

SSRO

Single Source
Regulations Office

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

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1. Introduction

- 1.1 Section 20 of the Defence Reform Act 2014 (the Act) states that the SSRO must issue guidance about determining whether costs are Allowable Costs under qualifying defence contracts (QDCs) or qualifying sub-contract (QSCs). The SSRO aims to keep its guidance current and relevant and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.2 The current Allowable Costs guidance was published in spring 2019.¹ The SSRO, in consultation with stakeholders, prioritised a review in 2019 of the guidance in Part H: Risk-related costs and associated guidance in Part E.5: Insurance.
- 1.3 As part of the review, which commenced in April 2019, the SSRO:
 - a. issued a working paper to the SSRO's Operational Working Group whose members are from the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors;
 - b. held group and individual meetings with members of the OWG to discuss the issues raised by the working papers;
 - c. received written responses to the working paper from eight stakeholders, including the MOD, ADS (on behalf of its member organisations), and six contractors.
- 1.4 A summary of the working paper and the feedback provided on it by stakeholders has been published separately.² The SSRO would like to take this opportunity to thank OWG members for sharing their views with us. Their input has helped the SSRO to develop the proposals for revision to its guidance that are contained in this document for public consultation.
- 1.5 The SSRO invites all interested parties to comment on the draft guidance contained in sections 2 and 3 of this document by 6 December 2019. The proposed timetable for publication and application of the final guidance is contained in section 4. Our consultation questions and details of how to respond to the consultation are contained in section 5.
- 1.6 The SSRO provides separate guidance on the cost risk adjustment made at Step 2 of the process to determine the contract profit rate for a QDC or QSC.³ The SSRO plans to review that guidance in 2020. That review will follow the completion of this Allowable Costs guidance consultation and the SSRO's review of contract profit rates. It will also consider any relevant recommendations for legislative change which may be provided by the SSRO to the Secretary of State in June 2020 as a result of its current review of legislation.

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

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

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

2. Uncertainty and risk

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

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

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

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

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

Existing guidance	Proposed guidance	Purpose of changes
	H.2 Risk contingency element	
	1. For the purpose of this guidance, risk contingency element means an element of the costs the contractor estimates it will incur to enable performance of the contract whose actual allocation to particular cost items cannot be known at the time the Allowable Costs are determined.	<ul style="list-style-type: none"> Provides a very broad definition of risk contingency element which may include known uncertainties and risks and 'unknown unknowns'.
	2. A risk contingency element in the contractor's costs may be an Allowable Cost subject to satisfying the requirements of this guidance.	<ul style="list-style-type: none"> Makes clear that a risk contingency element may be included in the Allowable Costs.
(See H.1.1)	3. The approach or approaches to be taken when quantifying a risk contingency element in costs should be appropriate to the circumstances of the case.	<ul style="list-style-type: none"> Clarifies that how any risk contingency element is quantified should take account of the circumstances of the case.
	4. The amount of any risk contingency element in Allowable Costs should be consistent with the requirement in Part H.1.3 that an estimate of Allowable Costs should aim to anticipate the actual Allowable Costs the contractor will incur in performing the contract, having due regard for economy and efficiency in the use of resources.	<ul style="list-style-type: none"> Reiterates that in estimating Allowable Costs the parties should seek to predict the actual Allowable Costs that will be incurred by the contractor.
	<p>5. The assessment of whether a risk contingency element is an Allowable Cost should consider:</p> <ol style="list-style-type: none"> whether the uncertain costs to which the risk contingency element may be allocated are of a type and arising from activities that would, if incurred, satisfy the requirements of costs that are appropriate; whether the uncertain costs to which the risk contingency element may be allocated would, if incurred, satisfy the requirements of costs that are attributable to the contract; and whether the amount of the risk contingency element is reasonable in the circumstances. 	<ul style="list-style-type: none"> Requires the relevant parties to consider the characteristics of the uncertain costs that a risk contingency element is intended to cover in determining whether the contingency is an Allowable Cost.

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

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

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

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

3. Insurance

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

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

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

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

4. Application of the revised guidance

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

Table 1: Consultation timetable

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

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

5. Consultation questions

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

