SSRO

Single Source
Regulations Office

Consultation on new and amended pricing guidance

Consultation responses

10 October 2024

Contents

1. Babcock 3
2. BAE Systems 7
3. Leonardo 14

.

1. Babcock

[redacted]

Guidance on the Pricing of Qualifying Defence Contracts and Subcontracts

Consultation on Guidance Changes from the Review of Legislation

Babcock International Group Response

We welcome the opportunity to participate in this consultation. As we are part of the Industry group DSAG, we are supportive of their response to this consultation.

We take this opportunity to point out some errors in the Profit Rate guidance Version 8.

Para 3.6 (page 11) should read 1st April 2024 and the table should read 2024/25 BPR.
Para 6.3 (page 11) footnote 12 requires update to reference Version 12 of the Guidance.
Para 6.4 (page 21) should also read 1st April 2024.

The responses to the questions posed by the SSRO are concerns and viewpoints expressed by Babcock.

Question 1: Our guidance on the cost risk adjustment remains under review. We welcome specific suggestions on any further improvements that could be made or alternative approaches on how to help stakeholders navigate step 2.

Reference to Appendix C in paragraph 4.11 implies that these are the only risk factors that should be considered. It should be clear that Appendix C provides a list of examples that is not exhaustive.

The cost-plus and estimate-based fee elements should not be automatically set at minus 25%. This does not reflect the risks that the contractor may be expected to take in terms of performance, especially in relation to KPI penalties. This should be assessed on a contract by contract basis.

Para 4.19-4.21 discusses transfer of risk. It should be noted that this does not automatically imply a negative assessment for CRA as the prime contractor still has to manage the MoD programme and deliver the contract. The ongoing risk is that a subcontractor may cease business and the prime will s

It is recommended that reputational risk is added to the list of examples in Appendix C.a

Question 2: Our guidance on the incentive adjustment remains under review. We welcome specific suggestions on any further improvements that could be made or alternative approaches on how to help stakeholders navigate step 3.

There should be some rationalisation in this area as some of the points are repeated or expressed with more detail. Para 5.10 h covers most of the detail.

Question 3: We welcome feedback on the proposed guidance and the worked example for costs associated with group profits.

The SSRO has taken the opportunity to have a standardised introduction across its guidance documents. The section about components requires some revision. In many cases components will be formed due to the pricing and contracting methodology used by MoD. In some cases, these will result in unintended reporting requirements. It is presumed that the regulations will be modified to adjust accordingly. Some of the new reporting requirements run counter to the legislation aims of value for money.

Section I, POCO adjustment requires additional commentary about situations when POCO does not apply. This will be the case where the subcontract is competed.

The worked example does provide some clarity as the table can seem quite daunting.

[redacted]

Question 4: We welcome feedback on any of the proposed guidance on these points in relation to the commercial pricing alternative pricing method, including any points of error and specific suggestions for improvement in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the legislation.

The principles of commercial pricing are understood and will work for some items. Where the specification changes substantially, this pricing option becomes redundant.

Question 5: We welcome feedback on any of the proposed guidance on the prices set by law pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the legislation.

No comment.

Question 6: We welcome feedback on any of the proposed guidance on the previously agreed pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

No comment.

Question 7: We welcome feedback on any of the proposed guidance on the novated contracts pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

Figure 2 is missing a 'No' decision point in box 3.

Question 8: We welcome feedback on any of the proposed guidance on the CRUV method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

No comment.

Question 9: We welcome feedback on any of the proposed guidance on the agreed changes to the contract profit rate pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which is compliant with the new legislation.

More clarity should be provided where the profit rate is provisional due to the CSA not being agreed and the treatment in this circumstance.

Question 10: We welcome feedback on any of the proposed guidance on the aggregation of components method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

The SSRO appear to have misinterpreted the regulations when producing the examples for CRA and IA. The intent is to apply contract level adjustments to the total allowable costs. The SSRO should make clear what should happen where alternative pricing methods are used. The current example excludes CRA and IA from the alternative pricing element when applying to the total contract.

[redacted]

Question 11: We welcome feedback on any of the proposed guidance changes made to support the usage of componentisation within the regime, including any points of error or specific suggestions for improvements in clarity and applicability.

From a pricing perspective we understand the need for components. This will remove the reporting of a blended profit rate at contract entry. This does not detract from the requirement to show the contract build up from components to total contract. This can be done in a tabular format.

The reporting aspect will be covered in more detail in the reporting guidance consultation. It is considered that a revised approach should be taken to reduce the contract reporting burden.

2. BAE Systems

BAE SYSTEMS

Consultation Response April 2024

Consultation on guidance changes arising from the review of legislation

In response to your invitation to comment on the SSRO's Consultation on 'Guidance on the Pricing of Qualifying Defence Contracts and Subcontracts' please see below BAE Systems' input.

Any observations made within this consultation response are in regards to the following new and updated guidance documents:

- Guidance on alternative pricing types – version 1
- Allowable costs guidance – version 7
- Guidance on the baseline profit rate and its adjustment – version 8

BAE Systems intends to provide a further response to the SSRO's open consultation regarding the new and updated reporting guidance before the June deadline for that consultation.

Question 1: Our guidance on the cost risk adjustment remains under review. We welcome specific suggestions on any further improvements that could be made or alternative approaches on how to help stakeholders navigate step 2.

Guidance on the baseline profit rate and its adjustment:

In Section 4.14 we do not agree with the guidance that the application of the estimate based fee default pricing method should have a starting point of minus 25 percent for the cost risk adjustment. The risks associated with contracting on a cost plus basis are not the same as those under an estimate based fee basis. The assessment should, as per your new guidance, start with a consideration of the financial risks to contractors, not just an assessment of whether the actual allowable costs of the contract will vary from the allowable costs in pricing. When assessing contract profitability, we measure relative profitability. This is driven by our shareholders, who measure our company's profit performance on a Return on Sales percentage. Under the estimate based fee approach a 'fixed' amount of fee is delivered, with any fluctuation in allowable cost diluting this relative profitability. Contracts using the estimate based fee method therefore carry a financial risk against their Return on Sales percentage that cost plus contracts do not. We believe this needs to be reflected in the agreement of the cost risk adjustment. The two are not the same.

Section 4.17 of the guidance on the baseline profit rate and its adjustments requires further clarity. Firstly, where reference is made to activities under a contract or component differing substantially from those underpinning the BPR, how would 'substantially' be defined? It is likely that contracting parties will take a differing view of what constitutes a substantial difference, especially given the wide range of activities which are captured within the comparator group (development, manufacture, support, maintenance and asset provision as cited in 4.16). The guidance would benefit from some examples.

Secondly, we do not believe contractors or the Authority generally have enough information to accurately assess the range of activities covered by the comparator group. Without detailed data to compare the activities and risk profiles of the comparator companies to that of the contract in question it would be difficult to provide evidence that an activity based adjustment is required to ensure no unfairly high or low rate of profit is applied to a contract or component as required by section 4.17.

Section 4.20 and 4.23 call for evidence to be provided in respect of the risk categories identified in Appendix C. Can further clarity, possibly including examples, be provided here as to what would constitute 'evidence'. It is unlikely a contractor's perception of future risk will always be underpinned by historic evidence. It may be more appropriate to refer to 'adequate justification' as defined in section 4.8.

Appendix C requires expanding with regard to reputational risk. This is included in the title of the fourth risk category, but is is not drawn out within the risk descriptions.

Question 2: Our guidance on the incentive adjustment remains under review. We welcome specific suggestions on any further improvements that could be made or alternative approaches on how to help stakeholders navigate step 3.

Guidance on the baseline profit rate and its adjustment:

Within 5.10.a, reference is made to any costs incurred by the contractor associated with the activities delivered to achieve enhanced performance delivery in pursuit of an incentive payment under step 3. We feel it necessary to expand this guidance to clarify that, where the initial agreement with the customer is that costs incurred in pursuit of an incentive are to be allowable, subject to meeting the AAR criteria, this should be the case irrespective of whether the incentive is successfully achieved or not.

The meaning of Section 5.10.h.v is unclear to us. In what way would the incentive adjustment applied be set to reflect the baseline profit rate and the cost risk adjustment selected at steps 1 and 2? We would assume the incentive adjustment is a discreet step within the profit rate calculation and it is not clear how discussions in agreeing step 3 would be impacted by steps 1 and 2.

Question 3: We welcome feedback on the proposed guidance and the worked example for costs associated with group profits.

Allowable costs guidance:

Section 1.23 of the allowable cost guidance clarifies that the price of a contract entered into prior to 1 April 2024 does not need to be re-determined unless the contract is amended. It also highlights that contracts entered into prior to 1 April 2024 must continue to apply the same contract profit rate calculated using the six step process. We believe this section would benefit from making clear that the applicable allowable cost and profit rate guidance are those relevant at the date the contract was entered into and that contracts entered into prior to 1 April 2024 should continue on the basis they were priced. We believe it is important that contracts entered into before 1 April 2024 are executed and reported on the basis of the profit and cost guidance at the time the contract was entered into. This is required to aide comparison of actual costs and profits with those estimated at the time of contracting and a correct final price adjustment, where applicable.

Specifically with regards to the POCO adjustment, we also believe that the guidance should include a clear statement that a further adjustment for profit on group costs is not required through allowable costs where a POCO adjustment has already been made via the 6-step profit calculation on contracts entered into prior to 1 April 2024.

Section I.4.1 states that the information upon which the POCO adjustment calculation is based is likely held by the prime contractor and its group subcontractors. BAES has concerns regarding the availability of this information at the right point in time. The new approach to adjusting for costs associated with group profits will require the availability of CSA and CRA adjustment figures from each of the relevant group subcontractors / further group subcontractors. We believe this may be more difficult in practice than logic would suggest, specifically when time pressures are experienced during contract negotiations. The calculation provided in guidance ensures the contractor is able to maximise the profit it is entitled to by including incremental CRA and CSA. It will therefore usually be in the contractor's interest to follow this process. But can further guidance be provided as to the consequence of following a simplified approach that would deliver lower profit, e.g. excluding all profit from the subcontractor's scope or adjusting the allowable costs for duplicated profit at a prime level. Could this later be considered an 'error' in the profit setting process as defined under Section 8 of the Alternative Pricing Guide that may be corrected at a later time, even though this is no longer covered by the 4 Step profit formula?

We are also concerned about the practical execution of the new POCO adjustment during the contract delivery stage and believe additional guidance may be required. For example, would it be acceptable within the bounds of the Regulations to deal with the allowable cost adjustment for costs associated with group profits via a regular reconciliation process (say, annual or quarterly) opposed to tracking any attributable subcontractor profit on an invoice-by-invoice basis in line with subcontractor claims? Financial management processes that have been set up and operating in some cases for years may not be able to perform these adjustments at all or such adjustments may be manual and time consuming.

The wording in section I.4.5 would benefit from simplification. While we appreciate that the regulation may drive the double negative definition, we would expect the guidance restate this wording to clarify the intent of the adjustment in simpler words that are easily understandable to the audience.

Section I.5.1 correctly highlights that it is not a requirement for a group sub-contract or further group sub-contract to be a QSC. For clarity, we believe it would be useful to specifically state all the circumstances in which an adjustment to costs relating to group profits is not required, e.g. competed group sub-contracts, alternatively priced group subcontracts and group sub-contracts that are below the minimum threshold.

Comments on Allowable Cost Guidance not related to 2024 legislative changes:

We are of the opinion that section A.3.1 (Redundancy costs) should be amended to remove the wording "but only if approved by the Secretary of State". An agreement between the MoD and the contractor as to the allowability of costs should be reached on the basis of the AAR principles as defined in Section 3 of the guidance and we believe the requirement for specific approval from the Secretary of State regarding redundancy costs is contrary to the overarching principles of allowable costs. The additional requirement of "only if approved by the Secretary of State" could result in costs which comply with AAR principles being deemed as not allowable because the Secretary of State chooses not to agree to the costs.

In 2022, the SSRO published a determination on the "Treatment of Research and Development Expenditure Credit when determining the extent to which research and development costs are allowable costs under a qualifying defence contract". In paragraph 7.8 of this determination it is stated that "The Referral Committee considers it would be beneficial for the SSRO to review its Allowable Costs Guidance in the light of the determination, to provide additional clarity on the treatment of RDEC and other tax reliefs when determining allowable costs". We would like to re-iterate this recommendation from the referral committee and believe further guidance regarding the treatment of RDEC when determining allowable costs would be beneficial as contractors are still encountering problems when trying to agree treatment of RDEC costs with the MoD.

Question 4: We welcome feedback on any of the proposed guidance on these points in relation to the commercial pricing alternative pricing method, including any points of error and specific suggestions for improvement in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the legislation.

Guidance on alternative pricing types:

Section 3.7 states that 'if the parties cannot agree that the GWS are of the same or substantially the same specification, then this method cannot be used to determine the price of the component'. We believe this paragraph should be expanded to highlight that contracting parties also have the option to seek an opinion or pre-referral advice from the SSRO in the process of arriving at such an agreement, if this is the case.

We agree with the further input provided by DSAG on this question and see little value in repeating it here.

Question 5: We welcome feedback on any of the proposed guidance on the prices set by law pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the legislation.

No specific comments or proposed changes other than those made by the DSAG response.

Question 6: We welcome feedback on any of the proposed guidance on the previously agreed pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

No specific comments or proposed changes other than those made by the DSAG response.

Question 7: We welcome feedback on any of the proposed guidance on the novated contracts pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

No specific comments or proposed changes other than those made by the DSAG response.

Question 8: We welcome feedback on any of the proposed guidance on the CRUV method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

Guidance on alternative pricing types:

We would seek further clarity in section 7.4 regarding the unit prices within the terms of such a framework agreement. Can this section be expanded to specify that the terms of the framework agreement may include agreed escalation factors or formulae so that unit prices may deviate in specified circumstances but terms cannot?

Question 9: We welcome feedback on any of the proposed guidance on the agreed changes to the contract profit rate pricing method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which is compliant with the new legislation.

Guidance on alternative pricing types:

Section 8.2a stipulates that the rate of profit on a contract or component can be changed after the time of agreement where 'an error has been identified in the determination of the contract profit rate. This may apply, for example, where the wrong baseline profit rate has been used in the calculation'. More clarity is required as to what would constitute an error under this pricing type. The words 'for example' would imply there could be numerous types of errors. This should be carefully defined and be clear on whether the firming up of provisional rates constitutes a change in the 'time of agreement' and therefore a new BPR / CSA.

Section 8.2b makes reference to the parties to a contract being able to agree a change to the incentive adjustment. However, Section 8 does not make any specific reference to cost risk adjustment (Step 2) or the capital servicing adjustment (step 4). We do not believe Regulation 19F, which references only to Regulation 11, or the resulting guidance from the SSRO, make it clear if an adjustment can be made to any step within the profit rate calculation or the specific ones highlighted. For example, can there be an error in assessment of financial risk in Step 2?

Question 10: We welcome feedback on any of the proposed guidance on the aggregation of components method, including any points of error or specific suggestions for improvements in clarity and applicability. Representations where parties are unsupportive of aspects of the guidance should be accompanied by alternative proposals which are compliant with the new legislation.

Guidance on alternative pricing types:

Example 7 'total incentive adjustment' contains an error in the calculation of the maximum price payable under the contract: *'Resulting in a maximum price payable under the contract of 220.55 + 2.75 = 217.28'* should read: *'Resulting in a maximum price payable under the contract of 220.55 + 2.75 = **223.3**'.*

Question 11: We welcome feedback on any of the proposed guidance changes made to support the usage of componentisation within the regime, including any points of error or specific suggestions for improvements in clarity and applicability.

Allowable costs guidance:

The wording in Section 1.10.c requires clarification. At a minimum, it would be helpful to include a reference to regulation 9.A.c here as this would point the reader to the applicable area of the regulations and schedule when attempting to understand this part of the guidance. But a summary statement explaining the meaning of this paragraph would be beneficial.

In section 1.11 we believe it is misleading to say "it is ultimately up to the parties to decide…." as the regulations do not in all cases afford the contracting parties a choice of forming a component, in particular where a contract has more than one profit rate. We believe the guidance requires clarity that while mechanisms of contracting may often be at the discretion of the contracting parties, componentisation is compulsory where the conditions laid out in regulation 9A and/or Section 1.10 are met. This has been evidenced through all our internal awareness briefs, where at virtually every session we have encountered the argument that we do not need to be overly worried about the separate profit rates that exist on QDC legs because we haven't agreed with the customer that we wanted to form a component and therefore we haven't. This is really significantly misunderstood and reading of the guidance alone as it stands has not clarified this for readers not involved in the training sessions.

Section 1.12 specifies that 'agreeing to form a component requires the parties to demonstrate a commercial purpose for having done so.' The guidance requires expanding to include a definition of 'commercial purpose' along with clarity on how such a purpose should be demonstrated.

Further to this we believe the intent of Section 1.12 and the concept of commercial purpose conflicts with the requirement to form a component when a differing profit rate is used (Section 1.10.b). Where only one pricing method is used, we think it is extremely unlikely having components for each different profit rate (and the associated reporting burden) will serve 'commercial purpose', nor will it drive value for money or provide a proportionate approach to componentisation. Often the application of a different profit rate is driven simply by changes in the BPR as a result of compliance with the regime with no discernible commercial decision being made at all. There will be a disproportionate cost to reporting at a component level and we strongly believe having components based purely on profit rate fluctuations will increase costs with no offsetting benefit to the MoD.

This is particularly marked in circumstances where components have been formed prior to the new regulations becoming effective on 1 April 2024. We do not agree that new component reporting structures can or should be enforced retrospectively (irrespective of the actual reporting being only required prospectively) without both parties agreeing to a variation of the contractual agreement. Where contractors have to absorb the costs of the increased reporting requirements related to components, the contract no longer has a fair and reasonable price, as had the reporting requirements been known at the time of agreement, the parties would surely have had to agree that the cost of meeting this statutory requirement would constitute Allowable Costs.

We understand that it is ultimately down to MoD to amend the definition of components introduced through tranche 1 of the changes, if they can be persuaded of the misjudgement we believe has been made here. However, we believe in carrying out its functions under Regulation 13.2., the SSRO should form their own view based on the evidence presented of whether the reporting on components where

- only profit rates differ achieves good value for money, and/or
- components already existed prior to the 1st April 2024 delivers fair prices to contractors,

and make representations to the MoD as a result of this. We continue to be available to engage with the SSRO on this topic to share the evidence that supports our opinion on this matter.

Additional feedback not in response to a specific question.

Currently no guidance has been issued by the SSRO on the interpretation of the new regulation 7.A 'Meaning of a new contract'. We believe the implementation of regulation 7A is open to interpretation and requires

clarity to aide contracting discussions. Regulation 7A.2.a makes reference to 'the same, or substantially the same, commercial outcome'. We would request that guidance be provided as to how 'substantially the same' would be defined, as we believe it is likely contracting parties may hold a differing view of this definition. In addition, regulation 7A.2.c makes reference to material additional commercial risk or duplication of cost and resource. We believe guidance is also required on the use of the word 'material'. For example, is the administrative burden of writing, agreeing, managing a separate contract and duplicating contract management activities enough to constitute material duplication of costs?

3. Leonardo

[redacted]

16th April 2024

Dear [redacted]

Guidance on the pricing of qualifying defence contracts and subcontracts

Leonardo UK Ltd fully supports the submission made by DSAG to the above consultation.

As, in this instance, DSAG's submission covers all the issues Leonardo wished to raise we are not making a separate detailed response to this consultation but are very happy to discuss any of the points raised in DSAG's response.

Yours sincerely

[redacted]
Leonardo UK Ltd

One Eagle Place, St James's,
London, SW1Y 6AF, United Kingdom
Tel: +44 (0)20 7340 6100

Leonardo UK Ltd
Registered in England & Wales No. 2426132
Registered Office: One Eagle Place, St James's, London SW1Y 6AF