SSRO

Single Source Regulations Office

Allowable Costs guidance review 2019

Summary of consultation responses

January 2020

Contents

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 QDCs and QSCs. The SSRO aims to keep its guidance on these matters current and relevant and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting. The current guidance on Allowable Costs[1] was published in spring 2019.

1.2 Following engagement with key stakeholders during summer 2019, the SSRO conducted an eight-week public consultation[2] on proposed changes to its Allowable Costs guidance on uncertainty and risk (Part H) and on insurance (Part E.5).

1.3 During the consultation period, the SSRO:

a. held individual discussions with members of the SSRO's Operational Working Group;[3]

b. received written responses to the working papers from eight stakeholders, including the MOD, ADS, five defence contractors and one consultant with knowledge of the regulatory framework.[4]

1.4 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 and these are available in SSRO (2020) *Allowable Costs Guidance Review 2019: Consultation Responses*.

1.5 The following sections of this paper summarise the views and evidence provided by consultation respondents, together with the SSRO's commentary on how these responses have informed the final guidance in the areas on which we consulted.

1.6 The final guidance resulting from the consideration of consultation responses has been published in SSRO (2020) *Allowable Costs Guidance Review 2019: Changes for 2020/21*.

1 SSRO (2018) *Allowable Costs Guidance*.
2 From 14 October to 6 December 2019. See SSRO (2019) *Allowable Costs Guidance Review 2019: Consultation on Changes for 2020/21*.
3 Comprising the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors.
4 The ADS response was explicitly supported by two of the defence contractors that responded to the consultation.

2. Uncertainty and risk

2.1 We set out below a summary of the key points made by stakeholders with regards to the proposed guidance on uncertainty and risk and how this has informed the final guidance to apply from 1 April 2020.

General comments

Overall approach

2.2 Industry respondents were generally positive about the proposed guidance changes and considered them to be an improvement on the existing guidance. ADS said the changes recognised the need for a case-by-case consideration of the circumstances affecting application of the guidance. This was echoed by industry respondents that considered the principles-based approach to guidance was helpful and that the proposed changes would make the guidance more flexible and workable within a broad framework. One industry respondent considered that the proposed guidance provided a greater level of clarity and consistency.

2.3 The MOD said the proposed guidance addressed some problems with the previous version but was unfit for purpose for two main reasons. Firstly, that the guidance does not use language which, the MOD said, it and contractors use in relation to this subject area. This, in its view, meant that there was little concrete guidance on what was or was not an Allowable Cost. Secondly, it considered the guidance lacked a clear set of overarching criteria by which to assess the allowability of costs. The MOD was concerned that the proposed guidance may be open to misinterpretation which could impact on negotiations.

2.4 We welcome respondents' generally positive feedback on the proposed guidance changes. We note the MOD's concerns and consider the matters of terminology and cost estimation in detail in paragraph 2.11 – 2.17 in this paper. We made some additional changes to ensure terms are clearly defined and related to terms used by stakeholders. We believe the guidance contains overarching criteria by which to assess the allowability of costs, which are provided in section 3 of the current guidance and which were revised in 2019 following consultation in 2018 with the MOD and other stakeholders. We made some additional changes to clarify how these criteria should be applied to costs affected by risk or uncertainty. We welcome feedback from stakeholders on the need for further review of the guidance in section 3 and the priority that should be attached to this. We liaised with the MOD to better understand their concerns and we are confident that the proposed form of the guidance is fit for purpose.

Examples

2.5 One industry respondent suggested the guidance would be improved further by the use of examples which, it said, would focus attention on relevant considerations.

2.6 We have previously considered the desirability of including examples in the guidance and concluded that, while desirable in some circumstances, there is a risk that they lead to an overly restrictive interpretation of the guidance. We remain open to suggestions from stakeholders as to examples which it might be helpful to provide within the SSRO's guidance. We have reflected on the potential for examples to enhance the guidance considered in this consultation and have included these in the final guidance where we consider they may be helpful.

Responsibility for risk

2.7 The MOD considered that the guidance should state that risk should be held by the party best placed to manage it. It considered this to be an important principle relevant to the achievement of good value for money. This point had been raised by ADS in response to earlier engagement on this subject.[5]

2.8 While we consider that ability to manage risk is a sound basis for allocating risk affecting contracts, we continue to believe it is a matter that goes beyond the scope of guidance for determining whether costs are Allowable Costs. The principle is already clearly established within the government's[6] and the MOD's[7] guidance on risk management which inform the agreement of QDCs and QSCs.

Application of the guidance

2.9 One industry respondent felt it was important that in publishing any new guidance the SSRO should emphasise when it takes effect. It indicated there had been issues determining which guidance should apply in the case of contracts which it said had been 'provisionally priced', although it did not consider such contracts conformed with the legislation.

2.10 When publishing new or revised guidance the SSRO routinely indicates when it takes effect. The revised guidance resulting from the consultation discussed in this document will apply to contracts which become QDCs or QSCs from 1 April 2020. The SSRO notes that the Regulations do not provide for contracts to be provisionally priced but recognise that prices might be re-determined as a result of a contract amendment. The relevant guidance to which the contracting parties must have regard will be that which applies at the time of agreement. The "time of agreement" is defined by regulation 2(1) and the SSRO has provided guidance for contractors to assist with determining the same.[8]

Part H1: Costs which are uncertain in occurrence or amount

Definitions

2.11 The MOD, ADS and some industry respondents sought further definition within the guidance of terms such as 'risk', 'uncertainty', 'contingency', and 'management reserve'. The MOD considered that the use of the term 'uncertain costs' to refer to costs affected by both risk or uncertainty made the guidance unclear and led to a failure to distinguish how such costs should be estimated. Industry respondents considered that terms were used interchangeably and in combinations within the guidance creating uncertainty and ambiguity. The MOD highlighted the taxonomy of terms it had provided in response to the SSRO's working paper in the summer, which it said reflected current practice. ADS and one industry respondent considered terms might be defined with reference to the definitions provided by the Project Management Institute (PMI). Another industry respondent provided its own definitions of risk, uncertainty, and different types of contingency (management, project and financial), although acknowledged that others may use differing terminology. Another industry respondent recognised that the guidance explained terms that were present in the legislation.

5 SSRO (2019) *Allowable Costs Guidance Review 2019: Stakeholder Responses to a Working Paper on Uncertainty and Risk*, paragraph 2.7.

6 See Section B in HM Government (2019) *The Orange Book: Management of Risk – Principles and Concepts*.

7 MOD (2015) *JSP 892 Risk Management Policy*.

8 Paragraphs 3.8 to 3.31 of SSRO (2019) *Reporting Guidance on Preparation and Submission of Contract Reports (Version 7)*.

2.12 Our engagement with stakeholders and our review of how terms are used by the MOD, contractors and professional bodies to discuss concepts related to uncertainty and risk (Appendix 1) found some significant definitional differences, for example, in the meanings given to the words 'uncertainty' and 'contingency'. These definitional differences pose a challenge to the preparation of guidance that needs to be applied consistently by different contracting parties. We consider it is important that where specific terms are used their meaning is unambiguous. We note, however, the concerns raised about use of the term 'uncertain costs' to refer to costs which are uncertain in either occurrence, amount or both, when it is common for the MOD and contractors to refer to uncertainty of occurrence as 'risk'. In finalising the guidance we have replaced the term 'uncertain costs' with references to estimated costs that may be affected by either risk or uncertainty. For ease of interpretation we have included a table which describes the character of such costs and applied terms which we believe are appropriate to guidance in light of the definitions in appendix 1. We acknowledge alternative terms may be in use, but maintain that it is the character of the cost as set out in the guidance and not the label which is ascribed to it which should determine the assessment of whether it meets the requirements of being an Allowable Cost.

How uncertain costs are quantified

2.13 The MOD considered that risk (costs whose occurrence was uncertain) and uncertainty (costs whose amount was uncertain) needed to be quantified differently. It said the guidance should describe how risk should be valued 'in terms of its likelihood and probability'. For uncertainty, guidance was needed on how the outcome of cost modelling techniques, for example, the 'most likely' figure or the 'P50' (median) value, should be used. It considered that for both risk or uncertainty the guidance needed to be clear about the treatment for contracts priced using estimated or actual Allowable Costs and explain the relationship to any final price adjustment that may be applied to the contract.

2.14 ADS supported the SSRO's position that deriving an appropriate estimate of Allowable Costs requires use of a methodology which is suitable for the purpose given the circumstances and that guidance should not prescribe the approach(es) to be taken. It considered that whether an estimate anticipated the actual Allowable Costs the contractor would incur would depend upon the estimating norms of the contractor. It questioned whether the estimate would be 'the expected cost of performing the contract'. One industry respondent considered that further guidance was needed on different approaches to quantifying uncertainty and noted that not all potential costs could or should be modelled. It agreed that it was not helpful to specify a statistical basis for determining the expected cost of a contract. Another respondent thought the proposed guidance should require that the estimate of Allowable Costs be based on the mean expected cost outturn whereby, it said, the risk of overspend was equal to the risk of underspend.

2.15 For the purpose of determining Allowable Costs we do not consider it necessary to provide guidance that differentiates between costs affected by risk and uncertainty, even if the approach to estimation may differ between them. The need to satisfy the requirements for Allowable Costs will apply equally to estimated costs which may or may not be incurred as to those for which the actual amount may be higher or lower than the estimated amount, recognising that logically the former is merely a subset of the latter. Additionally, we do not consider it appropriate for the SSRO to prescribe the approach(es) to be used to estimate costs, given the many approaches available and the need to consider what is appropriate in the circumstances of the case. We note, however, respondents' desire for additional direction on the matter of cost estimation, whilst not being prescriptive. We have therefore included in the final guidance that costs which are subject to risk or uncertainty should typically be estimated with reference to their expected value (as understood in a statistical sense), whilst allowing for the fact that other estimating metrics may be considered superior depending on the circumstances and therefore may be more suitable. We consider it out of *the scope of this guidance to set out the characteristic of the potential estimating metrics and reasonably assume that cost estimating practitioners will be able to determine the most suitable metric. We do however provide additional direction on factors to consider when determining whether an approach or approaches are appropriate to the circumstances.*

2.16 On the matter of how risk or uncertainty are treated in contracts priced using actual Allowable Costs, the final guidance (H.2.5) notes that where there are no estimated costs affected by risk or uncertainty (as should be the case in assessing whether a cost which has been determined to be actual against the requirements of Allowable Costs) there should be no requirement for a risk contingency element in the Allowable Costs.

2.17 On the matter of how the estimation of costs may be affected by the potential for a final price adjustment, we do not consider this requires clarification in the guidance. The final price adjustment amends the price of the contract, not the Allowable Costs, where the outturn costs are higher or lower than expected. Where, at the time of agreement, the estimate of Allowable Costs reflects the costs the contractor expects to incur a final price adjustment should not be anticipated. If, at the time of agreement, the estimate of Allowable Costs is such that the contractor anticipates there will be a final price adjustment we consider it must be the case that the estimate does not reflect the costs the contractor expects to incur (since the final price adjustment only applies where there is a cost variance) and should be revised.

Economy and efficiency in the use of resources

2.18 The proposed guidance requires an estimate of Allowable Costs to have due regard for economy and efficiency in the use of resources. The MOD considered this test could not be clearly applied. It repeated the suggestion it made in response to the SSRO's earlier working paper that the guidance refer to 'a well-run company seeking to maximise efficiency'. One industry respondent opposed the MOD's suggestion that a contractor being well-run and optimising efficiency should be a determinant of Allowable Costs. It considered that efficiencies would be negotiated into the contract price and did not therefore need to be considered further. It also questioned whether the requirements to be well-run and optimising efficiency could be expected of the companies that form the baseline profit rate comparator group. ADS considered that if contractors were expected to be well-run and optimising efficiency a similar expectation should also be made that the MOD would be a good customer, specifying its requirements clearly and not requiring changes to contracts which resulted in additional cost or inefficiency.

2.19 The inclusion in the proposed guidance of the requirement for a contractor's estimated Allowable Costs to have due regard for economy and efficiency in the use of resources reflects the requirements at paragraph 3.13.d. of the existing guidance; being a characteristic of a cost that is reasonable in the circumstances. We are of the view this requirement remains appropriate and do not propose to change it. The term was introduced in 2019 following engagement and consultation with stakeholders during 2018 as a more easily demonstrable and assessable consideration than whether, as previously, particular costs delivered value for money. As we said when introducing the term to the guidance, 'to the extent that economy and efficiency have influenced contract pricing… it should not be problematic for contractors to satisfy the MOD that due regard has been given to the cost of inputs (economy) or the outputs these inputs generate (efficiency)'.[9] We do not consider that the concept of 'a well-run company seeking to maximise efficiency' is any different in substance to that of 'having regard for economy and efficiency in the use of resources', but is less desirable for use in the guidance as it may be subject to wider interpretation, harder for contractors to demonstrate and lacks the benefit of familiarity, in that they are well established in other MOD and government guidance relating to demonstration of value for money[10] and it was reported that efficiency would form part of the negotiation. Accordingly, the final guidance (H.1.4 and H.2.3) reflects this requirement and makes clear its practical interpretation.

9 SSRO (2019) *Pricing guidance review 2018: Summary of consultation responses,* paragraph 2.39.

10 Ministry of Defence (2014) JSP 507 Investment Appraisal and Evaluation Part 1: Directive, paragraph 7.

2.20 We consider that the concerns raised by ADS about the MOD's performance as a customer are already dealt with by the guidance. In determining whether an estimate of uncertain costs is reasonable in the circumstances, consideration should be given to factors such as the specification of the contract (3.14.b of the existing guidance) and the impact of events which were not anticipated at the time of agreement (3.14.e).

2.21 Neither the final guidance or BPR methodology include a requirement for companies to be well run or optimise efficiency. The approach the SSRO takes to the requirements of Allowable Costs in respect of companies that form the baseline profit rate comparator group is set out in the question and answer briefing on our annual rates recommendation.[11]

Other comments

2.22 The following additional comments were made on specific parts of the proposed guidance.

Part	Summary of comments made
H.1.2	ADS considered that 'uncertain costs' in this paragraph needed to be defined. *As noted above, in finalising the guidance we have replaced this term.*
H.1.3	ADS supported the view expressed by the SSRO in its summary of working paper responses[12] that all risk must be considered in forming an estimate of the Allowable Costs. One industry respondent considered the guidance should state this more explicitly. *The final guidance now notes that for estimated costs to be Allowable Costs the estimate should include cost that are affected by risk or uncertainty.* Industry respondents questioned whether repeated reference needed to be made (here and elsewhere in the proposed guidance) to particular requirements, for example, 'having due regard to economy and efficiency in the use of resources' (which features in Part 3, paragraph 13d). *Although the guidance should be considered in its entirety, we consider it helpful in some cases to reinforce aspects of the guidance where these are particularly relevant to the achievement of value for money and fair and reasonable prices.*

11 SSRO (2018) Key questions and answers regarding the methodology 2019/20, question 14.
12 SSRO (2019) *Allowable Costs Guidance Review 2019: Stakeholder Responses to a Working Paper on Uncertainty and Risk*, paragraph 2.47.

Part	Summary of comments made
H.1.4	ADS sought clarification on the meaning of 'costs already incurred by the contractor'. It questioned whether this included sunk costs, costs incurred up to the point the contract became a QDC/QSC and the costs of pre-contract mitigation actions taken by the contractors prior to contract award. *For the purpose of this guidance we consider the term refers to any costs that have been incurred prior to the point at which the Allowable Costs are being determined. The extent to which these costs are Allowable Costs will depend on their meeting the requirements set out in the guidance.* ADS suggested that the guidance refer explicitly to mitigation actions agreed in risk mitigation plans and recorded in the original contract. *The final guidance (H.1.3) now refers to risk mitigation actions.* ADS queried whether the actual Allowable Costs which should be anticipated were 'the expected Allowable Costs'. *To the extent that 'anticipated' and 'expected' both refer to one's view of a future outcome, they have the same meaning. Where any statistical interpretation is ascribed this is now stated in the guidance. The final guidance (H.1.7) does now note that costs which are affected by risk or uncertainty might typically be estimated with reference to their expected value as that term is defined in the statistical sense.* One industry respondent sought clarification on the intended meaning of 'terms and conditions of the contract' in the proposed guidance (H.1.4), believing this meant both the requirement itself and the commercial terms and conditions associated with the contract. *We use the term to mean the agreement of the parties which establishes their mutual obligations for the purposes of delivering a requirement. This may include commercial terms and other aspects of the contract relating to the requirement.*
H.1.5	One respondent sought additional clarity on the requirement to 'consider the type, purpose and estimated amount of the uncertain costs'. *The term was intended to encourage consideration of whether costs are appropriate (type), attributable to the contract (purpose) and reasonable in the circumstances (estimated amount). However, we no longer consider the sentence necessary and have removed it from the final guidance.*
H.1.6	ADS questioned the necessity of referring to 'the relevant parties' throughout the guidance. *In previous engagement on the Allowable Costs guidance it has been considered desirable to refer to 'the relevant parties' as in some cases it may be the Secretary of State and a prime contractor or sub-contractor and in others it may be the prime contractor and a sub-contractor.*

Part	Summary of comments made
H.1.7	One industry respondent considered that in the absence of further direction on the evidence that might be considered sufficient to demonstrate that costs with varying degrees of uncertainty met the requirements of Allowable Costs there could continue to be disagreement between the contracting parties on this; leading to protracted contract negotiation. Another industry respondent cautioned against spurious accuracy in the assessment of risk. The MOD considered that the guidance needed to make clear that evidence would be required for any amount of contingency (for costs not identified in the modelling or risk register), and the guidance should indicate what evidence would be acceptable. *The range of evidence available to contractors to evidence risk or uncertainty will depend on the nature of the risk or uncertainty surrounding estimated costs. The MOD and contractors will have their own approaches to quantifying risk or uncertainty. Depending on the circumstances of the case, suitable evidence might include risk registers, lists of assumptions, cost models or other cost aggregation methods. The final guidance (H.1.9) provides examples of evidence that might be available and (H.1.10) additional direction on factors to which the relevant parties should have regard when determining what it is reasonable to expect would be available. Where there is disagreement between the parties as to whether adequate evidence has been provided to demonstrate that costs affected by risk or uncertainty are Allowable Costs the matter might be the subject of a referral to the SSRO for an opinion or determination.*

Part H2: Risk contingency element

Definition of contingency

2.23 ADS considered greater clarity was needed in defining contingency and risk allowance. One respondent considered there needed to be more explicit reference to contingency for risk and contingency for uncertainty. Another industry respondent indicated that ‘risk contingency element’ was not a commonly used term and suggested this might preferably be called ‘cost contingency for risk or uncertainty’. Another considered that the definition proposed in the guidance was broadly acceptable, but that it might usefully identify that the contingency would fund costs that may or may not happen and whose amount is unknown.

2.24 The SSRO’s guidance seeks to define the meaning of ‘risk contingency element’ which is a term used in the Regulations and is therefore the terms which has been used in the guidance. As noted earlier and in Appendix 1, the term ‘contingency’ appears to have different meanings. For some stakeholders it relates to an allowance for known risk and uncertainty. For others it relates to an allowance for unidentified risk (which is referred to by some others as ‘management reserve’). Our final guidance (H.1.1 an H2.2) provide a definition of term ‘risk contingency element’ for the purposes of the guidance, notes that different terms may be in use and that this should not alter the substantive interpretation or application of the guidance.

Unforeseeable events

2.25 ADS and two industry respondents sought additional clarity on how costs arising from unforeseen events (or ‘unknown unknowns’) should be treated in determining Allowable Costs and the cost risk adjustment. One industry respondent considered that a cost which might be incurred but whose value could not be known (or evidenced, other than by modelling) might still be an Allowable Cost. Another considered it might be helpful to make explicit reference to the consideration of past evidence to inform the determination of Allowable Costs where there was uncertainty. For example, where past experience indicated costs could be incurred in performance of a contract even though there was uncertainty about their amount or specific allocation to cost items.

2.26 The MOD considered that contingency for unidentified risks should only be permitted as an Allowable Cost where a robust justification was provided. It was concerned that contractors would be less thorough in their assessment of risks if they were able to include contingency for unidentified risks within the Allowable Costs.

2.27 As the final guidance makes clear (H.2.3), whether or not a 'risk contingency element' intended to capture the any estimated cost is determined to be an Allowable Cost , including those considered to be 'unknown unknowns', will depend on the extent to which the parties are satisfied that it meets the requirements of the guidance. This includes matters such as how it is quantified and there being a proportionate evidential basis to support its inclusion. The guidance now indicates matters to which consideration should be given in determining whether the amount of any risk contingency element is reasonable in circumstances.

Very-high impact, very-low probability risks

2.28 One respondent considered it might be helpful to provide additional guidance on alternative contractual approaches to dealing with very-high impact, very-low probability risks.

2.29 We note that where the probability of a risk occurring is very low estimated costs affected by the risk may not be considered reasonable in the circumstances and will not, therefore, be included in the Allowable Costs of the contract. There are a range of ways that the contracting parties may deal with such potential costs, for example, through the purchase of insurance, which might meet the requirements of Allowable Costs, or through the use of a pricing method based on actual Allowable Costs, or other terms and conditions of the contract. However, we do not consider that the choice in respect of contracting approaches is a matter to be addressed by the guidance on determining Allowable Costs.

Other comments

2.30 The following additional comments were made on specific parts of the proposed guidance.

Part	Summary of comments made
H.2.5	ADS considered that the assessment of whether an actual cost was reasonable in the circumstances should be made with reference to the view of uncertainty that prevailed when a cost was committed to. It thought this should be made clearer in the guidance. *In determining whether an actual cost is reasonable in the circumstances (for contracts which use pricing methods based on actual Allowable Costs) the extant Allowable Costs guidance (paragraph 3.14) already indicates that consideration must be given, among other factors, to 'uncertainty and risk affecting estimated costs' as well as 'the impact on actual costs of events which were not anticipated at the time of agreement'. We consider that guidance part H already gives effect to ADS proposition.*

Part	Summary of comments made
H.2.6	One respondent considered reference to a ‘reasonable person informed of the facts’ was inappropriate as such a person was unlikely, it said, to understand the topic at hand. ADS suggested including ‘with relevant experience’ after reasonable person. *The concept of ‘a reasonable person informed of the facts’ was introduced to section 3 of the guidance in 2019 following engagement and consultation with stakeholders in 2018. Its function within the guidance is to promote objectivity in the determination of Allowable Costs., We consider it unlikely that a person who did not understand the topic at hand, through relevant experience or otherwise, could be considered as being informed of the facts. While the final guidance at H.2 does not include the expression, it continues to feature in the Allowable Costs guidance at paragraphs 3.11 and 3.13.* One respondent supported the proposed guidance that the level of uncertainty surrounding costs should be consistent with the contractor’s experience in performing similar contracts. However, another considered this might result in risks that have not previously materialised being excluded from consideration. ADS highlighted that the contractor may not have any prior experience of performing similar contracts and that the guidance should, therefore, refer simply to what would be expected for similar contracts. *We do not consider any changes are required to the proposed guidance in respect of these points.* *The requirement (H.2.3.c in the final guidance) to consider whether the amount of any element of risk contingency in costs is reasonable in the circumstances given the contractor’s experience in performing similar contracts (now broadened to activities) should not preclude risks that have not previously materialised being excluded from consideration. However, the evidence of past experience will clearly be relevant to determining whether a contingency for the risk is reasonable in the circumstances of the contract in question.* *Where the contractor has no prior experience of performing similar contracts, the level of contingency associated with risk or uncertainty affecting costs might reasonably be higher than for a contractor with extensive experience, who might reasonably be expected to estimate the costs of performing the contract with greater certainty. If, as ADS suggested, the guidance required comparison to be made to the performance of similar contracts by other contractors (who may have more experience), this might result in the contractor being held to a higher level of expected performance in cost estimation than was reasonable in the circumstances.*
H.2.8	One respondent requested a more specific reference to the relevant parts of the SSRO’s reporting guidance. *The final guidance (H.2.6) includes a more specific reference in the footnotes.*

Part H3: Costs associated with mitigating uncertainty

Direct or indirect application

2.31 ADS noted that mitigating actions may be taken on a whole-company basis and the guidance should permit either the direct or indirect allocation of such costs to a contract.

2.32 The final guidance (H.3.2) acknowledges this point.

Foresight or hindsight

2.33 One industry respondent considered the proposed guidance might be clearer that in assessing whether the costs of mitigation are reasonable in the circumstances an assessment is required of the expected benefits of the mitigating action prior to it having been undertaken, not what actually occurred. Another was concerned that the guidance did not provide for some costs of risk mitigation to be deemed Allowable Costs if the mitigations were not called upon as the risk never materialised. ADS considered that the determination of whether costs of risk mitigation were Allowable Costs would need to be made at the time of price agreement, not retrospectively.

2.34 We consider that the final guidance (H.3.4) is sufficiently clear that, when determining whether the costs of mitigation are reasonable in the circumstances, due regard for economy and efficiency will be demonstrated by the relative amounts of the costs of mitigation and any <u>anticipated</u> reduction in the amount of a cost or costs as a result of the mitigating actions. The guidance applies equally to estimated and actual costs. The point at which the costs of mitigation will be determined to be Allowable Costs will be governed by the requirements of the contract pricing method.

What uncertainty is being mitigated

2.35 One industry respondent considered there was too much emphasis in the proposed guidance on mitigating cost uncertainty when the priority might be mitigating schedule risk.

2.36 The final guidance (H.3.1 to H.3.4) has been revised to refer to costs of mitigation which includes (H.3.3) costs of action to reduce the likelihood and impact of risk or uncertainty affecting the costs of performing the contract including schedule risk.

Other comments

2.37 The following additional comments were made on specific parts of the proposed guidance.

Part	Summary of comments made
H.3.2	One industry respondent considered that costs incurred by the contractor to avoid or reduce the effect of 'any financial imposition against the contract' (including liquidated damages) should be an Allowable Cost even if the cost reduced or avoided were not clearly a recoverable cost. *Our final guidance (H.3.3) requires that for the costs of mitigation to be considered to enable the performance of the contract, they must be incurred with the intention of mitigating risk or uncertainty affecting a cost which, if it was incurred, would satisfy the requirements to be appropriate and attributable to the contract, or some other aspect of contract performance, such as schedule. Costs associated with mitigating risk or uncertainty affecting a cost which, if incurred, would not be appropriate or attributable to the contract, or we not related to another aspect of contract performance would not be considered to enable the performance of the contract and, therefore, would not be Allowable Costs.* *We considered the related matter of whether the potential for incurring liquidated damages through breach of contract was a risk for which a contingency might be included in Allowable Costs in the summary of responses to our working paper on uncertainty and risk.[13] The current guidance (E.3) states that compensation [paid by a contractor] is not an Allowable Cost. While, in general, we considered it unlikely that it would be appropriate for an injured party to pay for its own compensation, as would be the case if such a cost were an Allowable Cost, we noted that there may be circumstance where some discretion was required. We indicated that more detailed consideration of this matter was required, which should include consideration of the other performance incentive mechanisms provided for under the regime. We remain open to receiving further commentary from stakeholders on this matter.*

Part H4: Cost risk adjustment

Relationship to contingency

2.38 ADS supported the view expressed by the SSRO in the summary of responses to its working paper[14] that the cost risk adjustment should not be regarded as a contingency for uncertain costs. It also supported the MOD's view, reported in that paper, that the cost risk adjustment should not be used to compensate contractors for the expected cost impact of risks which could be identified and estimated. ADS considered that the cost risk adjustment addressed risk areas that, by their nature, could not be estimated. In the light of this it suggested the guidance be more explicit that a cost risk adjustment could be applied to a contract even when a contingency (for identified and quantified risk) was included in Allowable Costs.

2.39 The contractor's ability to identify and quantify risk or uncertainty affecting a cost is not the central determinant of whether that risk or uncertainty is addressed in the determination of Allowable Costs or in determination of the cost risk adjustment for the contract. Indeed, given that the cost risk adjustment is intended to reflect the risk of the contractor's actual Allowable Costs under the contract differing from its estimated Allowable Costs, the ability to identify and quantify risk or uncertainty is as relevant to the determination of the cost risk adjustment as it is to the determination of Allowable Costs. In response to stakeholder feedback, the final guidance makes clear that the cost risk adjustment should not be used as substitute to the cost estimate to capture anticipated costs in the contract price.

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

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

2.40 *The current guidance on cost risk adjustment requires consideration, among other factors, of the extent to which cost risk should be covered through Allowable Costs,[15] which might include through having included a risk contingency element in the Allowable Costs. We do not consider any further direction is required in the Allowable Costs guidance at the present time but will consider the matter further when we review the guidance on cost risk adjustment in due course.*

Other comments

2.41 The following additional comments were made on specific parts of the proposed guidance.

Part	Summary of comments made
H.4.1	One industry respondent welcomed the clarification provided in the proposed guidance on how the risk of variance between estimated and actual Allowable Costs might be reflected through the agreement of a cost risk adjustment in determining the contract profit rate. One other respondent was concerned that the proposed guidance suggested it may be permissible to agree the Allowable Costs at a level which was lower or higher than the anticipated value of the actual Allowable Costs the contractor would incur in performing the contract (which was in contradiction to the proposed guidance at H.1.3). *The final guidance (H.1.4) makes clear that for a contractor's estimated costs to be Allowable Costs the estimate should aim to anticipate the actual Allowable Costs the contractor will incur in performing the contract. We do not consider there is anything in the guidance which suggests otherwise.*

Other matters

2.42 In finalising the guidance, we have made a number of minor revisions where feedback from respondents suggested greater clarity was needed or could be provided. We are grateful to those who suggested specific changes.

15 Paragraph 3.15 of SSRO (2019) *Guidance on the Baseline Profit Rate and its Adjustment (Version 5)*.

3. Insurance

3.1 We set out below a summary of the key points made by stakeholders with regards to the proposed guidance on insurance and how this has informed the final guidance to apply from 1 April 2020.

Part E5: Insurance

Different types of insurance

3.2 One industry respondent considered that the proposed guidance did not go far enough to provide unambiguous direction on determining whether insurance costs were Allowable Costs. It considered that insurance required by law, insurance that was required by the contract terms, and insurance which was typically purchased by businesses (including those in the baseline profit rate comparator group) should be Allowable in principal subject to meeting the requirement of the AAR test. It also considered it may be beneficial to identify types of insurance that would not be Allowable, for example, insurance against the risk of incurring liquidated damages or business interruption. Another industry respondent commented that businesses did not generally tend to incur unnecessary costs, and that this would be true of insurance costs.

3.3 We agree that insurance required by statute or by the contract terms should be considered to enable the performance of the contract. We have amended the guidance at E.5.2 to reflect this.

Who benefits from insurance?

3.4 One industry respondent considered it might be useful for the guidance to direct the relevant parties to consider who benefits from any insurance when determining whether it is an Allowable Cost. This, it said, was related to the pricing method used for the contract.

3.5 We have considered the question of who benefits from insurance and are not clear at the present time what guidance might be provided regarding the influence this has on whether insurance costs are Allowable Costs. We welcome further views from stakeholders on this to inform further consideration of the need for related changes.

Relationship to contingency

3.6 One industry respondent noted that the absence of insurance might result in an increase in the level of contingency in Allowable Costs.

3.7 We recognise that both the purchasing of insurance and the inclusion of contingency in costs are forms of mitigation against risk or uncertainty. The final guidance (H.2.5.c.i) requires that the assessment of whether the amount of any risk contingency element is reasonable in the circumstances considers 'the extent and nature of the risk or uncertainty affecting the estimated costs to which the risk contingency element may be allocated'. Given that the presence or absence of insurance will impact on the extent of uncertainty affecting estimated costs we consider no more specific guidance is required on this point.

Other comments

3.8 The following comments were made on specific parts of the proposed guidance.

Part	Summary of comments made
E.5.2	ADS suggested the guidance say 'met or reduced' as the contractor may be unable to recover all its costs under an insurance claim. *We have amended the final guidance to reflect this point.*
E.5.3	ADS considered the proposed guidance required revision as the cost of purchasing insurance would always be greater than the sum insured multiplied by the likelihood of occurrence due to the profit and administration costs of the insurer. One industry respondent reported that insurance purchased to provide cover for multiple contracts was often cheaper than purchasing separate insurance policies. *The test required by the guidance is whether the costs of insurance demonstrate due regard for economy and efficiency in the use of resources given the estimated likelihood and impact of the insured event. It does not require an assessment of actuarial fairness. In the final guidance we have included an additional requirement to consider what, if any, other benefits are anticipated to arise for the Secretary of State as a result of purchasing the insurance when determining is insurance costs are reasonable in the circumstances.*
E.5.4	One industry respondent explicitly supported the changes to the guidance on the indirect application of insurance costs to contracts.
E.5.6	The MOD considered that the guidance needed to make clear how uninsured costs associated with insured events would be estimated and how they would be treated under different contract pricing methods. *An uninsured cost is a cost which is affected by risk or uncertainty. We consider that the allowability of a contractor's uninsured costs associated with insured events should therefore be determined in the same way as any other costs. We have amended the guidance to make this point clear, but do not consider any further changes are required in this respect.*

Other matters

3.9 In finalising the guidance, we have made a number of minor revisions where feedback from respondents suggested greater clarity was needed or could be provided. We are grateful to those who suggested specific changes.

4. Future review

4.1 As part of the consultation we invited respondents to identify whether there were any aspects of the SSRO's pricing guidance that we should prioritise for review in 2020. Respondents identified a number of topics they considered required attention (Table 1).

Table 1: Pricing issues identified by consultation respondents

Topic	Comments
Cost risk adjustment	ADS and three industry respondents welcomed a review in 2020 of the guidance on the cost risk adjustment in determining the contract profit rate for a QDC/QSC and its interaction with guidance on uncertainty and risk in determining Allowable Costs.
Evidence to support determination of Allowable Costs	One industry respondent suggested a future review of guidance consider further clarification on what constitutes adequate evidence.
Contract price amendments	One industry welcomed consideration in 2020 of the need for guidance on the Regulations related to contract price amendment.
Alternative pricing	One industry respondent suggested a future review of guidance consider the treatment of products which might be priced with reference to catalogues or price lists
Private venture bid costs	One industry respondent suggested a future review of guidance consider private venture bid costs.
Cost of production	One respondent considered there should be a review of guidance on determining 'cost of production', which was relevant to the calculation of the capital servicing adjustment and the reporting by qualifying business units of estimated and actual rates claim reports.
Sunk costs	ADS considered that a clearer definition in guidance of sunk costs was required, considering actual costs, committed costs and costs in inventory at the time a contract become a QDC/QSC.

4.2 Additionally, ADS considered that the requirement to report any risk contingency element in Allowable Costs should be reviewed as it appeared to serve no useful purpose and the data would, it said, be of poor quality.

4.3 These matters have been logged and we will consider and discuss priorities for future work with stakeholders as part of the SSRO's corporate planning for 2020/21 and beyond.

4.4 There were two other matters raised by one industry respondent.

a. How costs that might be disallowed in QDCs or QSCs could be adjusted for in determining the baseline profit rate. The SSRO provided a response on this matter alongside its 2019 rates recommendation.[16]

b. The practicality of having multiple profit rates on a contract. The SSRO has invited feedback on matters related to the segmentation of profit rates in contracts as part of its consultation (closing on 28 February 2020) related to the 2020 review of the procurement framework for single source defence contracts.

16 See Section 14 of SSRO (2019) *Key questions and answers regarding the SSRO's Single source baseline profit rate, capital servicing rates and funding adjustment methodology*.

Appendix 1: Use of terms

A1.1. The following table presents definitions of terms relevant to the topic of uncertainty and risk in use by the MOD, contractors and professional bodies.

Table A1: Definition of terms related to uncertainty and risk

Source of definition	Concepts			
	Risk	**Uncertainty**	**Contingency**	**Management reserve**
International Organisation for Standardization (2009) *ISO 73:2009 Risk Management – Vocabulary*.	The effect of uncertainty on objectives, which may be either positive or negative.	Uncertainty arises where there is limited understanding of an event, its likelihood of occurring, or its consequences.		
Project Management Institute (2017) *A Guide to the Project Management Body of Knowledge – Sixth Edition.*	An uncertain event or condition that, if it occurs, has a positive or negative impact on one or more project objectives.		Contingency: An event or occurrence that could affect the execution of the project that may be accounted for with a reserve. Contingency reserve: Time or money allocated in the schedule or cost baseline for known risks with active response strategies.	Management reserve: an amount of the project budget or project schedule held outside of the performance measurement baseline for management control purposes, that is reserved for unforeseen work that is within the scope of the project.
Association for Project Management (2012) *APM Body of Knowledge (6th edition)*	*Detailed level:* An uncertain event or set of circumstances that, should it occur, will have an effect on achievement of one or more objectives. The potential of an action or event to impact (positively or negatively) on the achievement of objectives. *Higher level:* Exposure of stakeholders to the consequences of variation in outcome arising from an accumulation of individual risks together with other sources of uncertainty.		Money (or resource) set aside for responding to identified risks.	A sum of money held as an overall contingency to cover the cost of some unexpected event. A management reserve covers things that could not have been foreseen, such as changes to the scope of the work or unidentified risks. The more uncertainty there is, the more management reserve is required; so highly innovative work will need a larger management reserve than routine work.

Source of definition	Concepts			
	Risk	Uncertainty	Contingency	Management reserve
MOD Risk Management Policy (JSP 892 Pt 2, v1.0 July 2015))	An uncertain future event that could have an effect on the achievement of objectives. A risk consists of a cause, an event and consequence(s), and its magnitude is often expressed as a product of its impact and likelihood. A risk: • is forward-looking (not a current issue); • has an element of uncertainty; • could affect the achievement of objectives; • must be credible and foreseeable; and • can have both positive and negative effects.			
MOD Investment Appraisal and Evaluation Part 2 (JSP 507)	The probability of a cost or benefit turning out different to that predicted. An event which may or may not occur, where the probability of occurrence and financial impact are susceptible to measurement.	An event that will occur, which has more than one possible outcome. The condition in which the number of possible outcomes is greater than the number of actual outcomes and it is impossible to attach probabilities to each possible outcome.	An allowance of cash or resources to cover unforeseen circumstances	
MOD Acquisition System Guidance Preferred Terms & Definitions for Risk Management	A risk is a significant, unplanned, and uncertain event or situation that, should it occur, has an effect on at least one project or programme activity, or business objective. Overall, a risk is assessed by combining its probability and the magnitude of its impact(s) on objectives. A detrimental risk is often called a 'threat'; and a beneficial risk is called an 'opportunity'.	Arises from any situation where the outcome cannot be precisely predicted. Uncertainty includes both the variability of estimates, typically captured as a three-point estimate, and the potential occurrence of specific threats and opportunities.	Resources held in reserve for the unknown i.e. unforeseeable risks (contrast with Management Reserve).	Planned resources set aside for response actions, especially fallback actions, making provision to an appropriate degree for the known aggregated risk. The Management Reserve will be derived from the available risk information, in a justified and auditable way. Although the reserve, or a portion, may be held centrally, objectives cannot be delivered confidently without it so it must be explicit and protected. Note that completely unknown risks cannot be catered for within a Management Reserve (contrast with Contingency).

Source of definition	Concepts			
	Risk	Uncertainty	Contingency	Management reserve
MOD response to SSRO working paper (16 July 2019)	A risk is a discrete event which may or may not occur, and which would affect the cost borne by the supplier. All risks should be included in allowable costs. Where the impact or likelihood is difficult to calculate using standard techniques, evidence-based judgment may be applied.	In this context, uncertainty is used to describe the extent to which actual costs might vary from expected costs. Uncertainty is dealt with through Step 2 of the contract profit setting process, and therefore never compensated through costs.	A sum included in the price to cover costs that might be borne by the contractor but have not been picked up by though their risk management or cost modelling processes. Contingency may be an allowable cost where there is clear evidence that 'unknown unknowns' have frequently increased costs historically, or the cost modelling technique employed systemically underestimates expected costs. Where contingency is included, it should be made clear that the contractor will not seek relief for unforeseen costs beyond those that might be payable under the Final Price Adjustment, except where these fall into specifically agreed categories.	
Industry responses to SSRO working paper July 2019	(1) Risk provisions: All provisional costs deemed uncertain during the bid process by the management responsible: work package contingencies, project contingencies, management contingencies. (2) Threats and opportunities (3) Risk and uncertainty are treated as separate elements when estimating Allowable Costs. Risk is measurable, whereas uncertainty is not. (4) A risk may or may not arise with an estimated impact and likelihood of occurrence.	(1) Uncertainty – variations (2) Risk and uncertainty are treated as separate elements when estimating Allowable Costs. Risk is measurable, whereas uncertainty is not. (3) Uncertainty describes an event that will happen, but with a potentially wide range of variability in impact on Allowable costs.		