Ministry Of Defence Guidelines For Industry

3. Variation Of Price (VOP)

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Use of Variation of Price (VOP) Arrangements in MOD Contracts

Introduction

1. Ministry of Defence (MOD) policy is to seek FIRM prices wherever possible. Where this cannot be achieved due to differing perceptions of forward inflation risk, MOD will be prepared to consider the negotiation of FIXED prices which can be varied in accordance with an appropriate formula set out in the Contract and which utilises appropriate recognised indices.

Background

2. One commitment from the Strategic Defence Review is an intent to bear down on defence inflation. This is defined as the average rate of increase in pay and prices of all goods and services making up the Defence Budget. Defence inflation will exceed the general level of inflation when the rate of increase of indices used in VOP formulae for fixed price contracts, exceeds that for the GDP deflator which measures inflation in the economy as a whole.

3. This document reflects the guidance on measures to bear down on defence inflation issued to MOD procurement staff. Unless otherwise stated, the guidance applies equally to competitive and non-competitive procurement. It should be noted that the approach described herein does not have the support of the CBI. The MOD, however, is committed to bear down on inflation in defence procurement and will look to negotiate with contractors on an individual basis.

Selection of a Firm or Fixed Price Approach

4. FIRM prices are to be the basis for all contractual commitments up to 5 years duration in all but the most exceptional circumstances, e.g. for requirements for which the price includes constituent elements whose market price is particularly volatile. However, where there is doubt over the value for money (VFM) advantages of FIRM prices, FIXED prices including VOP arrangements may be used. In such circumstances and where FIXED prices are needed for contracts of longer duration than 5 years, VOP arrangements which more closely track level of inflation in the economy generally will be preferred. This should be achieved by the use of indices such as the output based Producer Price Indices for manufacturing industry, or the incorporation in the FIXED price arrangement of a significant Non Variable Element (NVE) (see paragraph 13) as part of the pricing mechanism where, exceptionally, there may be justification to use input based indices. Pricing arrangements for longer term contracts will be exposed to investment appraisal to identify which approach, FIRM or FIXED, and in the case of the latter, which indices, offers best VFM. FIRM prices, or FIXED prices that use indices more closely aligned with general inflation should normally represent good VFM, and there will be a clear predisposition towards their use unless there is a strong case to believe this does not offer best VFM. Justification for the selection of the chosen pricing approach will be documented with any supporting investment appraisal outcome clearly referenced. The preference, subject to VFM, will be for firm prices to be negotiated. Where this is not possible, then a VOP clause may be considered using an appropriate output index. Only in exceptional circumstances, and only after agreement at Director of Contracts level within the MOD, will consideration be given to the use of a VOP clause that uses Input Indices. In such event, the formula at Annex B may be used noting that the level of NVE to be calculated will take account of the projected performance of the Input Indices when measured against inflation in the economy at large using, for example, the GDP deflator.

Tendering

5. The following procedures and practices will usually be followed by MOD, in seeking to establish the optimum VOP arrangements:

a. **Competitive Tenders.** In order to facilitate equitable comparison of the bids, the MOD Invitation to Tender (ITT) will, wherever possible, prescribe the basis of the VOP formula by stating, inter alia, the Base Date for its operation, the proposed Index/Indices, the source of the Index/Indices, the level of the NVE and the outline of the VOP Clause in the proposed Contract, based upon one of the specimen clauses at Annex A or B (as appropriate) but tailored to the particular circumstances of the requirement being tendered. The fact that the VOP requirements may be prescribed in this way does not prevent any

Tenderer offering an alternative VOP formula or a FIRM price, in addition to that which has been described in the ITT, if he so wishes. In such an event, MOD would expect that the rationale for the alternative is clearly stated in the tender response, in order that it can be given proper consideration. In the search for best VFM, MOD may seek options for FIXED and for FIRM prices, in order to be able to assist the tender evaluation process. MOD will use the Defence Analytical Services Agency (DASA) to help to ensure fair comparisons are made of the VOP formulae, where different Indices are being proposed.

b. **Non-Competitive Tenders**. Where it is possible to do so, the same approach for prescribing the VOP requirement will be adopted in single source ITTs as those described for competitive tenders. The MOD's Specialist Procurement Services (SPS) staff will be used to verify the Contractor's base data for use with any proposed VOP formula. This will include identifying the manner in which the tenderer has priced or intends to price any of his major sub-contracts, in accordance with the proposed purchasing/manufacturing plan and thus the extent to which any of his proposed sub-contracts use the VOP formula described in the ITT. If appropriate, MOD will wish to be made aware of any other VOP formula(e) that are being applied to work or services to be performed by sub-contractors, with explanations of the differences.

Sub-Contracts

6. Where appropriate, VOP is intended to be applied in the same manner as the prime contract (see paragraph 4). It is recognised however, that on occasions the nature of individual sub-contract VOP provisions may not be those adopted for the prime contract e.g. where the nature of work and the relevant indices which should apply, are different. Where, exceptionally, for non-competitive requirements, the Tenderer has not been able to establish the sub-contract VOP arrangements at the outset, any estimated provision for inflationary factors that has been made in the Tenderer's quotation will be treated by MOD as FIRM price elements, until such time as the prices are fixed for these elements.

Overseas Contracts/Sub-Contracts

7. The indices used for VOP will normally be the appropriate Output Indices published by or for the government of the country where the work is to be performed. This approach is notwithstanding any separate arrangements that may be appropriate to take account of variations in exchange rates.

Timing of VOP Negotiations

8. VOP conditions will always be agreed before or at the same time as the base price and other price-related terms (such as Interim Payments, Liquidated Damages etc.) and should be regarded as an integral part of price fixing.

Specimen Clauses

9. The principal features of the new VOP arrangements have been developed into a specimen clause (see Annex A). The methodology illustrated by this Clause may be varied to meet the circumstances of a particular requirement. Such a clause will be included in ITTs for competitive and non-competitive work, unless exceptionally input indices are to be used (see paragraph 4 above) in which case the specimen at Annex B may be used.

Changes in Base of Agreed Indices

10. If there is any change in the basis of the indices, e.g. a revised statistical base during the period of the contract and before the adjustment of the final contract price, or should the agreed indices cease to be published, e.g. because of a change in the Standard Industrial Classification, both sides will agree a fair and reasonable adjustment to the relevant index or, if appropriate, agree revised indices for use in the formula which will be expected to have substantially the same effect as those originally established.

Amendment to Contract

11. When a contract containing a VOP condition is amended, the parties will review the VOP provisions to ensure that they continue to reflect the original intentions of the contract. FIRM prices will normally be preferred for discrete packages of work added to contracts. When considering whether or not any amendment to the VOP provisions of a contract is necessary, account will be taken of the following circumstances, which are the most likely to have generated the requirement for an Amendment:

a. Where delivery of additional quantities is to follow on immediately after the existing quantities at approximately the same rate, and the contractor is prepared to continue his original base price, a simple extension of the delivery programme over which VOP will be applied will normally suffice. However, if there is any change in base price and/or index movement assumptions, the parties will consider whether it is more appropriate to place a new contract.

b. Where additional quantities or different items not already covered by the contract are required and where economic conditions at the time of pricing any amendment are significantly different to those prevailing at the time the original contract was priced (for example, where different indices are appropriate), it would be more appropriate for the parties to consider revised VOP arrangements.

c. Where modifications to the Article to be delivered are required, the principles in 10a. and 10b. should be followed, provided the price(s) of the modifications are shown separately. If the parties agree that the Index remains relevant, an alternative could be to re-base the price of a modification to the base price of the contract and include the price of the modification within the price of the Article to be delivered, thus avoiding any change to the VOP provision.

d. When a contractual delivery programme is to be amended, MOD and the Contractor will need to agree whether or not a change should also be made to the period over which escalation is calculated.

Payment of VOP

12. The payment arrangements for VOP will vary according to the circumstances of the contract. The VOP clause contained in the contract will usually provide for final adjustment of the contract price on delivery or contract completion. However, in contracts where there are milestone payments or successive deliveries for which VOP would normally apply, it may be more appropriate for VOP increases to be paid on an interim basis e.g. as part of a milestone payment arrangement or delivery programme.

Non-Variable Element

13. The use of an output index will partially compensate, through the agreed price, for the productivity gains made by Industry through management decisions on inter alia component and material sourcing, the use of capital, labour and plant, and reactions to the pressures inherent in an efficient and competitive market. However, an NVE may be required even when an output index is used, e.g. where, due to technological advance, the rate of productivity growth of an individual company exceeds that for the general industrial sector from which the output index being used is obtained, or where for reasons related to a particular contract, significant elements of cost in a price are not affected by price rises and a greater proportion of costs are firm. In competitive situations, tenders may be invited on a "with or without" NVE basis to establish any linked contingency element associated with its inclusion. For non-competitive requirements, the level of any such contingency should be visible as part of normal price negotiation and equality of information requirements.

Productivity and Learner

14. In a similar vein, the use of an output index will not preclude the negotiation through the base price of allowances for learner in the manufacturing or production process. Learner at task level, and productivity at sector level, are two discrete issues.

Target Cost / Maximum Price Contracts

15. The principles for the treatment of inflation in fixed prices will be applied to incentive pricing arrangements such as Target Cost, Target Profit, Maximum Price and Maximum Fee, if any.

Conclusion

16. The MOD is committed to bear down on defence inflation. A greater use of firm pricing should reduce the incidence of VOP arrangements. Where these are required, output indices will be favoured for application in any VOP formulae. The use of input indices will be exceptional and only acceptable where there are demonstrable VFM benefits.

17. Queries arising from this Guideline in the context of particular contracts should be addressed to the relevant Contracts staff detailed in the relevant ITT/contract documentation.

Annex A Variation of Price - Specimen Clause using Output Index

1. The prices stated in the Schedule of Requirements are FIXED at (..date..) price levels. The prices do not include provision beyond this date for increases or decreases in the market price of the Articles being purchased. Any such variation shall be calculated in accordance with the following formula:

$$V = P\left[a + b\frac{O_i}{O_o}\right] - P$$

Where:

V represents the variation;

P represents the FIXED price as stated in the Schedule of Requirements;

a represents the non-variable element (NVE);

b represents the variable element ;

a+b = 1.0;

Oo represents the Output Price Index figure for the base date (.....) (as above);

Oi represents the weighted average Output Price Index figure for the period (..to..) (i.e. the period during which costs are anticipated to be incurred in order to meet the contractual delivery date(s)), weighted in accordance with the distribution of costs incurred over that period.

Note: An example Index would be Office National Statistics (ONS) Business Monitor MM22 Table 2 (7209299000) Producer Price Index Numbers of Output (Home Sales) All Manufacturing Products of Manufacturing Industries other than food, beverages, petroleum and tobacco manufacturing - unadjusted, however indices should be selected that most accurately represent the product in question.

2. In the event that any changes occur to the basis of any of the Indices, (e.g. a revised statistical base) or where an index ceases to be published, during the period of the Contract and before final adjustment of the Contract Price(s), the Authority and the Contractor shall agree a fair and reasonable adjustment to the relevant Index, or, if appropriate, shall agree revised

formulae which will have substantially the same effect as those specified herein.

3. The Contractor shall notify the Authority of any significant changes in the purchasing/manufacturing plan on the basis of which these provisions were drawn up and agreed or, of any other factor having a material bearing on the operation of these provisions such as to cause a significant divergence from their intended purpose, in order that both parties may consider whether any change in this provision would be appropriate.

4. Prices shall be adjusted taking into account the effect of the above formula as soon as possible after publication of the relevant indices or at a later date if so agreed between the Authority and the Contractor. Where an Index value is subsequently amended the Authority and the Contractor shall agree a fair and reasonable adjustment to the price, as necessary.

5. Claims under this Condition shall be submitted to the Bill Paying Branch, certified to the effect that the requirements of Clause 4 of the above have been met.

Notes

1. Indexed escalation provisions need to be related to the base date or dates on which the Base Price to be escalated is agreed.

2. Escalation of any prices which are already on a FIRM basis, is clearly inappropriate. Care needs to be taken to ensure that such costs are not included within costs to be escalated in cases where the risk of inflationary increases has been removed or taken into account in fixing the Base Price. This should be taken into account either in setting the base date (see Note 1) or in the non-variable element (NVE). Similarly, sub-contracts for which separate VOP arrangements have been agreed, in accordance with paragraph 6 of the Guideline, should not be included when calculating adjustments to the original FIXED price. Adjustments arising from such sub-contracts are dealt with outside the VOP arrangements applying to the main contract price.

3. In negotiating VOP arrangements, the search for undue precision should be avoided. The choice should be to seek an arrangement which will fairly reflect the effects of changes in general economic conditions on the Contractor's costs, in an administratively manageable way.

Annex B Variation of Price - Specimen Clause using Input Index

1. The Prices stated in the Schedule of Requirements are FIXED at (....date....) (i.e. the base date) cost levels in respect of Labour and Materials. The prices do not include provision beyond this date for increases or decreases in the basic prices of materials or labour costs or in labour productivity. Any such variation shall be calculated in accordance with the following formula:

$$V = P\left[a + b\frac{L_i}{L_o} + c\frac{M_j}{M_o}\right] - P$$

where:

V represents the variation;

P represents the FIXED price as stated in the Schedule of Requirements at ...... rates and prices;

a represents the non-variable element (NVE)

b represents the Labour (including relevant Overheads and Profit) element of the FIXED price;

c represents the Material (including relevant Overheads and Profit) element of the FIXED price;

a+b+c = 1.0;

Lo represents the Labour Index figure for (......) (i.e. the date on which VOP arrangements commence) (as above):

Li represents the weighted mean Labour Index figure for the period (..to..) (i.e. the period during which Labour costs are anticipated to be incurred in order to meet the contractual delivery date(s)), weighted in accordance with the distribution of Labour usage over that period;

Mo represents the Material Index figure for (.....) (i.e. the date on which VOP arrangements commence) (as above);

Mj represents the weighted mean Material Index figure for the period (..to..) (i.e. the period during which Material costs are anticipated to be incurred in order to meet the contractual delivery date(s)), weighted in accordance with the distribution of materials payments over that period;

2. The Index numbers referred to in Clause 1 above shall be taken from the following Tables:

> a. Labour - (e.g. Labour Market Trends incorporating the Employment Gazette Table 5.3 `Average Earnings Index: All Employees: by Industry (unadjusted)': column headed `Machinery and Equipment nec (29)').
>
> b. Material - (e.g. CSO Business Monitor MM22 Table 1 `Price Index Numbers of Materials and Fuel Purchased...': row headed `Machinery and Equipment not elsewhere classified PLLQ 62922290000').

3. In the event that any changes occur to the basis of any of the Indices, (e.g. a change in datum or a revised statistical base) during the period of the Contract and before final adjustment of the Contract Price(s), or should the Tables referred to cease to be published, e.g. because of a change in the Standard Industrial Classification (SIC) [such as that from SIC 1980 to SIC 1992 implemented in 1995], the Authority and the Contractor shall agree a fair and reasonable adjustment to the relevant Index, or, if appropriate, shall agree revised formulae which will have substantially the same effect as those specified herein.

4. The Contractor shall notify the Authority of any significant changes in the purchasing/manufacturing plan on the basis of which these provisions were drawn up and agreed or, of any other factor having a material bearing on the operation of these provisions such as to cause a significant divergence from their intended purpose, in order that both parties may consider whether any change in this provision would be appropriate.

5. Prices shall be adjusted taking into account the effect of the above formula as soon as possible after publication of the relevant indices or at a later date if so agreed between the Authority and the Contractor. Where an Index value is subsequently amended the Authority and the Contractor shall agree a fair and reasonable adjustment to the price, as necessary.

6. Claims under this Condition shall be submitted to the Bill Paying Branch, certified to the effect that the requirements of Clause 5 of the above have been met.

Notes

1. This specimen illustrates a simple formula showing the Contract Price divided into Labour and Materials elements. In some Contracts, another formula structure might be more relevant. For example: Variation a; for single commodity purchasing a Labour element might not be needed; Variation b; if certain materials are expected

to escalate in price significantly compared to others to be purchased, it might be sensible to include two or more different material elements in the formula. In general it is advisable to use as simple a formula as possible.

2. Indexed escalation provisions need to be related to the base date or dates on which the Base Price to be escalated is agreed. These may be different as between Labour and Materials. For example, the Labour element may have been based on agreed annual average charging rates for the financial year in which the Base Price is agreed. Such rates already anticipate changes in cost levels and application of formula VOP during the period would clearly be inappropriate. Assessing the base date for Materials costs would be subject to different considerations.

3. Care also needs to be exercised in determining the dates to be inserted against Li and Mj in the formula above. It will normally be appropriate, through non-competitive price investigations, or otherwise through receipt of spend or commitment profiles from the Contractor, to take account, not only the periods over which Labour and Material costs will be incurred but, also their incidence within those periods.

4. Escalation of agreed Material prices which are already on a FIRM basis, or pay rates on which future increases have been agreed, is clearly inappropriate. Care needs to be taken to ensure that such costs are not included within the Labour and Material costs to be escalated in cases where the risk of inflationary increases has been removed or taken into account in fixing the Base Price. This should be taken into account either in setting the base date (see Note 1) or in the non-variable element (NVE). Similarly, sub-contracts for which separate VOP arrangements have been agreed, should not be included when calculating adjustments to the original FIXED price. Adjustments arising from such sub-contracts are dealt with outside the VOP arrangements applying to the main contract price.