Pricing of Single Source Non-qualifying contracts

Our Policy

It is MOD Commercial Policy to replicate some of the same approaches and mechanisms as the Single Source Contract Regulations 2014 when pricing Non-qualifying contracts, in order to achieve fair and reasonable prices.

Purpose and Scope

1. The guidance in this Commercial Policy Statement relates to single source contracts which are **not** covered by the Single Source Contract Regulations 2014 (SSCR) (hereafter called Non-qualifying contracts).

2. This guidance is not relevant to qualifying contracts covered by the SSCR (i.e. a Qualifying Defence Contract (QDC) or a Qualifying Sub-contract (QSC)). When you are procuring on a single source basis you must assess whether your potential or actual contract is a QDC, which you can do by following the guidance at Chapter 2 SSCR guidance.

3. In particular, this guidance covers:

    a. Allowable Costs;

    b. Contract Pricing Statements;

    c. Profit;

    d. Rates;

    e. Transparency in terms of:

        (1) Reporting; and

        (2) Open Book;

    f. Records; and

    g. Profit and Loss Sharing on firm / fixed price contracts (Final Price Adjustment).

These areas are covered in more detail later.

4. This guidance has been created as definitive guidance for MOD Commercial Officers so 'you' indicates an action on the Commercial Officer.

Background

5. A key purpose of the SSCR is to ensure that the price of a qualifying contract is fair and reasonable to both the MOD and the contractor. The SSCR aim to achieve this through offering protections to both parties, for example openness and transparency to the MOD and a fair return on costs and capital to the contractor.

6. The aim of agreeing fair and reasonable single source prices is a sound objective, whether the contract is a QDC or a Non-qualifying contract. Therefore, when dealing with a Non-qualifying contract, it is MOD Commercial Policy to replicate some of the same approaches and mechanisms as apply to qualifying contracts, in order to achieve fair and reasonable prices. The MOD seeks to do this through agreement of pricing procedures and through the negotiation of appropriate contract conditions.

What Are The Key Principles When Dealing With Non-Qualifying Contracts?

7. A key principle is that a contract price should be agreed that is fair and reasonable to both parties. In the absence of competitive tendering, ensuring the MOD gets value for money is always a challenge. The MOD needs protections against the contractor's ability to price without the pressures of competition and in the knowledge of having a near-guarantee of follow-on work.

8. Contract prices are made up of costs and profit. Achieving fair and reasonable prices for both parties is about ensuring the costs are reasonable for the MOD to pay and that the contractor receives a fair return for the risk they take in delivering the MOD's requirements.

9. In deciding what protections are required, you must consider the value and risk profile of your requirement. Non-qualifying contracts may be high value, where they are excluded or have been exempted from the SSCR however, in most cases it is expected that this guidance will apply to single source contracts below the threshold for a QDC, which is £5M. This guidance explains when it is MOD policy to include certain protections (e.g. DEFCON 812 – Open Book) and when it is a matter of judgement (e.g. DECON 813 - Contract Reporting). The DEFCONs mentioned in this guidance provide a reference to the value of the contract where they must be included. The value is a guide and you should exercise judgement as to whether the protections the DEFCONs offer should be included in your contract. For lower value contracts, you must consider where it may be appropriate to include a narrative condition based on the DEFCON(s) according to the risk and value profile of your procurement.

10. Where all elements of the contract, including the contract price, can be agreed in advance, you should use the existing principle of No Acceptable Price No Contract (NAPNOC). You can find further information in the NAPNOC topic.

Tender Process

11. You must follow the guidance in the Choosing a Competitive or Non Competitive Approach and Commercial Strategies Commercial Policy Statements to inform your decision whether single source procurement is appropriate. You must use the DEFFORM 47ST and include the appropriate DEFCONs mentioned in this guidance, which are relevant to your contract, based on the value of your procurement and the degree of transparency you require from your contractor.

Pricing

Allowable Costs

12. Statutory guidance will be published by the Single Source Regulations Office (SSRO) as part of the framework of the SSCR. This guidance is called the Statutory Guidance on Allowable Costs and will be made available on the SSRO's website. It details the costs which are allowed by the single source legislation to be included in a QDC governed by the SSCR.

13. It is MOD policy that you should also use the SGAC when pricing a single source Non-qualifying contract. There are three guiding principles which must be met in order for a cost to be included in the contract price. Costs must be:

a. appropriate – the type of cost is appropriate to be recovered through a MOD single source contract. The statutory guidance will list the types of costs that are considered appropriate to include;

b. attributable – the cost relates directly or indirectly to the activity being undertaken for the contract and be necessary for the fulfilment of the contract;

c. reasonable – the costs are reasonable in the circumstances and represent value for money in achieving the desired outcome.

14. You should follow these principles together with the statutory guidance for both direct and indirect costs.

Pricing Methods

15. You should choose an appropriate pricing method for your contract, based on the risk profile of your requirement:

a. Firm / Fixed price - so long as both parties have a good understanding of the cost estimates and are reasonably confident they can be achieved and priced accordingly, then agreeing a firm price (or fixed price with an agreed variation on price based on pricing indices, generally for contracts greater than five years), is a good way to incentivise the contractor to good performance. It transfers both 'upside' and 'downside' risk to the contractor. If they perform efficiently they should beat the cost estimates and earn greater profit; but if they perform poorly then costs may overrun and they will earn less profit, or make a loss.

(1) Where you are unable to agree a firm or fixed price due to uncertainties about elements of the cost estimates, then you have a choice. You could agree a hybrid price, where you price the uncertain elements on ascertained costs, such as cost plus, and the more certain elements as firm or fixed prices. Or, you may wish to agree a fully firm or fixed price, but at the time of contract placement agree a provisional price, to be fixed at a later date. Provisional pricing is not NAPNOC compliant and you must use it carefully; MOD policy is that a price must be agreed before no more than 25% of the work has been completed. There are two DEFCONs

which you must include in your contract if it is subject to provisional pricing:

(a) DEFCON 127 (Price Fixing Condition for Contracts of Lesser Value) for Non-qualifying contracts with a value up to £1M; or

(b) DEFCON 643 (Price Fixing (Non-qualifying contracts)) for Non-qualifying contracts valued at or greater than £1M.

(2) The main purpose of these DEFCONs is to oblige the contractor to keep records and allow the MOD access to them, when the contract has been let and work started on the basis of provisional prices. In a single source environment it would be totally unreasonable if only the contractor had access to this critical pricing information. Access to this information puts the MOD on a more equal footing with the contractor and helps the two parties convert provisional prices to a firm or fixed price, when that is the chosen pricing methodology.

b. Cost-Plus – in a cost plus contract the MOD bears most of the risk of a cost overrun. The contract price will be based on all of the costs of delivering the requirement with an agreed percentage for profit. Because the MOD bears the risk, the profit rate should always be lower than scenarios when the contractor is bearing risk. The only way a contractor bears any risk in a cost-plus arrangement is if the MOD seeks to limit its liability by use of a maximum price. In this case, if a contractor chooses to incur costs above this maximum price, it will do so at its own expense. As the price of the contract is not known at the time the contract is placed, cost-plus pricing is not NAPNOC compliant. Where your contract, or a component of your contract is priced as cost-plus, you must ensure you include DEFCON 653 (Pricing On Ascertained Costs).

c. Target Cost Incentive Fee (TCIF) - a target cost is calculated based on estimated costs agreed at the date the contract is entered into. The final contract price is then determined at the end of the contract by reference to the actual costs incurred by the contractor. The final price is subject to an adjustment by contract terms governing for example any stated Maximum Price or Minimum Fee, plus the sharing between the parties of any cost overrun or under-run against the target cost. You should not use TCIF if costs can be estimated with a reasonable degree of certainty, if that is the case then you should agree a firm or fixed price, which is a much better method for incentivising contractor performance. Neither should you use TCIF if there is too much uncertainty in estimating a target cost, in that case there is too much risk in this method for both parties. You should instead be looking at risk reduction studies or some form of hybrid pricing (i.e. a mix of firm prices for the more certain elements, and cost-plus arrangements or volume driven pricing for the less certain aspects).

d. Volume driven pricing – effectively a hybrid type of pricing because it is partly based on an estimate of costs (as with a firm or fixed price contract) and partly based on actuals (as with an ascertained cost arrangement, such as cost-plus). In volume driven pricing the cost or rate (e.g. cost per widget; or cost per hour) is negotiated and agreed between the MOD and the contractor, on the basis of cost estimates. The actual contract price is subsequently agreed on the basis of applying those agreed cost or rate estimates to the actual number of items, or hours, required by the MOD. For example, the contract agreed rate might be a firm price of £75 per widget (based on estimates) which is then applied to the actual number of widgets used by the MOD. So at £75 per widget if the MOD actually used 100,000 widgets the volume driven contract price would be £7.5M, whereas if the MOD actually used 80,000 widgets the contract price would be £6M.

Contract Profit Rate

16. The previous arrangements for agreeing a contract profit rate (the Government Profit Formula, under the 'Yellow Book' regime) will end with the commencement of the SSCR in December 2014. These arrangements were based on a voluntary agreement between the MOD and industry but were often disregarded, more so in recent years.

17. Under the new legislative arrangements, the SSRO will publish a Baseline Profit Rate (BPR) which must be used as the starting point when agreeing a profit rate for qualifying contracts subject to the SSCR. The BPR will be published in March each year to take effect from April. You can find details of the BPR in Chapter 4 of SSCR guidance. However, there is no legal requirement to use the published profit rate in a Non-qualifying contract.

18. However, the MOD does not intend to have a separate benchmark when considering what might be an appropriate profit rate to negotiate when pricing a Non-qualifying contract. It is MOD Commercial Policy that you should consider the published BPR as a reference point when negotiating the profit rate on a Non-qualifying contract of £1m or more, subject to paragraph 19.

19. The profit rate set by the legislation for a QDC is considered as the fair return that is appropriate to give a contractor, for the protections the MOD has (e.g. open book rights), to assist the MOD to ensure that the contract costs are fair and reasonable. You must also consider these factors when agreeing the profit rate for a Non-qualifying contract. For instance, it would be appropriate to use the published QDC allowances if the contractor was providing an appropriate level of openness and transparency of costs as described in paragraphs 34 - 47. This is not to say you must seek everything you would obtain had it been a QDC, it will be a matter of judgement about what level of openness you consider being appropriate, based on factors such as the value and risk profile of your requirement, knowledge of previous outturn costs, past contractor performance.

Profit on Profit

20. Profit on profit (also called fee-on-fee) can occur when your prime contractor places sub-contracts with companies or business units to which they are related[1]. The sub-contractor's invoice to the prime may legitimately include an element of profit, because that is how companies often operate their accounting systems and profit centres. The invoiced cost (plus profit) from the group sub-contractor then becomes a cost to the prime, which is charged to the MOD and attracts the agreed prime contract profit rate. This means that, although the MOD has paid the contract profit rate on the costs accounted for by the prime, the true profit rate the MOD will pay is higher because of the profit on profit elements. When the contract is high value and there are many such transactions, the sums involved can become significant.

21. The principle when dealing with this issue is clear, the MOD should not pay profit on profit in the single source prices it pays prime contractors. The challenge is to find a mechanism to stop it happening or eliminate its effect. For QDCs, the SSCR includes a mandatory step in agreeing the contract profit rate to ensure this issue is addressed. It is called the 'POCO adjustment' (Profit On Cost Once), and will be submitted by the contractor with their price proposal, and verified on a sample basis by Cost Assurance and Analysis Service (CAAS).

22. When dealing with a Non-qualifying contract you should consider the following in relation to the elimination of 'profit on profit':

a. Are there any group sub-contracts involved? Profit on profit is only an issue where there are group sub-contracts. Assuming there are:

(1) What is the value of the prime contract and the group sub-contracts? If you have a high value contract with lots of group sub-contracting, then it is a more pressing issue to consider than in a low value contract.

(2) You should place the onus on the contractor to provide disclosure of any intra-group sub-contract profits contained within their price proposal. The contractor should declare either that they have eliminated such profit from their price proposal, or provide a calculation to show how its effect can be removed from the final agreed price. The Contract Pricing Statement (see paragraph 23) should record how profit on profit has been addressed, if relevant.

(3) The contractor may choose to submit a POCO calculation, as if the contract was a QDC. If they do, and the amounts are material, you should consider requesting CAAS to verify the calculation. Where you require support from CAAS you should submit a DEFFORM 122.

[1] A prime contractor will pay profit to a sub-contractor that is **not** related to the prime's own group, and the prime will then add their own agreed profit rate to that sub-contract. However, this is not classed as profit on profit. The term is only intended to mean the profit on profit that occurs on transactions between related group companies.

Contract Pricing Statement

23. The Contract Pricing Statement (CPS) is an important document that is required by legislation when pricing a QDC. It is MOD Commercial Policy that the Contractor must complete a CPS for all single source contracts, including a Non-qualifying contract.

24. The CPS must provide a record of the facts and assumptions made in setting the contract price at the time of entering into the contract. The CPS should contain the following information:

a. details of the Allowable Costs and the contract profit rate used to determine the contract price;

b. the version of the SGAC (described in paragraph 12) in force at the time of contract agreement;

c. a description of assumptions and calculations relevant to the Allowable Costs under the contract, including assumptions and calculations relevant to any risk or contingency included in those costs. The calculations and assumptions must:

(1) cover each element of the costs; and

(2) identify any facts or assumptions provided by the MOD and used in the calculation of the costs;

d. describe any other information which is materially relevant to the pricing of the contract.

25. Responsibility for completing the CPS rests with the contractor, whose price proposal it supports. You should expect the contractor to submit a draft CPS with their price proposal, after which the CPS may be developed jointly, as the price is negotiated and facts and assumptions are agreed. Ideally, the CPS should be agreed and signed at the same time as contract award, and certainly no later than 1 month after contract signing.

26. When accepting a CPS from a contractor you must have in mind the test of an adequate CPS, does it explain with clarity why that price has been agreed? If it fails to do this to any material extent, then it is not fit for purpose.

MOD Agreed Rates

27. The MOD has well established processes for CAAS to agree labour and overhead recovery rates with major contractors and some smaller contractors, and then recommend those rates to a designated 1* Commercial Officer, who may accept them formally for use across MOD single source contract pricing. Through improved openness and transparency provisions in the SSCR legislation, CAAS will in future have greater and more timely visibility of contractor's costs, for agreeing rates. The advice in Chapter 3 of the SSCR guidance is that commercial staff should always use MOD agreed rates where they exist, when pricing QDCs.

28. The MOD does not intend to have a separate set of rules for agreeing contractor rates when pricing Non-qualifying contracts. Agreed recovery rates

are a sub-set of Allowable Costs and in recommending rates, CAAS will use the Statutory Guidance on Allowable Costs to gain assurance that the rates are fair and reasonable and represent value for money.

29. If you are pricing a Non-qualifying contract, and MOD agreed rates exist for the contractor you are dealing with, you must use those rates in pricing your contract. A list of contractor business units and the designated 1* responsible for reviewing CAAS recommendations is in the Pricing – Contractor Rates: The CAAS Recovery Rates Programme Commercial Policy Statement.

30. You should only disregard MOD agreed rates if you have strong reasons to believe they have become materially inaccurate in which case you should consult with CAAS and the designated 1* Commercial Officer for that contractor. The only other reason you should disregard agreed rates is if you believe there are overriding value for money reasons to do so, such as in achieving trade-offs in other areas of the contract. However, you should not disregard MOD agreed rates without appropriate consultation and approval of your line management and the lead 1* Commercial Officer. The contractor must record the reasons for any departure from MOD agreed rates in the Contract Pricing Statement.

31. In nearly all cases you should use MOD agreed rates where they exist. This is not to say you shouldn't challenge the contractor's price proposal in areas where agreed rates are being used. For example, the contractor may be using a MOD agreed recovery rate of £100 per hour and applying that to 2,000 hours of work, to give a line item cost of £200,000. While you should not reject the pre-agreed £100 per hour rate (unless for the reasons outlined in paragraph 30), you must, in conjunction with your project team, scrutinise and challenge the 2,000 hours to determine if it is reasonable.

Pricing Sub-contracts

32. Due to supply chain complexity, for higher value contracts and contracts which are inherently risky, you should consider what information you require in order to monitor sub-contractor performance. You should consider the protections and rights provided by the various DEFCONs (e.g. transparency of costs, protection against excess profit) and seek to negotiate these into sub-contracts as you judge appropriate, through the flow down of the appropriate DEFCONs.

33. The DEFCONs you should consider including in the prime contract (which only then can be flowed-down into the supply chain) are:

a. DEFCON 811 – Profit and Loss Sharing Arrangements, on firm and fixed price contracts.

b. DEFCON 812 – Open Book rights, for flow-down into sub-contracts greater than or equal to £1M.

c. DEFCON 813 – Contract Reports, for flow-down into sub-contracts greater than or equal to £25M.

d. DEFCON 814 – Confidentiality, when you have negotiated inclusion of DEFCON 813.

Transparency

Contract Reporting

34. For Non-qualifying contracts valued at £5m or more, you should consider the inclusion of DEFCON 813 (Contract Reporting) in your contract, which secures the MOD rights to a similar contract reporting regime as applies under the SSCR for QDCs. It also places an obligation on the prime to flow down the DEFCON into sub-contracts above £25M. You must consider which of the reports you consider to be relevant for your contract and negotiate with the contractor.

35. You can find details of the reports which the contractor must submit in compliance with the SSCR in Chapter 5 of the SSCR guidance.

Open Book and Audit Rights

36. Open book rights are a fundamental means of providing the MOD with assurance that costs included in the contract price meet the guidelines of being Allowable Costs (as described in paragraph 13).

37. For Non-qualifying contracts not protected by the SSCR, DEFCON 812 (Single Source Open Book) seeks to replicate some of the open book rights and has a requirement for the conditions to be flowed down the supply chain into single source sub-contracts. It is MOD policy to include DEFCON 812 (Single Source Open Book) in any Non-qualifying contract of £1M or more.

38. Under the conditions of DEFCON 812 (Single Source Open Book), the contractor must keep appropriate records for, whichever is the earliest of:

a. 6 years after the end of the financial year in which they were created; or

b. 2 years after contract completion.

Post-Costing

39. For Non-qualifying contracts, it is MOD policy to retain post-costing rights and in appropriate circumstances to agree a contractual profit / loss sharing arrangement on firm and fixed price contracts. To maintain the MOD's post-costing rights you must include DEFCON 812 (Single Source Open Book) (which replaces DEFCONs 648 / 648A (Availability of Information), both of which will be archived from December 2014), in all single source Non-qualifying contracts of £1m or more. See paragraph 42 in relation to seeking protection against excess profits. You can find more information in the Post Costing topic.

Contract Costs Statement

40. If you are pricing a Non-qualifying contract, or any part of such a contract, on a cost plus basis you will need the contractor to provide a Contract Costs Statement (CCS), which the MOD can then investigate, for the purpose of agreeing the contract price. In a cost plus contract you will need to include DEFCON 653 (Pricing on Ascertained Costs), which calls up the

required CCS, in the form of DEFFORM 812 (Contract Costs Statement Declaration Non-qualifying contract). Likewise, if you have a Non-qualifying firm or fixed price contract, you may also require an Interim and / or Final CCS. You will need these if you want to understand the actual costs incurred to date (e.g. to inform pricing of a contract amendment), or at the end of a contract (e.g. for post-costing and / or possible application of DEFCON 811 excess profit / loss provisions). In a firm or fixed price contract you can achieve this by inclusion of DEFCON 812 (Single Source Open Book) and DEFCON 695 (Contract Costs Statement Post-Costing (Non-qualifying contract)), both of which call up DEFFORM 812 (Contract Costs Statement Declaration (Non-qualifying contract).

41. The CCS should provide details of the actual costs the contractor has incurred through the performance of the contract, at any time in the contract duration or at contract completion. The contractor is only permitted to include up to 2% of cost estimates in the CCS, with the remainder recorded as actual expenditure. Having analysed the CCS for a firm or fixed price contract, you may calculate that a final price adjustment is due, where there is a significant variance between the estimated costs at contract placement and the actual costs at contract completion as explained in paragraph 42. A final price adjustment can only be made where DEFCON 811 (Single Source: Profit and Loss Sharing on Firm / Fixed Price Contracts) was included when your contract was placed, or where you have negotiated the use of a similar narrative condition.

Profit and Loss Sharing on Firm and Fixed Price Contracts (Final Price Adjustment)

42. When the MOD agrees a firm or fixed price contract based on estimated costs, then provided the contract has been priced with reasonable accuracy, the contractor is incentivised to good performance - if they can better the cost estimate they can keep the cost underrun as additional profit. Provided that the MOD also has good transparency rights (e.g. DEFCON 812 (Single Source Open Book)) we can obtain visibility of the true cost of that efficient performance, and reflect that in subsequent pricing.

43. Equally, if the contract has been priced inaccurately, then the contractor may be able to better the cost estimates and obtain extra profit, without being efficient or performing well. If we also had no transparency rights to learn of the true costs of delivery, then in those cases the MOD would have little or no visibility of the true costs of the contract and no guarantee of value for money.

44. Finally, there are situations where the parties might both have good confidence of the accuracy of estimates, but they might both be wrong. In this scenario, in a firm or fixed price contract, the contractor might make a significant windfall profit or they might make a significant loss.

45. In 2004 MOD and industry agreed to address these pricing risks by agreeing DEFCON 648A (Availability of Information), which provided (at clause 4) for a contractual sharing of excess profits and losses, when they reached a certain threshold. The principle was that contractors would still be incentivised to earn additional profit (up to 5% of the contract price) but when profit went

over that excess level it would be shared. Similar provisions covered contractor losses.

46. For Non-qualifying contracts, the MOD has introduced DEFCON 811 (Single Source: Profit and Loss Sharing on Firm / Fixed Price Contracts), which replicates the final price adjustment mechanism in the SSCR and replaces the price adjustment clause in DEFCON 648a (Availability of Information) which will be archived from December 2014. MOD policy is that for Non-qualifying contracts from £5m to £50m, you should include DEFCON 811 unless there are good reasons not to. You must always seek to include DEFCON 811 in Non-qualifying contracts valued above £50m. You must include DEFCON 811 in conjunction with DEFCON 812 (Single Source Open Book) and DEFCON 695 (Interim Summary Cost Statement – Post Costing). If you believe DEFCON 811 should not be included, you must obtain appropriate line management agreement, and the contractor should record why the DEFCON has been omitted in the Contract Pricing Statement.

47. DEFCON 811 (Single Source: Profit and Loss Sharing on Firm / Fixed Price Contracts) details the calculation to be used for the final price adjustment. We have created a calculator to help you assess the value of any adjustment. A final price adjustment under DEFCON 811 can only be made when the amount of adjustment is greater than or equal to £250K.

Confidentiality

48. Protection of information obtained through openness and transparency is essential in safeguarding the commercial interests of the contractor. You must include DEFCON 814 (Confidentiality) in a contract containing DEFCON 812 (Single Source Open Book) and / or DEFCON 813 (Single Source Contract Reports and Notifications). For Non-qualifying contracts, DEFCON 814 places an obligation on the MOD to provide a similar level of protection for information received through open book and reporting, as the SSCR provides for information received on qualifying contracts.

Contacts, Training and Further Information

49. The Web Access Page for this topic contains a summary of the topic, details of who you can speak to for advice, and what training is available. It also contains links to other relevant topics and information.