth on this issue separately
E.4.2 Notional transactions are generally not Allowable.	E.4.3 Notional transactions are generally not Allowable Costs.	

E.4.3 Civil penalties and fines, are not Allowable as these are payments imposed to compensate for harm done through the wrongdoing of the party concerned, which in this case would be the contractor, and as such generally do not meet the Appropriate, Attributable and Reasonable criteria.	E.4.4 Costs arising from civil penalties and fines are not Allowable Costs. Such costs result from charges imposed by third parties on contractors to penalise them for wrongdoing or to derive compensation for harm done. As such, they do not satisfy the requirements of Allowable Costs.	Would prefer final sentence to state "As such, they are not appropriate and therefore do not satisfy the requirements of Allowable Costs"

Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
We propose to replace Part G.2 – Financing costs in the current Allowable Costs guidance with the guidance below.		
Capital servicing adjustment: Allowable Costs guidance G.2 Financing costs G.2.1 Any costs associated with the raising of capital will generally not be Allowable. The step 6 capital servicing adjustment is intended to compensate for servicing of capital and the SSRO would not expect these to form part of the Allowable Costs. The SSRO publishes separate guidance7 on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital they employ in delivering QDCs or QSCs.	G.2.1 Costs associated with the raising and servicing of capital are not Allowable Costs. The approach to calculating the step 6 capital servicing adjustment compensates for these costs. The SSRO publishes separate guidance on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital they employ to enable the performance of a QDC or QSC.	

Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
We propose to replace sections 17 to 23 in the current profit rate guidance with the guidance below. Subsequent paragraphs will be re-numbered		
17. Basis of capital servicing adjustment 17.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the capital servicing adjustment: "Take the amount resulting from step 5 and add to or subtract from it an agreed amount ("the capital servicing adjustment"), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract."	**17 Basis of the capital servicing adjustment** 17.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the capital servicing adjustment: "Take the amount resulting from step 5 and add to or subtract from it an agreed amount ("the capital servicing adjustment"), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract."	
17.2 Regulation 11(8) requires that: "In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:	17.2 Regulation 11(8) requires that: "In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:	

a. must have regard to the capital servicing rates in force at the time of the agreement; b. must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are Allowable Costs under the contract; and c. may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor's obligations under the contract."	a. must have regard to the capital servicing rates in force at the time of the agreement; b. must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are Allowable Costs under the contract; and c. may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor's obligations under the contract."	
Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
18. Importance of Step 6 adjustment 18.1 The capital servicing adjustment ensures that a contractor receives an appropriate and reasonable return on their investment in fixed and working capital. In the calculation of the baseline profit rate the comparator company data is adjusted to set a baseline with respect to capital employed upon which Step 6 can be added. The approach to this adjustment and the capital servicing rates that apply in the calculation of the baseline profit rate are the same as those at Step 6. This process is set out in the *Single source baseline profit rate, capital servicing rates and funding adjustment methodology*.	(See 17.5)	
	17.3 Section 30 of the Act sets out that "[the Act] and single source contract regulations apply to qualifying subcontracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors)".	Should be similar in ACG

<table>
<tr>
<td>18.2 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2018[3] are:

<table><tr><th>Item</th><th>Rate</th></tr><tr><td>Fixed Capital</td><td>X</td></tr><tr><td>Positive working capital</td><td>X</td></tr><tr><td>Negative working capital</td><td>X</td></tr></table></td>
<td>17.4 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2019 are:

<table><tr><th>Item</th><th>Rate</th></tr><tr><td>Fixed Capital</td><td>X</td></tr><tr><td>Positive working capital</td><td>X</td></tr><tr><td>Negative working capital</td><td>X</td></tr></table></td>
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<td>Pricing guidance review 2018
Consultation on changes for 2019/20 - October 2018
Text revised/moved Text added</td>
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<td>18.3 To determine this appropriate and reasonable return, the MOD and contractors must have regard to these rates.</td>
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<td>(See 18.1)</td>
<td>17.5 In the calculation of the baseline profit rate (Step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2018) Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology.</td>
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<tr>
<td>19. Calculating the capital servicing adjustment
19.1 The Capital Servicing Adjustment (CSA) calculation requires input of three pieces of data that are likely to be held by the prime contractor and their group sub-contractors and not the MOD – the fixed capital, working capital and cost of production. The prime contractor should propose the CSA adjustment to the MOD, supported by the facts, assumptions and calculations relied upon; the MOD should scrutinise those matters and request any further</td>
<td>18 Calculating the capital servicing adjustment</td>
<td></td>
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</table>

information required to agree the final adjustment.		

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
19.2 The calculation is structured around the above-mentioned three elements of capital servicing used when fulfilling a qualifying defence contract, or qualifying sub-contract, - fixed capital and working capital (positive and negative). These elements of capital cost when combined are classified in this guidance as being 'capital employed'.		
19.3 The total value of capital employed is then assessed in conjunction with the total cost of production in order to apply a rate of capital servicing (by way of a ratio) that is proportionate to the level of capital employed and used in the cost of production for a qualifying defence contract or qualifying sub-contract.	18.1 This guidance sets out the approach that should be followed to calculate the capital servicing adjustment using a ratio of capital employed to the total cost of production (CP:CE ratio) of a relevant unit of business which is likely to be performing the contractor's obligations under the contract (the "CSA calculation").	Although, in practice, the CP:CE ratio is nearly always used to calculate the CSA, there may be circumstance where we agree to use the capital directly attributable to a contract instead. We therefore suggest changing this to read: This guidance sets out the approach that should be followed to calculate the capital servicing adjustment where a ratio of capital employed to the… and add the sentence. 'Where the parties agree not to use the CP:CE ratio, the method employed must be clearly set out"
19.4 The capital servicing rates published by the Secretary of State are then applied to determine the capital servicing adjustment to be used in		

Step 6 of the calculation of the contract profit rate.		
19.5 The diagram on the next page sets out the four computations to be followed in order to determine the capital servicing adjustment. A simple worked example is described at Appendix C to this guidance. 19.6 The following section sets out the principles to be followed in order to assess the level of capital employed and the total cost of production.	18.2 The next sections of the guidance set out the calculation of Capital Employed and of Cost of Production, which are required for the calculation. The diagrams after that guidance set out the four computations to be performed. A simple worked example is described at Appendix C to this guidance.	
Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
	18.3 The CSA calculation compensates for an appropriate and reasonable return on all capital employed by the contractor for the purposes of enabling the contractor to perform the contract. On this basis financing costs should not form part of Allowable Costs.	
	18.4 The CSA calculation assumes that the capital intensity of the unit of business is equivalent to the capital intensity of the performance of the contract. This assumption is a reasonable estimate because a unit of business will normally perform many contracts of a similar nature under similar conditions and it is therefore reasonable to expect that the QDC or QSC will be performed on the same basis with equivalent capital requirements.	Should say is equivalent to the ratios of both fixed and working capital to cost of production of a particular contract.
20. Calculation of capital employed 20.1 A contractor must initially establish the average capital employed for the unit of their business most relevant to the qualifying defence contract (or qualifying defence sub-contract),	18.5 The contractor must use the information of the unit of business most relevant to the contract, which may be a subsidiary company, division,	Add “as agreed between MOD & Contractor” after “unit of business most relevant to the contract”. Delete rest of para.

such as a subsidiary company, division or site location. The contractor should apply the most relevant unit of their business based upon their professional judgement. 20.2 If figures cannot reasonably be isolated then, in exceptional circumstances, capital employed can be calculated for a contractor's business as a whole	Qualifying business unit (QBU), or site location, and is selected based upon professional judgement. If reliable information cannot reasonably be isolated to a unit of business the information of the contractor's business as a whole may be used.	
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
	19 Calculation of capital employed 19.1 Capital employed is the debt and equity investment necessary for a unit of business to function. Directly calculating this may be difficult because a unit of business may not separately report the debt and equity necessary for a business to function from other debt and equity investment. Capital employed is instead indirectly calculated with reference to the equal and opposite balance sheet items for which more granular information is available	
(See 20.3)	19.2 Capital employed should be computed as the total assets less total liabilities, excluding interest-bearing liabilities, of the business unit.	
	19.3 Capital employed is the average capital employed over the same period used to determine cost of production. At a minimum this is the average of the opening and closing position.	
20.3 The next step is to allocate the capital employed in the balance sheet (the net assets) between those items that qualify for capital servicing allowances and those that do not.	19.4 The capital employed is adjusted to remove elements that are not part of normal operations, are equivalent to debt, or irrelevant for single source procurement. These adjustments seek to achieve a result that, when taken with the	Remove "equivalent to debt, or irrelevant for single source procurement"

	cost of production as a ratio, approximates the capital intensity of the performance of the contract as closely as is practicable.	

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20.4 The list below indicates those items that will generally be excluded in determining the total capital employed: a. goodwill; b. adverse (debit) balances in retained earnings; c. investments in shares and securities; d. shares held in and permanent loans to subsidiary companies; e. cash demonstrably surplus to requirements (for example short term investments, deposits, and cash demonstrably in excess of the amount required for working cash resources for day to day operations); f. capital not employed efficiently, such as: i. land and buildings not in occupation; ii. plant and machinery demonstrably not in use; iii. where held for speculative purposes or for long term expansion not yet planned; or	19.5 The following items should generally be excluded from the general definition of total assets less total liabilities, except for interest bearing liabilities: a. items not representing capital employed in normal operations, for example: i. intangible assets with an indefinite useful life; ii. fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets iii. investments in shares and securities; iv. loans to or from other companies, including non-trading balances with group entities; v. assets held for sale and idle assets not required for the normal operation of the business; or vi. cash in excess of the amount required for normal operations; b. items that are indirect ways of raising money that should be treated as debt equivalents, for example: i. deferred tax assets or liabilities; or ii. retirement benefit surpluses or obligations;	Suggest rewording last part of first sentence to read "total assets less current liabilities" Add interest bearing liabilities to list of exclusions. Would welcome more details on excess cash as always contentious. c. would distort CP:CE ratio unless CP was also adjusted. Suggest removal

iv. where there has been unreasonable delay in disposal of surplus assets. g. certificates of tax deposit; and h. where advance payments by the MOD relating to single source contracts have not been accounted for in a way that reduces them.	and c. items generally not relevant for single source MOD contracting.	
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
20.5 The following items can generally be included in assets in determining the total capital employed in the business unit (these may result in an addition or a deduction from balance sheet figures dependent upon circumstances): a. Assets in the course of construction. b. Trading balances with subsidiary, affiliate and other group companies. c. Inventories, which can be included in capital employed based on costs derived from values recorded in the statutory accounts. This is subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of any inventory in the balance sheet, provided it is accompanied by Auditor Attestation. If a contractor has not already done so in its balance sheet then interim payments on account of work in progress are to be deducted. d. Patents and trade-marks, may be included to the extent that a company can demonstrate that they are registered in the name of the contractor and have not lapsed (or the contractor has a valid	(See 19.2)	Suggest re-instatement. Detail may be useful

licence to use) and they actively or defensively contribute to the conduct of the business, even if they are not shown in the contractor's balance sheet.20 Guidance on the baseline profit rate and its adjustment 2018/19. CONTINUED OVERLEAF		
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
20.5 CONTINUED e. Development expenditure may be included up to the value shown in the balance sheet 'net' of amortisation and impairment. This is provided that orders have been received, or are likely to be received, for the product developed or under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders. f. Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as a source of capital, and is not deducted from assets. g. Progress payments in respect of the partial completion of a contract are deducted from the value of the related work-in-progress and any excess is treated as capital employed. h. Prepayments by the MOD on single source contracts, calculated after adjusting the contractor's work-in-progress for any difference between the balance sheet's valuation of labour	(See 19.2)	

and overhead costs and the valuation for pricing purposes, are deducted. CONTINUED OVERLEAF		
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
20.5 CONTINUED i. Where costs are spread over several years in accordance with an agreed spreading schedule any amount not incorporated into prior period pricing rates at a balance sheet date will be included as an asset in capital employed. j. The net balance sheet figure for trade receivables is included in capital employed.	(see 19.2)	
20.6 Further general adjustments will then be applied in addition to creditors' figures captured in the financial statements. a. Finance lease creditors will be treated as a source of capital and therefore not deducted. b. All loans (including bank overdrafts) are treated as a source of capital, and therefore are not deducted. CONTINUED OVERLEAF	(See 19.2)	

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20.6 CONTINUED c. Share capital and any fixed interest loans such as debentures and specific bank (or other) loans, are usually averaged on the balance sheet figures unless any new items have been introduced during the year, when the date of such introduction is used to give a more precise average figure for that year. Short-term and fluctuating borrowed money such as bank overdrafts may be averaged by deducting the balance sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review. d. Current tax liabilities or assets and deferred taxation are treated as a source of capital, and therefore not deducted. Liabilities to make payments in respect of group relief should be treated in the same way. e. Declared dividends are treated as a source of capital, and therefore not deducted. f. Non-current liabilities, including pension liabilities, should be excluded.	(see 19.2)	

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20.7 Provided no further adjustment has taken place in the group accounts, a contractor's total capital employed in the business unit is taken as being the average of its total net assets as shown in the relevant opening and closing balance sheets for the entity for the period under review.	(see 19.3)	
	19.6 Where cash is held in a group pooling arrangement outside the balance sheet of the unit of business used for the calculation, a value of cash required for normal operations of the business unit may be included as an element of capital employed.	
	19.7 Further adjustments may be required as part of the calculation if they can be reliably estimated and have a material impact on the result. Any adjustment required will depend on the information available and the specific circumstances of the contract being delivered. Examples of such situations are: a. where a pervasive change is expected to occur that will affect the capital employed of the unit of business; or b. where considering the timing of a significant transaction during the period will give a more precise average.	Need to make general statement re normal practice (use actuals) and then allow exceptions by agreement with MOD.

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21. Fixed and working capital 21.1 For these purposes, in order to calculate the split of total capital employed between fixed and working capital (positive or negative), consideration needs to be given to identify those capital items that are of a 'fixed' in nature from the balance sheet. This figure is then subtracted from the total capital employed figure (as described above) and the balance is then determined as being 'working capital'.	**20 Fixed and working capital** 20.1 To calculate the split of capital employed between fixed and working capital employed a contractor should identify balance sheet items that are fixed in nature; this will generally include items that are held for more than one year. This 'fixed capital value' figure is subtracted from the capital employed and the balance is the 'working capital value', which may be positive of negative.	
21.2 Adequate justification should be provided to support the calculation of both fixed and working capital.	20.2 Adequate justification should be provided to support the calculation of both fixed and working capital.	
22. Calculation of cost of production 22.1 The information required for the calculation of cost of production is derived from the information supplied during the course of the assessment of cost recovery rate claims, such as the financial or management accounts. It will normally include all of the material, labour and overhead costs of the business unit subject to adjustment for certain items outlined in the paragraphs below.		
	21 Calculation of cost of production 21.1 Cost of production is the cost incurred by the functioning of a business before financing	This definition is Operating Cost Not Cost of Production.

	charges; the general definition being operating revenue less operating profit/loss.	Should be cost of one year's output (NOT sales).
Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
22.2 Cost of production, annualised where appropriate, is computed for the same relevant unit for which capital employed is computed. Among other items, it should include: a. direct costs; and b. indirect costs, with the exception of those items set out below.	21.2 Cost of production should be computed for the same relevant unit of business for which capital employed is computed and should be derived from the same information source to ensure both calculations are made on the same basis. The information should be annualised where appropriate because the capital servicing rates to which the CP:CE ratio is applied are on an annual basis.	Should read " from same financial records"

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22.3 It should exclude: a. capital expenditure; b. the cost of raising and servicing loan capital; c. distribution of profits; d. notional transactions; e. costs related to assets excluded from capital employed; f. discounts allowed on external sales; g. any loss arising from either an excess or deductible provision of a purchased insurance that arises from a MOD claim; h. the cost of premiums and payments for insurance which cover: i. that element of consequential loss insurance that relates to loss of profit; and ii. the contractor's own defects in materials or workmanship incident to the normal course of construction, such as the costs to repair defects in materials or workmanship, and for breach of contract. i. compensation payments of an abnormal nature to the extent that they are excluded from overheads; CONTINUED OVERLEAF	21.3 The following items should generally be excluded from the general definition of Operating revenue less Operating profit/loss: a. the cost of raising and servicing capital; b. costs related to items excluded from capital employed; and c. costs generally not relevant for single source MOD contracting.	NO must be for total business unit cost of production to be comparable with Capital Employed.

Allowable Costs guidance Issued 1st Feb 18, Applies from 1 Apr 18 *Text repositioned* *Text deleted*	**Pricing guidance review 2018 Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
22.3 CONTINUED j. lump sum additions to pension schemes to the extent that they are excluded from overheads; k. subscriptions and donations of a political or charitable nature; l. credits, grants or refunds deducted from overheads; and m. any other costs not considered Allowable under the guidance published by the SSRO.		
	21.4 Where exceptional adjustments have been made to capital employed in accordance with paragraph 19.5, a corresponding adjustment to cost of production may be required.	Suggest making it clear that this needs to be agreed by both parties
23. Calculation of capital servicing adjustment 23.1 Having followed the processes outlined above, the information available should then be sufficient to allow the four computations to be completed.		
23.2 Appendix C to this document sets out a worked example of the calculations required having determined the key information.		

Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Computation 1 Determine Ratio of Capital Employed to Cost of Production Fixed Capital Value **Plus** Working Capital Value (positive or negative) **EQUALS** Total Capital Employed **Divide into** Cost of Production **EQUALS** Cost of Production as a Proportion of Capital Employed (CP:CE)	**Computation 1** Determine Ratio of Capital Employed to Cost of Production Fixed Capital Value **Plus** Working Capital Value **EQUALS** Total Capital Employed **Divide into** Cost of Production **EQUALS** Cost of Production as a Proportion of Capital Employed (CP:CE)	
Computation 2 Determine the individual proportions of Total Capital Employed Fixed Capital Value **Divided by** Total Capital Employed **EQUALS** Fixed Capital as a proportion of Capital Employed Working Capital Value (positive or negative) **Divided by** Total Capital Employed **EQUALS** Working Capital as a proportion of Capital Employed	**Computation 2** Determine the individual proportions of Total Capital Employed Fixed Capital Value **Divided by** Total Capital Employed **EQUALS** Fixed Capital as a proportion of Capital Employed Working Capital Value **Divided by** Total Capital Employed **EQUALS** Working Capital as a proportion of Capital Employed	

Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Computation 3 Apply Capital Servicing Rates Fixed Capital as a proportion of Capital Employed **Multiplied by** Fixed Capital Servicing Rate **PLUS** Working Capital (positive) as a proportion of Capital Employed **Multiplied by** Positive Working Capital Servicing Rate **OR (if Working Capital is negative)** Working Capital (negative) as a proportion of Capital Employed **Multiplied by** Negative Working Capital Servicing Rate **EQUALS** Capital Servicing Rate[4] [4] The Capital Servicing Rate can be positive or negative	**Computation 3** Apply Capital Servicing Rates Fixed Capital as a proportion of Capital Employed **Multiplied by** Fixed Capital Servicing Rate **PLUS** Working Capital (positive) as a proportion of Capital Employed **Multiplied by** Positive Working Capital Servicing Rate **OR (if Working Capital is negative)** Working Capital (negative) as a proportion of Capital Employed **Multiplied by** Negative Working Capital Servicing Rate **EQUALS** Capital Servicing Rate[5] [5] The Capital Servicing Rate can be positive or negative	

Allowable Costs guidance **Issued 1st Feb 18, Applies from 1 Apr 18** *Text repositioned* *Text deleted*	**Pricing guidance review 2018** **Consultation on changes for 2019/20 - October 2018** *Text revised/moved* *Text added*	**Comments**
Computation 4 Calculate the Capital Servicing Adjustment for Step 6 Capital Servicing Rate **Divided by** Cost of Production as a proportion of Capital Employed (CP:CE) **EQUALS** Capital Servicing Adjustment to be used in Step 6 of CPR	**Computation 4** Calculate the Capital Servicing Adjustment for Step 6 Capital Servicing Rate **Divided by** Cost of Production as a proportion of Capital Employed (CP:CE) **EQUALS** Capital Servicing Adjustment to be used in Step 6 of CPR	

To: [redacted], SSRO From: [redacted], Hd SSAT

Date: 19 December 2018

ALLOWABLE COSTS - RESEARCH AND DEVELOPMENT EXPENDITURE CREDIT

Dear [redacted]

We responded to the SSRO's proposed changes to the Statutory Guidance on Allowable Costs on 7 December 2018. In the accompanying e-mail, I said that we would respond separately on the proposal on Research and Development Tax Credits (RDEC). [redacted] and I have previously discussed this matter with [redacted] and others from the SSRO.

The MOD strongly opposes the proposal for changing the way that RDEC is dealt with in single source contracts. The amendments proposed at D 1.6 and E 4.2 would have the effect that the Government pays twice for R&D costs that the Government funds. The current system avoids this by providing a mechanism by which the Government can claim back tax credits paid to companies for the R&D it has already paid for either directly or through the overheads. This amounts to around £50M per annum, most of which flows back to the Defence Industry through additional contracts to procure and support military equipment

The MOD objection to this change is three-fold: it is not the intent of the policy; it is fundamentally unfair that HMG should pay twice for R&D, failing the public perception test; and it is contrary to the technical definition of allowable costs.

Policy Intent

The tax credit scheme was introduced to boost private companies' investment in R&D. It was conceived as a tax credit – as opposed to a rebate - to ensure that even loss-making companies benefited. Changing the system to provide additional money to companies who do not use their own money to fund R&D is therefore diametrically opposed to the intent of the scheme. Where the MOD pays a contractor to perform R&D under single source pricing arrangements, which will include profit within the agreed price, the Government's view is that an additional incentive to do the work is neither needed nor justified. This argument was agreed by the Treasury when they endorsed the current arrangement. It was also accepted by the Review Board in 2014.

Fairness

Following on from this point, is the question of fairness. There is no justification for HMG to pay twice for R&D that companies do on our behalf. This does not represent value for money for the tax-payer and effectively increases the profitability of single source contracts for no additional benefit to the public. This would be a visible change with no justification, which HMG would be rightly criticised for. It would therefore fail the public scrutiny test

Allowability

It is an important principle of the regime that costs should not be allocated to a single source contract unless they are met by the contractor. Where the R&D tax credit has been applied at 12%, the contractor has only met 88% of the cost of undertaking the work, with the rest being provided by the Government. To minimise uncertainty for suppliers, the MOD only

reclaims the difference when the credit is awarded by HMRC, but the principle is no different from buying subsidised fuel or netting off prompt payment discounts.

Next Steps

The current approach was agreed by HMT and MOD, is well understood by industry and is legally, logically and presentationally defensible. A fundamental change to this approach would not be in HMG's or the public's interest and would be difficult to defend.

That said, we understand why it might not be appropriate to provide statutory guidance on the treatment of specific tax credits. We would therefore not object to the guidance being changed to be silent on this issue, providing that the principle that costs, or portions of costs, recovered elsewhere are not allowable is clearly set out.

We are happy for the contents of this letter to be made public alongside our previous return.

11. Thales UK Ltd

SSRO pricing guidance review 2019/2020:

The table below includes references to your initial pricing guidance review paper issued in Oct 2018.

In order to simplify the answers to the questions below,

a. *Do the proposed revisions make the guidance more or less clear?*
b. Will the proposed revisions make the guidance more or less easy to apply?

Thales UK have commented against each section in the table below

Aspect of guidance	**Paragraphs in proposed guidance**	**Thales UK Ltd , responses (due by 7th Dec 2018)**
Requirements of Allowable Costs	2.2 to 2.5	Verification of cost is causing additional burden on contractors and it's not totally clear what is acceptable to ensure(satisfy) that a cost is allowable so application can be quite time consuming . UK Industry does not incur cost that is not necessary for business optimisation and there should be a principle of accepting business costs necessarily incurred for running a business especially those as a result of legislative changes. There needs to be an evidence checklist which uses the information that is already supplied in detail as part of the Business unit reporting in terms of cost detail and function narrative (not a reinvention of another wheel) There should be some suggested timescales for agreement of rates used for pricing and rate agreement and the process should be similar to that of an external audit in respect of speedy year end timescales. If we agree estimates more than 6 months into the year they are of little benefit and more and more time is spent on justifying estimates in line with actual experience. An estimate by its nature is best opinion at the time of assessment and will change. There needs to be some clear examples of the sort of evidence that is required and suggestions for attributing indirect cost. (Heads, hours, space etc) For Companies who operate in Business units where there are other activities other than MOD this is particularly important as even when a cost is allowed the MOD will not ever pay 100% of the cost so disallowing in **total** costs which have no evidence of benefit to the MOD is in my view incorrect (though common practice) as the MOD only ever pay a proportion of the cost 'allowed'. The Mod get the benefit of increased business activity and efficiency improvements.

Aspect of guidance	Paragraphs in proposed guidance	Thales UK Ltd , responses (due by 7th Dec 2018)
	3.1 to 3.3	The clarification of *enabling* the performance of the contract is unclear. Indirect costs incurred by the businesses are not just for the benefit of one contract. The MOD is only *paying* for the indirect costs apportioned to MOD work. (Point as above), Cost can be recovered as part of the hourly rate or a material uplift but care must be taken in comparisons and it's the total cost that is the key not percentage of overhead etc. There are many costs that need to be incurred especially for Companies as part of a larger group which may not necessarily enable performance but improve the financial strength and future performance of the Company.- e,g Group costs. The issue we have is MOD are almost afraid of making a judgement on something that they may have done so previously, as the guidance does not make provision for the judgement of those operating to it. As a result they are taking the guidance literally rather than pragmatically. Companies do not incur unnecessary cost and usually have strict policies for any cost they may be incurring and do not differentiate those expense policies for the MOD. Therefore it may be appropriate to consider that if costs satisfy the board and auditors of the Company and the HMRC then that may be sufficient to satisfy the MOD.
	3.4 to 3.5	The references to 'suitable' and 'reasonable person' and 'public scrutiny' all introduce a level of ambiguity that dissuades agreement by MOD. Perhaps the words needs to say 'in assessing that a cost is appropriate those responsible for agreement shall pay due regard to whether the cost has been legitimately incurred (or to be incurred) by the Company and accepted as a legitimate cost by their Board, Auditors and HMRC
	3.6 to 3.7	There is currently no reference to the QMAC, being the method of allocation of costs that we agree in respect of costs charged to a MOD contract A Company can have both Commercial and MOD rates and often the rate may be customer driven. A company had a duty to its shareholders to ensure it recovers its total cost from fee paying customers

Aspect of guidance	Paragraphs in proposed guidance	Thales UK Ltd , responses (due by 7th Dec 2018)
	3.8 to 3.10	Regarding reasonableness – will the guidance be changed to allow the concept of a product cost which has a market value?
Research and development	D.1.1 to D.1.3	Research costs incurred are generally not able to enable a contract until the research has finished and a contract can then gain some benefit of the expertise gained. It's very difficult as you do not know the outcome at the beginning of a research project nor indeed whether it will be successful and certainly not at the outset the benefit that can be derived. Companies should continue to explore the benefits of research and the guidance should support this and not discourage. Any new technology will require investment and this should be allowed, though we agree in principle the proposed benefits can be discussed up front. We cannot have a regime that only rewards success as otherwise no one would try!
	D.2.1 to D.2.5	The reference to contractors accounting principles should be deleted as we may agree different treatment with the MOD. If we can demonstrate a benefit to a project we may have already written the cost off but not necessarily included the cost in our claims.
	D.3.1 to D.3.2	For Contractors whose sole work is not just MOD , we must recognise that even if the MOD do allow an element of costs in our claims , only a proportion is paid through MOD business. It is unreasonable to want to only pay for a proportion of successful costs. The costs incurred are subject to internal approvals. Therefore it may be appropriate to consider that if costs satisfy the board and auditors of the Company and the HMRC then that should be sufficient to satisfy the MOD.
	E.4.1 to E.4.4	We agree and have been explaining for some time that R&T tax credit should not be offset from our allowable cost nor indeed any other method of *sharing the benefit with the MOD*– The tax credit is essentially a tax benefit to stimulate business investment which should not then be stifled. Any attempt to do so , would not only work against the Government's aim of growing R&D but it would mean a system where one part of government implements an industry incentive (R&D tax credit), in the expectation of another part of government clawing that incentive back (in part, or in whole).

Aspect of guidance	Paragraphs in proposed guidance	Thales UK Ltd , responses (due by 7th Dec 2018)
Capital servicing adjustment	17.1 to 17.5	We need worked examples to align back to a set of statutory accounts. Industry has been calculating CP CE ratios for some time and there may be some consequences of "simplification" – such as treatment of customer advances that will not be clear unless there is a specific example ,
	18.1 to 18.5	There is an assumption that working capital requirements are similar for all contracts and for the speed of agreement, the CAS allowance can be calculated from a set of statutory accounts, and this could just be reviewed by exception. If the CSA is calculated from a set of statutory accounts or sets (some Group Companies have Property Companies) this means not all the elements will be from Qualifying business units so the qualifying reference needs to be removed.
	19.1 to 19.7	The exclusions do not seem appropriate as a Company that does a mixture of work will definitely have both assets and liabilities have balances that are not relevant for single source contracting
	20.1 to 20.2	Definition of adequate justification is unclear as accounts are always audited externally. External audit should be adequate.
	21.1 to 21.4	Fairly straightforward.
Application of the revised guidance	n/a	Thales is willing to participate in any discussions in order to ensure the objectives of DRA 2014 are met, especially in respect of the evidence that is needed to support our rate claims, We are keen to work together to improve the process of agreement to ensure a fair return for Industry and also ensure the resource required is not excessive. The requirements for estimates are a legal requirement but the level of detail is not always sufficient and it just means we have to confirm estimates in line with outturn throughout a year. We are aware that all parties are working together .

Additional questions:

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?*

There seems reluctance at times for the MOD to accept various aspects of remuneration policy such as variable compensation and other methods of reward. These are common in Industry and not so common perhaps in Government and may cause an element of angst.

Thales have worked with the MOD to ensure that all remuneration policy is understood and demonstrate we only pay an employee what we have to for retention and in line with common Industry practice.

There is sometimes an offer to include part of a cost – this is not a practice to be recommended. If cost is excluded from a Company's claim then this needs to be reflected in the BPR calculation as that calculation implies recovery of all overhead cost incurred;

d. Do you have any concerns regarding the proposed publication and application dates of the revised guidance?
No. The application must be consistent for all contractors

e. What, if any, aspects of the SSRO's pricing guidance should the SSRO;s priority for 2019

- The six step profit adjustment including incentive mechanisms
- Inclusion of the concept of a product price
- Clarificationon Bids and Proposal recovery and IFRS 15.