SSRO

Single Source
Regulations Office

Guidance on the pricing of qualifying defence contracts and subcontracts

Consultation on guidance changes arising from the review of

Contents

1. Introduction

Background

1.1 In April 2022, the Secretary of State for Defence concluded his periodic review of the regulatory framework established by Part 2 of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations). The outcome of the review was published in the MOD's Defence Command Paper titled "Defence and Security Industrial Strategy reform of the Single Source Contract Regulations 2022" published on 4 April 2022 (the Command Paper), which proposed significant changes across the principal features of the regulatory framework relating to:

- the controls on prices of qualifying contracts (qualifying defence contracts and qualifying sub-contracts); and
- the transparency required from defence contractors over their prices and other matters.

1.2 The MOD is giving effect to its policy intent by changing primary and secondary legislation. Changes to the Act are being made through Schedule 10 of the Procurement Act 2023, which received Royal Assent on 26 October 2023. The MOD expects that changes to the Regulations will be given effect in two tranches, through two statutory instruments.

1.3 In May 2023 the SSRO issued a working paper to the MOD and industry members of the Defence Single Source Advisory Group (DSAG) outlining our early intended approach to developing guidance in response to the upcoming legislative changes. We received feedback on this working paper which we have incorporated into the guidance issued alongside this consultation.

1.4 We are issuing this consultation on the new pricing guidance to ensure alignment with the new legislative position. These changes have been informed by discussions with the MOD and Industry stakeholders, most prominently DSAG and the SSRO's Operational Working Group (OWG).

1.5 We will continue to work closely with the MOD as its legislative timetable progresses, and we will be clear in our communications with stakeholders about our plans and work on other changes to the regulatory framework. This is likely to require a programme of significant development and change over time and we are engaging with stakeholders about how this can best be delivered.

1.6 Details on the implementation of the guidance on which we are consulting is contained in section 8 of this document.

1.7 Details of the consultation review period and how to respond are contained in section 9. We have allowed 12 weeks for responses, the deadline for receipt of which is 17 April 2024.

2. Overview of pricing guidance changes

2.1 The SSRO currently publishes three pieces of pricing guidance:

a. Guidance on the baseline profit rate and its adjustment;

b. Allowable costs guidance; and

c. Guidance on inflation.

2.2 The SSRO's Guidance on the baseline profit rate and its adjustment supports parties to a QDC or QSC to understand how adjustments are made to the baseline profit rate to arrive at a contract profit rate. The current guidance on the baseline profit rate and its adjustment is version 7.3, which applied from 1 April 2023.

2.3 The SSRO's allowable costs guidance supports parties to a QDC or QSC to determine whether the requirements of allowable costs are met. The current allowable costs guidance is version 6, which applied from 7 November 2022.

2.4 The SSRO's Guidance on inflation supplements the SSRO's existing allowable costs, profit, and reporting guidance on the topic of inflation. The current guidance on inflation is version 1, which applied from 7 March 2023.

2.5 Proposed changes to the Act and Regulations necessitate revisions to these existing pieces of guidance. In addition, the SSRO proposes to issue new guidance to assist the parties to QDCs and QSCs to apply the new alternative methods of pricing contracts enabled by the amended Act and provided for in the amended Regulations.

2.6 The remainder of this document explains the new and revised guidance and that we are now consulting on. It covers the following topics:

The baseline profit rate and its adjustment

- Cost risk adjustment – Changes to the scope to the cost risk adjustment (CRA), which has been expanded, and new considerations must be made when agreeing a CRA.
- Removal of profit rates steps – Profit on Cost Once Adjustment (POCO) and the SSRO funding adjustment.

Allowable costs

- Profits arising from costs made by a person connected with a primary contractor – This adjustment replaces the POCO adjustment which had been dealt with in the guidance on the baseline profit rate and its adjustment.

Alternative pricing

- New guidance covering the seven new methods of pricing as alternatives to the application of the pricing formula.

Cross cutting issues

- Componentisation of contracts – pricing of contracts in circumstances where a part of a contract is treated distinctly from other parts for the purpose of pricing.
- Contracts entered into prior to 1st April 2024.

General matters

- Changes to the Act and the Regulations necessitate guidance restructuring and further minor amendments to ensure it correctly reflects the revised legislation whilst remaining accessible for users.
- Additional standardisation in the presentation of guidance intended to make it more accessible to users.
- Amendments in response to general stakeholder feedback and queries raised with the SSRO on application of the guidance since existing documents were last updated.

2.7 Each piece of SSRO pricing guidance now also contains a common introduction. This provides an overview of the ways in which a QDC or QSC may be priced and highlights for the reader other key related aspect of the legislation. The aim is to help readers understand how these legislative provisions fit together and are supported by the SSRO's guidance.

2.8 The baseline profit rate and capital servicing rates for financial year 2024/25 will be determined by the Secretary of State and published in March 2024. The final guidance on the baseline profit rate and its adjustment will include the rates, when issued.

2.9 The following sections provide commentary on our new guidance. Where applicable we refer to feedback we have received and how it has shaped the current consultation, and feedback we receive as part of this consultation is expected to inform the further development of the guidance.

3. Guidance on the baseline profit rate and its adjustment

3.1 This section details the changes to the guidance on the baseline profit rate and its adjustment. The changes cover:

a. Changes to guidance on the application of the cost risk adjustment to reflect the revised scope of the adjustment.

b. Removal of guidance on the POCO adjustment from the guidance on the baseline profit rate and its adjustment. This adjustment, if applicable, will now be made to the allowable costs (see section 4 of this consultation).

c. Removal of guidance on the SSRO funding adjustment, which will no longer be required.

d. Changes to the incentive adjustment to better align the guidance structure with other sections and to reflect feedback provided to the SSRO on its application.

Cost risk adjustment

3.2 The revision to the step 2 cost risk adjustment (CRA) as set out in the amended Act and Regulations expands the scope of what the parties may consider when determining the appropriate CRA to include not only the cost risk(s) that estimated allowable costs may differ from actual allowable costs (as is presently the case), but wider financial risks linked to entering into the contract or component which may have some other financial impact on the contractor.

Section 17(2) Adjust that rate [the baseline profit rate] by an agreed amount, being an amount falling within specified parameters above or below the baseline profit rate, so as to reflect the financial risks to the primary contractor of entering into the contract or component, taking into account the particular type of activities to be carried out by the primary contractor under that contract or component.[1]

3.3 We are publishing guidance changes to support stakeholders to understand the new requirements of the CRA, including:

a. the definition of financial risks;

b. the factors to consider when deciding on the appropriate adjustment; and

c. the factors to consider when taking into account the particular type of activity under the contract or component.

3.4 The Regulations maintain the current range of the CRA at plus or minus 25 per cent of the baseline profit rate.

3.5 The SSRO previously proposed to include in our guidance four risk categories that had been developed by the MOD, with input from particular suppliers, to support navigation of the CRA. These factors provide a useful guide to the circumstances and features of the contract or component being priced that should be taken into account when considering the extent of financial risk associated with agreeing the CRA, ensuring that relevant risk factors are not overlooked.

3.6 Feedback from industry stakeholders supported maintaining a flexible approach to navigating the CRA. Whilst the risk factors were recognised by some stakeholders as useful, they were not considered exhaustive in their scope, and it was insufficiently clear that the factors were illustrative and not exhaustive. We believe that including these risk factors in our guidance, while indicating they are illustrative and not exhaustive, strikes the right balance in directing parties to particular matters they should be considering under the CRA whilst maintaining the ability of the parties to focus on the matters they consider to be most relevant within the bounds of the legislation.

3.7 The legislation includes a new requirement that when determining a CRA, parties must take into account "*the particular type of activities to be carried out by the primary contractor under that contract or component".* The SSRO has sought stakeholder views on the guidance it should provide to contractors and the MOD in respect of this new requirement.

3.8 The SSRO suggested this requirement might be informed by the activity-based profit benchmarks it calculates as part of its annual baseline profit rate assessment. For example, our benchmarks show that activities such as common commercial construction or ancillary services tend to generate lower rates of profits on average than the manufacturing and support type activities which make up the baseline profit rate.

3.9 Industry stakeholders suggested that such an approach may in effect introduce multiple activity-based baseline profit rates, of which they were not supportive. The SSRO sought further proposals from stakeholders as alternatives to the approach we had suggested, but we received no alternative proposals.

3.10 Given the concerns expressed to us, our guidance explains that application of the baseline profit rate alone will be sufficient in the majority of cases to meet the requirement to have taken into account the activities to be carried out. This is because the activities which underpin the baseline profit rate cover the majority of those undertaken in QDCs and QSCs. Where activities under the QDC or QSC differ substantially from those which underpin the baseline profit rate, the guidance recommends that a proportionate approach be agreed between the contracting parties as to whether the activities under the contract indicates a higher or lower rate of profit should be agreed.

3.11 The guidance draws attention to the SSRO profit benchmark as a useful reference point in this regard, but it is not prescriptive. We believe this provides a consistent and implementable approach to applying the new legislative requirements in a way that addresses industry concerns.

3.12 The current section of the guidance on principles to be considered retains the same key principles, adapted to reflect the revised scope of the CRA. Modifications have been provided to better align the principles with the current allowable costs guidance on risk and uncertainty.

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

Profit on cost once adjustment

3.13 Changes to section 17(2) of the Act and regulation 11(4) mean that a profit on cost once (POCO) adjustment is no longer part of the determination of the contract profit rate. Any profit that has been applied to costs more than once must now be addressed through an adjustment to the allowable costs. The guidance on the step 3 POCO adjustment step has been removed and is replaced by a new section in the allowable costs guidance - Costs associated with group profits.

SSRO Funding adjustment

3.14 Changes to section 17(2) of the Act and regulation 11(4) mean that the SSRO funding adjustment is no longer part of the determination of the contract profit rate. This section has therefore been removed in its entirety.

Incentive adjustment

3.15 The guidance changes are to reflect:

- the revised provisions under section 17(2) of the Act and regulation 11(6) to apply an incentive adjustment to components of the contract, and
- the reduction in the number of steps in the determination of the contract profit rate from six to four.

3.16 Together with guidance changes to reflect the revised regulations, we are also taking the opportunity to update to the guidance on the incentive adjustment to improve its clarity and applicability. The proposals are intended to:

- improve consistency in structure and content with other parts of the guidance; and
- take account of representations made by our stakeholders on the guidance, gathered as part of our engagement on the MOD's policy development on the legislative changes.

3.17 Stakeholder feedback on this has emphasised the need for clarity between the parties on the operation of any incentive adjustment. In particular, clarity was sought by industry on how costs incurred by the contractor associated with the activities or initiative enhanced performance delivery should be treated. The guidance makes clear that there should be a clear agreement between the parties on all aspects of the application and operation of the incentive adjustment. However, the SSRO is not empowered to prescribe in guidance the specific approach the parties should take. This remains a matter of commercial judgement between the parties to the contract, within the bounds of what the Act and Regulations permit.

3.18 The regulations do not change to the maximum available incentive adjustment of two percentage points. As such this aspect of the guidance remains unchanged.

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 apply step 3.

Other changes

3.19 The legislation introduces two new adjustments to the contract price: the total cost risk adjustment and the total incentive adjustment. These adjustments form part of the new provisions for the alternative pricing of contracts and is not part of the 4 steps to determine the contract profit rate. We have included in the guidance on the four-step contract profit rate setting process steps two and four (the cost risk adjustment and the incentive adjustment) new material to make the reader aware of these new adjustments and where to locate the guidance on their application.

3.20 The guidance on the capital servicing adjustment now reflects its new position as step 4 in the contract profit rate setting process. Amendments have been proposed that recognise that the capital servicing adjustment may now be agreed for a component as well as a contract. The guidance encourages a proportionate approach in this regard. Changes have been made to aid clarity of certain aspect of the calculation. Section 7 of this document describes these changes and other minor amendments we intend to make to the guidance.

4. The allowable costs guidance

4.1 This section details the proposed changes to allowable costs guidance on which we are consulting. The proposed changes cover:

- the guidance on costs associated with mitigating risk or uncertainty in light of the changes to the cost risk adjustment;
- componentisation of contracts; and
- how an adjustment to allowable costs is to be made where costs arise from profits made by a person connected with a primary contractor.

Costs associated with mitigating risk or uncertainty

4.2 As further explored in paragraphs 3.2-3.12 of this consultation, the scope of the cost risk adjustment is changing. During initial engagement with stakeholders when preparing for this consultation, we received feedback from industry stakeholders that there was sometimes confusion over how costs associated with risk and uncertainty should be treated where a cost risk adjustment was also in place.

4.3 We have therefore provided clarification that these costs should be include in estimates of allowable costs (to the extent they meet the relevant requirements), and that the CRA should only be used to reward the one or the other party for risk bearing in relation to the contract.

Costs associated with group profits (previously POCO)

4.4 Schedule 10 amends section 20 of the Act to provide as follows:

(2A) Single source contract regulations may provide that the requirements set out in subsection (2)(a) to (c) are not met in relation to a cost where the cost arises from profits made by a person connected with the primary contractor.

(2B) The regulations may specify the circumstances in which a person is connected with the primary contractor.

4.5 The referenced requirements in subsection (2)(a) to (c) are that a cost must be appropriate, attributable to the contract, and reasonable in the circumstances.

4.6 The requirements are set out in regulation 13A. In practice, this new provision will replace the Profit on Cost Once Adjustment that has been removed from the calculation of the contract profit rate.

4.7 This adjustment to allowable costs ensures that if a party to a qualifying defence contract enters into a group or further group sub-contract then profit arises only once in relation to allowable costs included in the group or further group sub-contract price. This is because the price under the regime should be fair to contractors, and if a contractor is profiting twice on the contract and a group sub-contract then the price is higher than the fair price, and therefore does not meet the other objective of providing value for money to the taxpayer.

4.8 The SSRO's proposed guidance describes the legislative requirements for the adjustment and provides a worked example calculation to aid stakeholders' understanding of how the regulation applies in practice.

4.9 Key parts of the proposed guidance include how to determine the attributable profit and how that is to be applied to the allowable costs to calculate the final contract price.

We welcome feedback on the proposed guidance and the worked example.

5. Alternative pricing

5.1 The changes to section 15 of the Act enable the price payable under QDCs or QSCs (or components of those contracts) to be determined by a means other than the pricing formula. New section 15(2) provides as follows:

"The regulations must provide for the price payable under the contract, or any component, to be determined—

(a) in accordance with the formula in subsection (4), or

(b) in such circumstances as may be specified in the regulations, in accordance with another method."

5.2 The circumstances in which alternative pricing may be used are set out in the Regulations. The Act also enables the Regulations to make provision requiring a particular method of alternative pricing to be used in specified circumstances (new section 15(2B)). Where the circumstances for the purpose of alternative pricing do not apply, the price payable is to be determined using the pricing formula.

5.3 The new Chapter 3 of Part 3 of the Regulations (Alternative pricing of contracts) sets out the approach to pricing in accordance with *another method;* which we refer to in this paper as "alternative pricing". The following seven alternative pricing methods are provided for:

a. Commercial pricing;
b. Prices determined in accordance with law;
c. Previously agreed price;
d. Novated contract price;
e. Competed rates applied to uncompeted volumes (CRUV);
f. Agreed changes to the contract profit rate; and
g. Aggregation of components.

5.4 New section 35A of the Act provides that "The SSRO may issue such guidance as it considers appropriate in relation to the application or interpretation of this Part or single source contract regulations".

5.5 Pursuant to this power and the SSRO's statutory aims of ensuring fair and reasonable prices and value for money in carrying out our functions, the SSRO proposes to issue guidance to assist the parties to QDCs and QSCs to apply the alternative pricing methods in accordance with the legislation. The remainder of this document explains our guidance proposals for each alternative pricing method. A version of the proposed guidance has been published alongside this document.

Commercial pricing

5.6 Section 3 of the guidance covers the "commercial pricing" alternative pricing method. The MOD considers that it may be possible to gain adequate assurance on value for money for a QDC or QSC where the price under those contracts (or relevant components thereof) are determined by market forces. The Regulations allow the price payable to be determined by reference to market prices rather than by application of the pricing formula (now referred to in the regulations the "default pricing method").

5.7 The guidance explains to the user how to apply the commercial pricing method. Key parts of the proposed guidance relate to the following areas:

a. The regulations allow for a price to be determined based upon pricing information relating to particular types of historical transactions in specified circumstances. These transactions and circumstances are explained in the guidance alongside reference to the relevant regulations in paragraph 3.2 of the Alternative pricing guidance. We welcome feedback on the accessibility and clarity of how this has been explained in the guidance and any suggestions for improvement.

b. The legislation introduces specific terms and concepts which must be understood and applied when using this method. For example, the guidance explains the meaning of "the same or substantially the same specifications", "open market" and "competitive environment", the interpretation of which must be agreed between the parties in the application of this pricing method. Explanations and definitions are provided in the guidance aimed at defining or explaining these terms and concepts and we welcome feedback on their suitability.

5.8 Discussions with SSRO stakeholders indicated that the SSRO should seek to provide clarity in guidance on specific aspects of this pricing method. The guidance seeks to explain:

a. How it should be determined if the goods, works or services (GWS) being procured are of substantially the same specifications.

b. That the commercial pricing method may not be used in circumstances where the Secretary of State has made a direct payment for the research and development of the GWS in question and explains what is meant by a direct payment.

c. The need for transparency between the parties on the evidence they hold that is relevant to the determination of a commercial price and where the burden of proof lies in various circumstances.

d. The approach to determining the contract price where there are multiple instances of transaction data relevant to the good(s) being priced. For example, where the supplier has sold the GWS in a previous competition at difference prices or there is no single open market price for the good(s) being procured.

e. The approach that should be taken to determine the price differential based between the original commercial price and the price of the QDC or QSC (or component) – "a reasonable adjustment" (noting that the GWS must be of the same or substantially the same specifications).

5.9 The guidance seeks to maintain flexibility for the parties to reach an agreement based on the varying circumstances in which this method may be applied. It does this whilst ensuring the parties are aware of the legal requirements that must be met, thus aiming to value for money and fair and reasonable prices.

We welcome feedback on the new guidance in relation to commercial pricing 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.

Prices set by law

5.10 Section 4 of the guidance covers the "prices set by law" alternative pricing method. The guidance explains the circumstances in which this pricing method can be used, and how the price of the contract or component must be determined if this method is applied.

5.11 This method is intended to apply when a law exists whose application is in conflict with the pricing provisions of the Act and Regulations. This might include, for example, services from a regulated UK utility provider. In such cases this method allows the alternative pricing provisions to be applied so far as is necessary. Any aspects of the price that can be determined in accordance with the Act and Regulations, and not be in conflict with the relevant other law, are to be applied.

5.12 The Regulations set out a range of requirements that must be met in order for this method to be applied. A flow chart is included in the guidance in order to help users of the guidance navigate these requirements.

5.13 To assist users of the guidance, examples are provided of when this method may and may not be applied. It also emphasises the duty on the contracting parties to be aware of their legal obligations in respect of pricing, including the existence and nature of any laws that may conflict with the pricing requirements for a QDC or QSC. Exclusions are explained, such as laws which govern the sales of single source defence GWS in countries other than the UK, such as the Federal Acquisition Rules in the United States.

5.14 The Regulations require the price under this pricing method to be determined either:

- as specified in the relevant law; or
- if a price is not specified, as close as possible to the price that would have been determined under the Regulations, but for the relevant law.

5.15 In the latter of these circumstances the guidance explains how a price might be derived by disapplying other pricing provisions to the minimum extent possible. This appears to the SSRO to be an efficient way of meeting the legislative requirement, avoiding the need to price the contract several times in order to determine what is "as close as possible".

We welcome feedback on any of the proposed guidance on the prices set by law pricing method, and 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

Previously agreed price

5.16 Section 5 of the guidance covers the "previously agreed price" alternative pricing method. This method applies in circumstances where either:

- an amendment to an existing contract results in that contract becoming a QDC (a QDC by amendment); or
- where the parties to a QDC agree to transfer an obligation to provide GWS transfers to another QDC.

5.17 A QDC by amendment may have distinct parts of the price that have been agreed. This alternative pricing method may apply to those elements. Under this method the agreed parts will become a component at their agreed amounts, and will not be subject to repricing unless the parties agree otherwise. The remaining part(s) of the contract will be priced in accordance with the pricing provisions of the Act and Regulations.

5.18 Where an obligation to provide GWS is transferred from one QDC to another, this alternative pricing method may apply to the element that has been transferred. Under this method the agreed parts will become a component at their agreed amounts, and not be subject to repricing unless the parties agree otherwise.

5.19 The guidance explains the elements of the agreed price which relate to:

a. Unamended parts; and
b. Parts related to GWS;
c. provided under the contract prior to the date of conversion; or
d. to be provided after the date of conversion.

5.20 We received feedback to our working papers that our use of the terms "sunk" and "committed" prices which have been used in relation to this method are confusing and not necessary. These terms have not been used in our guidance.

We welcome feedback on any of the proposed guidance on the previously agreed pricing method, including any 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.

Novated contracts

5.21 Section 6 of the guidance covers the novated contracts alternative pricing method. Novation occurs when a party to the contract changes. Where a contract novation occurs in that situation, an existing QDC or QSC is extinguished and replaced with another under which the incoming party takes up the rights and obligations which duplicate in all material respects those of the outgoing party. This alternative pricing method may be applied to ensure the price of the new QDC or QSC remains the same as the price of the QDC or QSC it replaces.

5.22 The guidance explains the conditions which must be met and how the contract price must be determined under this method. This can be summarised in that when a QDC or QSC is novated, but remains the same in all other material respects, the price of the new contract is the same as the contract it replaces. This is set out in

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.

Competed rates applied to uncompeted volumes (CRUV)

5.23 Where a competed framework agreement exists for the provision of certain GWS, and the framework agreement contains the unit prices or rates of those GWS, this method may be applied to determine the price of QDCs or QSCs awarded in accordance with that framework agreement for the procurement of the GWS by applying the unit prices or rates to the uncompeted estimated volume of GWS.

5.24 Section 7 of the guidance sets out the circumstances in which the CRUV alternative pricing method may be applied. It goes on to explain the method of determining the price of the contract or component, which is to apply the competed prices or rates in the framework agreement to the estimated volume of GWS being procured.

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.

Agreed changes to the contract profit rate

5.25 Section 8 of the guidance covers the agreed changes to the contract profit rate alternative pricing method. It explains that the pricing method may be applied if the price was originally determined using the pricing formula, and the parties agree to change the contract profit rate.

5.26 The guidance explains the limited circumstances in which this method can be applied, which are where an error has been identified in the calculation of the original contract profit rate, or a step 3 incentive adjustment is to be applied. In these cases, the parties may agree to adjust the price to correct the error, or apply the incentive adjustment (as the case may be).

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.

Aggregation of components

5.27 Section 9 of the alternative pricing guidance covers the aggregation of components alternative pricing method. The new pricing provisions allow for the price payable under a contract to be made up individually priced components (regulation 4A). The aggregation of components pricing method allows the total contract price (the aggregate of all component prices) to be adjusted to reflect financial risks of entering into the contract, or to provide an incentive in relation to a particular provision of the contract which may include the use of different contract profit rates or regulated pricing methods.

5.28 Our guidance describes the legislative basis for each of these adjustments, and provides a worked example to aid practitioners.

5.29 This pricing method allows for the price payable for the contract to be determined by adding together the prices of each of the components of a contract. Where this method is used to determine the overall price for the contract, the amended section 17(2) of the Act and regulation 19G will allow for the overall price to be further adjusted to:

a. reflect the financial risk to the primary contractor of entering into the contract, taking into account the particular types of activities undertaken under that contract, where these risks have not been fully covered within component level cost risk adjustments (the aggregated contract cost risk adjustment); or

b. as determined by the Secretary of State, an additional financial incentive (the aggregated incentive adjustment) to the primary contractor as specified by the Secretary of State for provisions of the contract;

5.30 One, or both, of these adjustments may be applied to a contract whose price is determined in this manner.

5.31 There are restrictions on the range of values for a cost risk adjustment and an incentive adjustment as set out in the SSRO's guidance on the baseline profit rate and its adjustment. These restrictions apply in the determination of the contract profit rate for each component under the contract, and to any further adjustment which may be applied to the aggregate price. The worked example in the guidance shows how these limits apply.

We welcome feedback on any of the proposed guidance on the aggregation of components method, including any 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.

6. Cross cutting issues

6.1 Changes to certain legislative provisions for pricing of QDCs and QSCs are relevant to the application of all contract pricing methods. These are:

- componentisation of contracts; and
- transitional arrangements.

Componentisation of contracts

6.2 At present, Regulation 10 allows for different regulated pricing methods to be used for "defined components" of a contract. However, there is currently no further provision for defined components of a contract to be treated differently (such as having different contract profit rates), other than in the case where the parties propose to make a pricing amendment to a qualifying defence contract.

6.3 The changes to the Act and the Regulations will now enable contracts to be "componentised". The changes to section 15 of the Act provide for the determination of the price of a "component" of a contract. The definition of a component is introduced in new section 15(6):

In this Part, "component", in relation to a contract, means a part of the contract that is to be treated distinctly from other such parts in determining the price payable under the contract.

6.4 Section 15(7) of the Act provides that a part of a contract is to be treated distinctly (and a component is therefore formed), where either the Regulations contain provision to that effect (i.e. the effect of applying the Regulations is that part of the contract is treated distinctly in determining the price payable) or the parties agree that it should.

6.5 Regulation 9A lists three of the circumstances in which a component must be formed. These are where in determining the price payable under the contract:

a. more than one contract pricing method has been applied to determine the price payable under the contract. For example, where the price formula is used alongside at least one other alternative pricing method, or application of the price formula using more than one default pricing method that determines the allowable costs (e.g. cost plus and firm price); or

b. more than one contract profit rate has been used in the application of the pricing formula. For example, one part of the contract is amended in such a way that retains the same contract pricing method as the unamended part, but the contract profit rates differ between the amended and unamended parts; or

c. the price of a part of the contract has been re-determined in accordance with a provision of the Schedule to the Regulations that requires that part to be treated as a new component. The Regulations provide for a range of methods for amending the price of a contact that the parties may choose to apply. Some of these methods involve determining part of the contract price separately to the remainder of the contract price, thus having formed a component in accordance with section 15(7) of the Act. These scenarios include:

i. Where the parties have agreed to price a part of a qualifying defence contract in accordance with regulation 19C Previous agreed price, regulation 19C (6) specifies the part(s) of the contract that must be a component.

ii. Where parties have previously agreed to price a contract or component under regulation 19A (commercial pricing), and parties then agree to amend the contract to remove a contractual requirement to provide GWS. Where costs have been or will be incurred in relation to the reduced requirement, these costs must be treated as a component.

iii. Where parties have previously priced a contract or component under regulation 19C (the previously agreed prices method) and now propose to amend that contract or component. If the parties wish to amend the agreement so that some of the GWS that were previously priced under the previously agreed prices method would now be priced using another method under the regulations, then these elements must be treated as a component.

6.6 Central to the application of componentisation is the concept of a contract pricing method. A contract pricing method means:

- one of the alternative pricing methods, such as commercial pricing (see section 5); or
- one of the default pricing methods using the pricing formula (which were previously referred to as regulated pricing methods), such as firm price or cost plus.

6.7 In the three circumstances listed under Regulation 9A, the part of the contract relating to the application of each contract pricing method, or different contract profit rates, would be a component.

6.8 The Regulations do not allow for a component to be formed by agreement unless there is a demonstrable commercial purpose for the agreement. That purpose should not however be to affect the amount of any final price adjustment.

6.9 A new introductory section is now included in all of the SSRO's pricing guidance to assist in the application of componentisation. This section provides an overview of the contract pricing methods available and how a contract may be formed of components using those methods.

6.10 Industry stakeholders have raised concerns that misapplication of componentisation could undermine value for money and fair and reasonable pricing. The SSRO's guidance restates the legislative requirement that must be met in order to create components in a contract, including that there must be a demonstrable commercial purpose. The SSRO cannot however issue guidance which seeks to restrict the application of the pricing provisions that the parties seek to apply in a way that is consistent with the legislation.

6.11 Ultimately it is a matter of commercial judgement as to whether a contract should be formed in such a way that must result in components being created, and this will require the consent of the contracting parties. It is not within the remit of the SSRO to issue guidance on how these judgements should be made, for example on whether a contract should be amended or not, or whether a certain default pricing method should be used.

We welcome feedback on any of the proposed guidance changes made to support the proper and proportionate usage of componentisation within the regime, including any specific suggestions for improvements in clarity and applicability.

Contracts entered into prior to 1 April 2024

6.12 The changes to the legislation include that the six contract profit rate steps have been reduced to four, removing the POCO and SSRO funding adjustments.

6.13 For contracts or pricing amendments entered into before 1 April 2024 which applied a contract profit rate calculated using the six step process, those contracts will continue to apply the same contract profit rate and no recalculation is required. This is explained in the relevant guidance.

7. Other changes to the guidance

7.1 We are taking the opportunity to make the following amendments to the guidance aimed at improving clarity on its application.

Allowable costs guidance (version 6)	
Section change relates to	Issue and explanation of change
Definition of a cost incurred	The guidance does not define what it means to incur a cost. We are inserting a new paragraph 3.2 a definition to assist parties in understanding this term.
The AAR Principles	We have edited paragraph 3.1 to remove repetition and improve clarity.
The AAR Principles	Corrected a grammatical error in paragraph 3.6.
The AAR Principles	We have corrected an issue with paragraph 3.12 which resulted in a cut off sentence.
Exceptional or abnormal costs	Paragraphs F.1.3 and F.3.4 require that the SSRO be informed of negotiations or agreements under certain circumstances. We have removed these instructions as we do not believe them to be needed.
Current guidance on the baseline profit rate (version 7.3)	
Section change relates to	Issue and explanation of change
Regulation 13 – cost risk adjustment and capital servicing adjustment.	Regulation 13 explains that cost risk adjustments and capital servicing rates can be agreed on a group basis and sets out how the process to the agreement of a contract profit rate is different in such circumstances. The current guidance does not discuss this option, and therefore stakeholders may not be aware of it. We are setting out what rates agreed on a group basis are and confirming that the guidance applies to them in the same manner as it applies to other rates.
Evidential standards for the cost risk adjustment	Our guidance on allowable costs and on the capital servicing adjustment already provides guidance on how parties should consider taking a proportionate approach to evidencing. We also provide this guidance on evidencing within our guidance on the cost risk adjustment.

Step 4 – The capital servicing adjustment	Following feedback from contractors in relation to calculating the step 4 adjustment, the guidance will make clear that a CSA adjustment of zero is only likely in exceptional circumstances, and that if contractors are calculating a zero adjustment they should recheck their calculations in the first instance. DefCARS provides an automatic CSA calculator. Similarly, a negative value for fixed capital would only occur in exceptional circumstances and we make clear that contractors calculating a negative value here should first recheck their calculations.
The four steps	We have added a new section (Section 6 Final calculation of the CPR) which provides illustrative examples of how to add the four steps together to produce the contract profit rate.
Cash held in group pooling arrangements	We clarified the existing to guidance that where cash held in a group pooling arrangement and is included as an element of capital employed, this amount should not be in excess of the amount required for normal operations, by stating that this means the amount should not include any surplus pooled funds that are utilised by another entity.

8. Implementation

8.1 The guidance on which we are consulting will become effective on 1 April 2024.

8.2 Following receipt of responses to this consultation, the SSRO will consider these responses and update guidance later in 2024, unless there is an exceptional need to update earlier.

8.3 Guidance changes in response to tranche two of the Regulations will be considered and consulted on post April 2024. The SSRO will communicate more precise dates to stakeholders as the timelines on the release of tranche two Regulations becomes clear.

9. Responding to the consultation

9.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on matters raised above and specifically on the following consultation questions:

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

- **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.
- **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.

9.2 Consultees are not required to answer all the questions if they are only interested in some aspects of the consultation.

9.3 Completed consultation responses should be sent:

- by email, including arranging an appointment to speak to the SSRO about the consultation to: consultations@ssro.gov.uk (preferred).
- by post to: Review of legislation pricing review consultation, SSRO, G51/G52, 100 Parliament Street, London, SW1A 2BQ.
- by telephone, including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767.

9.4 Responses to the consultation should be received by 17th April 2024. Responses received after this date may not be taken into account.

9.5 The SSRO also welcomes the opportunity to meet with stakeholders to discuss the proposals during the consultation period. If you wish to arrange such a meeting, please contact us at the earliest opportunity using the details above.

9.6 In the interests of transparency for all stakeholders, the SSRO's preferred practice is to publish responses to its consultations, in full or in summary form. Respondents are asked to confirm in the response whether they consent to their response being published and to the attribution of comments made. Where consent is not provided comments will only be published in an anonymised form.

9.7 Stakeholders' attention is drawn to the following SSRO policy statements, available on its web site, setting out how it handles the confidential, commercially sensitive and personal information it receives and how it meets its obligations under the Defence Reform Act 2014, the Freedom of Information Act 2000, the UK General Data Protection Regulation and the Data Protection Act 2018.

- The Single Source Regulations Office: Handling of Commercially Sensitive Information[2]; and
- The Single Source Regulations Office: Our Personal Information Charter.[3]

2 https://www.gov.uk/government/news/handling-commercially-sensitive-information
3 https://www.gov.uk/government/organisations/single-source-regulations-office/about/personalinformation-charter