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DRAFT STATUTORY INSTRUMENTS

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**2014 No.**

**The Single Source Contract Regulations 2014**

**PART 3**

**Pricing of contracts**

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**10.**—(1) The price payable under a qualifying defence contract to the primary contractor must be determined in accordance with the formula—

$$(CPR \times AC) + AC$$

Where

- (a) “CPR” is the contract profit rate for the contract, determined in accordance with regulation 11; and
- (b) “AC” means the primary contractor’s allowable costs (see section 20), determined in accordance with one of the six regulated pricing methods described in paragraphs (4) to (11) below.

(2) The parties to a qualifying defence contract may agree which of the regulated pricing methods is to be used for that qualifying defence contract.

(3) The parties to a qualifying defence contract may agree that different regulated pricing methods are to be used for defined components of that contract.

*Firm pricing method*

(4) Under the firm pricing method, the allowable costs are the allowable costs as estimated at the time of agreement.

*Fixed pricing method*

- (5) Under the fixed pricing method, the allowable costs are the allowable costs as—
  - (a) estimated at the time of agreement; and
  - (b) adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different allowable costs).

*Cost-plus pricing method*

(6) Under the cost-plus pricing method, the allowable costs are the actual allowable costs determined during the contract or after the contract completion date.

*Estimate-based fee pricing method*

(7) Under the estimate-based fee pricing method, the allowable costs by which the CPR is multiplied are the allowable costs as estimated at the time of agreement.

(8) The allowable costs which are added to the product of the CPR and the allowable costs determined in accordance with paragraph (7) are the actual allowable costs determined during the contract or after the contract completion date.

*Volume-driven pricing method*

(9) Under the volume-driven pricing method, the allowable costs are the allowable costs per unit of volume multiplied by the actual volume of output of the contract.

(10) The allowable costs—

- (a) must be estimated at the time of agreement; and
- (b) may be adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different allowable costs).

*Target pricing method*

(11) Under the target pricing method, the allowable costs are the allowable costs as estimated at the time of agreement.

(12) In this regulation, “specified” means specified in the contract at the time of agreement.

**Steps in determining contract profit rate**

**11.**—(1) The contract profit rate for any qualifying defence contract must be calculated by taking the following six steps.

*Step 1 – baseline profit rate*

(2) Take the baseline profit rate in force at the time of agreement, which is—

- (a) until 31 March 2015, 10.70%;
- (b) on or after 1 April 2015, the rate published in the London Gazette in accordance with section 19(4).

*Step 2 – cost risk adjustment*

(3) Adjust the baseline profit rate by an agreed amount which is within a range of plus or minus 25% of the baseline profit rate, so as to reflect the risk of the primary contractor’s actual allowable costs under the contract differing from its estimated allowable costs.

*Step 3 – profit on cost once*

(4) Deduct from the amount resulting from step 2 the adjustment determined in accordance with regulation 12 (“the POCO adjustment”), so as to ensure that profit arises only once in relation to those allowable costs under the contract that relate to the price payable under any group sub-contract (including any further group sub-contract).

*Step 4 – SSRO funding adjustment*

(5) Deduct from the amount resulting from step 3 the SSRO funding adjustment in force at the time of agreement, which is—

- (a) until 31 March 2017, zero;
- (b) on or after 1 April 2017, the rate published in the London Gazette in accordance with section 19(4).

*Step 5 – incentive adjustment*

(6) Where the Secretary of State determines that the amount resulting from step 4 should be increased so as to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State, increase that amount by an amount (“the incentive adjustment”) specified by the Secretary of State, that amount not to exceed two percentage points.

*Step 6 – capital servicing adjustment*

(7) Take the amount resulting from step 5 and add to or subtract from it an agreed amount (“the capital servicing adjustment”), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract.

(8) In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State—

- (a) must have regard to the capital servicing rates in force at the time of agreement;
- (b) must not apply any adjustment in respect of any costs of the fixed and working capital employed by the primary contractor which are allowable costs under the contract; and
- (c) may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor’s obligations under the contract.

(9) The capital servicing rates are—

- (a) until 31 March 2015—
  - (i) for fixed capital, 6.20%;
  - (ii) for positive working capital, 2.07%;
  - (iii) for negative working capital, 1.25%;
- (b) on or after 1 April 2015, the rate published in the London Gazette in accordance with section 19(4).

**Calculation of profit on cost once (“POCO”) adjustment**

**12.**—(1) This paragraph applies to a qualifying defence contract if, at the time of agreement, the primary contractor is party to, or proposes to enter into, a group sub-contract.

(2) Where paragraph (1) applies to a qualifying defence contract, and the Secretary of State is satisfied that—

- (a) the allowable costs of that qualifying defence contract that relate to the price payable under any group sub-contract have been decreased by an amount equal to the attributable profit on that group sub-contract, and
- (b) the allowable costs of that qualifying defence contract that relate to the price payable under any further group sub-contract which relates to the group sub-contract described in paragraph (a) have been decreased by an amount equal to the attributable profit on that further group sub-contract,

the POCO adjustment is zero.

(3) Where paragraph (1) applies to a qualifying defence contract, and the Secretary of State is not satisfied of the matters described in paragraph (2)—

- (a) the parties may agree an amount by which the contract profit rate for that qualifying defence contract must be decreased in order to exclude the attributable profit that has been included;
- (b) the POCO adjustment is the amount so agreed.

(4) Where paragraph (1) does not apply to a qualifying defence contract, the POCO adjustment is zero.

(5) “Group sub-contract” means a contract—

- (a) the price payable under which includes an amount of profit;
- (b) which is made between the primary contractor and any person associated with the primary contractor;
- (c) the value of which is no less than £100,000;
- (d) the award of which was not the result of a competitive process (as defined in regulation 59 or 60); and
- (e) where the goods, works or services to be provided under the contract are necessary to enable the performance of the qualifying defence contract.

(6) “Further group sub-contract” means a contract—

- (a) the price payable under which includes an amount of profit;
- (b) which is made between two or more persons, each of which is associated with the primary contractor or a group sub-contractor;
- (c) the value of which is no less than £100,000;
- (d) the award of which was not the result of a competitive process (as defined in regulation 59 or 60); and
- (e) where the goods, works or services to be provided under the contract are necessary to enable the performance of a group sub-contract or further group sub-contract.

(7) The attributable profit is—

- (a) where all of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the qualifying defence contract, all the profit element in the price payable under that group sub-contract or further group sub-contract;
- (b) where only part of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the qualifying defence contract, that part of the profit element in the price payable under that group sub-contract or further group sub-contract which relates to the output necessary for that performance.

(8) Attributable profit does not include—

- (a) any capital servicing adjustment made under step 6 of regulation 11;
- (b) any profit which is received by a person which is not associated with the primary contractor.

(9) In determining the value of a contract for the purposes of sub-paragraph (5)(c) or (6)(c) (as the case may be), paragraphs (5) to (12) of regulation 5 do not apply.

(10) In this regulation, “group sub-contractor” means a person with which the primary contractor makes a group sub-contract.

### **Rates agreed on a group basis**

**13.**—(1) This regulation applies where the Secretary of State proposes to enter into two or more qualifying defence contracts with the same primary contractor (“the prospective contractor”) within the period of one year (“the relevant year”).

(2) The prospective contractor and the Secretary of State may agree an amount which may be used as the cost risk adjustment (regulation 11(3)) for any qualifying defence contract entered into between the prospective contractor and the Secretary of State within the relevant year, so as to reflect

the risk of the primary contractor's actual allowable costs under any qualifying defence contract differing from its estimated allowable costs.

(3) An amount agreed under paragraph (2) must be within a range of plus or minus 25% of the baseline profit rate.

(4) The prospective contractor and the Secretary of State may agree an amount which may be used as the POCO adjustment (regulation 12(3)) for any qualifying defence contract entered into between the prospective contractor and the Secretary of State within the relevant year, so as to ensure that profit arises only once in relation to those allowable costs under any qualifying defence contract that relate to the price payable under any group-sub-contract (including any further group sub-contract).

(5) The prospective contractor and the Secretary of State may agree an amount which may be used as the capital servicing adjustment (regulation 11(7)) for any qualifying defence contract entered into between the prospective contractor and the Secretary of State within the relevant year, so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform any qualifying defence contract.

(6) In agreeing a capital servicing adjustment under paragraph (5), the prospective contractor and the Secretary of State must—

- (a) have regard to the capital servicing rates in force at the date that the amount is agreed;
- (b) not apply any adjustment in respect of any costs of fixed and working capital which are expected to be included as allowable costs under any qualifying defence contracts to which the amounts agreed under this regulation will apply; and
- (c) use an average fixed and working capital for any business unit which is likely to be performing the primary contractor's obligations under any such qualifying defence contracts.

### **Re-determination of contract price**

**14.**—(1) This regulation applies where the Secretary of State and the primary contractor propose to amend a qualifying defence contract (or a defined component of a qualifying defence contract) in a way that would affect the price determined under regulation 10 or this regulation.

(2) Where the allowable costs relating to the amendment are severable from the allowable costs under the contract before the amendment, the amended contract price is the total of—

- (a) the price payable under the contract before the amendment; and
- (b) any increase or decrease in the price payable under the contract which is attributable to the amendment.

(3) Where paragraph (2) applies—

- (a) the price payable in respect of the amendment must be determined in accordance with the formula in regulation 10(1);
- (b) the parties to the contract may agree which of the regulated pricing methods is to be used.

(4) Where paragraph (2) does not apply—

- (a) the price payable under the amended contract must be re-determined in accordance with the formula in regulation 10(1);
- (b) the parties to the amended contract may agree—
  - (i) which of the regulated pricing methods is to be used for the amended contract;
  - (ii) that defined components of the amended contract will be priced by different pricing methods.

### **Target cost incentive fee (“TCIF”) adjustment**

15. The circumstances specified for the purposes of section 16(1) are that—
- (a) the qualifying defence contract—
    - (i) contains provision to the effect that the total price payable under the contract (or any defined component of the contract) is subject to adjustment in accordance with section 16(1)(b); and
    - (ii) specifies the matters which must be taken into account in determining the amount of that adjustment; and
  - (b) the price payable under the contract (or those defined components) was determined using the target pricing method.

### **Procedure for determining final price adjustment**

16.—(1) The amount specified for the purposes of section 21(4)(b) (value of qualifying defence contract of or above which this regulation applies) is £5,000,000, and an adjustment may be made to the total price payable by the Secretary of State under a qualifying defence contract (“final price adjustment”) if either—

- (a) the price payable under the contract—
    - (i) has been determined by the firm pricing method, the fixed pricing method or the volume-driven pricing method; and
    - (ii) the total value of the contract is of or above that amount; or
  - (b) the price payable under one or more defined components of the contract—
    - (i) has been determined by the firm pricing method, the fixed pricing method or the volume-driven pricing method; and
    - (ii) the total value of the defined component or components the price of which has been so determined is of or above that amount.
- (2) The amount specified for the purposes of section 21(5)(b) (value below which direction excluding final price adjustment may be made) is £50,000,000.
- (3) The matter specified for the purposes of section 21(6) (matters to which the Secretary of State must have regard in deciding whether to make such a direction) is the effect that making a direction might have on the terms of any subsequent contract that the Secretary of State expects to enter into with that primary contractor.
- (4) A final price adjustment may only be made where the amount of the adjustment would be at least £250,000.
- (5) The Secretary of State may, within—
- (a) three months after receiving a contract costs statement (regulation 29), or
  - (b) 15 months after the contract completion date,

whichever is the sooner, notify the primary contractor that the Secretary of State intends to make a final price adjustment.

(6) The primary contractor may, within three months after providing a contract costs statement, notify the Secretary of State that it intends to make a final price adjustment.

(7) Where a notice is given under paragraph (5) or (6), the Secretary of State and the primary contractor must attempt to agree the amount of the final price adjustment, but if they are unable to reach an agreement either the Secretary of State or the primary contractor may refer the matter to the SSRO for determination.

- (8) A reference under paragraph (7) may be made—

- (a) after the contract completion date; but
  - (b) no later than two years after the contract completion date.
- (9) In making a determination, the SSRO must have regard to—
- (a) the information that was available to each party at the time of agreement;
  - (b) whether the parties disclosed, in a timely manner, the facts and assumptions they used to determine the allowable costs or the contract profit rate;
  - (c) efforts made by the parties to determine whether any allowable cost included in the price payable under the contract met the requirements set out in section 20(2)(a) to (c);
  - (d) any evidence that reductions in the actual costs under the contract are due to efficiency measures taken by the primary contractor.

### **Calculation of final price adjustment**

**17.**—(1) Where the outturn profit rate exceeds the contract profit rate, the final price adjustment is to be calculated in accordance with whichever of paragraphs (2) to (4) applies.

(2) Where the difference is at least 5% but less than 10%, the contract price is decreased by an amount equal to 25% of the outturn profit which exceeds excess level 1.

(3) Where the difference is at least 10% but less than 15%, the contract price is decreased by an amount equal to the total of—

- (a) 50% of the outturn profit above excess level 2; and
- (b) 25% of the outturn profit above excess level 1 (but excluding the outturn profit which is above excess level 2).

(4) Where the difference is at least 15%, the contract price is decreased by an amount equal to the total of—

- (a) 75% of the outturn profit above excess level 3;
- (b) 50% of the outturn profit above excess level 2 (but excluding the outturn profit which is above excess level 3); and
- (c) 25% of the outturn profit above excess level 1 (but excluding the outturn profit which is above excess level 2).

(5) Where the outturn costs exceed the contract price, the contract price is increased by the total of—

- (a) an amount equal to 25% of that excess up to the loss level; and
- (b) an amount equal to 50% of any such excess above the loss level.

(6) In this regulation—

- (a) “excess level 1” means the contract profit which would have been achieved under the contract (before the application of the final price adjustment) if—
  - (i) “AC” in the formula in regulation 10(1) were the outturn costs; and
  - (ii) the contract profit rate were 5 percentage points higher;
- (b) “excess level 2” means the contract profit which would have been achieved under the contract (before the application of the final price adjustment) if—
  - (i) “AC” in the formula in regulation 10(1) were the outturn costs; and
  - (ii) the contract profit rate were 10 percentage points higher;
- (c) “excess level 3” means the contract profit which would have been achieved under the contract (before the application of the final price adjustment) if—

- (i) “AC” in the formula in regulation 10(1) were the outturn costs; and
- (ii) the contract profit rate were 15 percentage points higher;
- (d) “loss level” means the loss which the primary contractor would have made under the contract (before the application of the final price adjustment) had the outturn costs been 5% higher than the contract price;
- (e) “outturn costs” means the amount of the primary contractor’s actual costs under the contract which meet the requirements set out in section 20(2)(a) to (c);
- (f) “outturn profit” means the difference between the contract price and the outturn costs;
- (g) “outturn profit rate” means the outturn profit, expressed as a percentage of the outturn costs;
- (h) references to “the difference” are to the difference between the outturn profit rate and the contract profit rate;
- (i) references to the contract profit rate or contract price exclude any amount resulting from step 5 of regulation 11 (incentive adjustment);
- (j) references to actual costs or the contract price exclude any liquidated damages or interest on overdue payments payable under the terms of the contract.

#### **Determination of contract profit rate adjustments**

**18.**—(1) This regulation applies to any adjustment that has been agreed under step 2, 3 or 6 in regulation 11 (including an adjustment agreed on a group basis under regulation 13).

(2) The SSRO may, on an application by the Secretary of State or the primary contractor made within two years after the contract completion date, determine whether the amount of the adjustment is appropriate.

(3) In making a determination, the SSRO must have regard to—

- (a) the information that was available to each party, and
- (b) the statutory guidance in place,

at the time of agreement.

(4) In making a determination that relates to the amount of an adjustment agreed under step 2 (cost risk adjustment), the SSRO must have regard to the terms of the contract.

(5) If the SSRO determines that the amount of the adjustment was not appropriate, it may determine that the contract price is to be adjusted by a specified amount.

#### **Determination of allowable costs**

**19.**—(1) The Secretary of State may not make an application under section 20(5) for a determination of the extent to which a particular cost is an allowable cost unless—

- (a) the Secretary of State has sent the primary contractor a written notice requiring the primary contractor to show that the requirements set out in section 20(2)(a) to (c) are met in relation to that cost;
- (b) at least 20 working days have elapsed since the date of that notice; and
- (c) no response, or no response which the Secretary of State considers to be satisfactory, has been received.

(2) An application must be made within two years after the contract completion date.

(3) In making a determination, the SSRO must have regard to—

- (a) the information that was available to each party at the time of agreement;



- (b) the statutory guidance in place at the time of agreement;
- (c) in the case of a contract which contains provision of the kind described in regulation 15 (TCIF adjustment), those provisions;
- (d) whether the parties disclosed, in a timely manner, the facts and assumptions they used to determine the allowable costs or the contract profit rate.