

SSRO

Single Source
Regulations Office

Pricing guidance review 2018
Consultation on changes for 2019/20
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1. Introduction

- 1.1 Section 18 of the Defence Reform Act 2014 (“the Act”) requires that the Secretary of State, or an authorised person, and primary contractors have regard to guidance issued by the SSRO in relation to any of the six steps for determining the contract profit rate for a qualifying defence contract (QDC) or qualifying sub-contract (QSC). Section 20 of the Act states that the SSRO must issue guidance about determining whether costs are Allowable Costs under QDCs and QSCs. The SSRO aims to keep its guidance current and relevant and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.2 The current pricing guidance was published in spring 2018. It includes guidance on:
 - a. Allowable Costs¹ (Allowable Costs guidance); and
 - b. the application of the six-step process to calculate the contract profit rate² (profit rate guidance).
- 1.3 The SSRO, in consultation with stakeholders, prioritised the following areas where its pricing guidance would be reviewed in 2018:
 - a. the requirements of Allowable Costs (the AAR test);
 - b. research and development costs (R&D);
 - c. capital servicing adjustment (CSA); and
 - d. cost risk.
- 1.4 As part of the review, which commenced in April 2018, the SSRO:
 - a. issued working papers on the first three of the topic areas to the SSRO’s Operational Working Group whose members are from the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors;³
 - b. held group and individual meetings with members of the OWG to discuss the issues raised by the working papers; and
 - c. received written responses to the working papers from 13 stakeholders, including the MOD, ADS, ten contractors and a consultant with expertise in this area.
- 1.5 A summary of the working papers and the feedback provided on these has been published separately in SSRO (2018) *Pricing Guidance Review 2018: Stakeholder Responses to Working Papers*. The SSRO would like to take this opportunity to thank stakeholders for sharing their views with us. Their input has helped the SSRO to develop the proposals for revision to its pricing guidance that are contained in this document for public consultation.
- 1.6 The SSRO invites all interested parties to comment on the draft guidance contained in sections 2 to 5 of this document by 7 December 2018. The proposed timetable for publication and application of the final guidance is contained in section 6. Our consultation questions and details of how to respond to the consultation are contained in section 7.

¹ SSRO (2018) *Allowable Costs Guidance*.

² SSRO (2018) *Guidance on the Baseline Profit Rate and its Adjustment 2018/19*.

³ The SSRO’s engagement with stakeholders on guidance related to cost risk has been deferred to allow additional time for the MOD to develop its proposals for legislative change in this area following the Secretary of State’s review of the legislation completed in December 2017. Details of any proposals for guidance changes related to cost risk will be published in due course and be the subject of a separate public consultation.

2. Requirements of Allowable Costs (the AAR test)

We propose to replace paragraph 2.2 in the current Allowable Costs guidance with the guidance below. Subsequent paragraphs will be re-numbered.

Key to changes: Text deleted Text revised/moved Text added

Existing guidance	Proposed guidance	Purpose of changes
<p>2.2 Section 20(4) of the Act places the onus upon the primary contractor of a QDC to demonstrate to the Secretary of State (if required) that costs meet those requirements set out in this guidance as being Allowable. The burden of proof rests with the contractor and it is essential that the MOD has the ability to verify, challenge and agree the material costings that are submitted as being Allowable.</p>	<p>2.2 For the purpose of pricing QDCs and QSCs the Act requires both the parties to be satisfied that particular costs meet the requirements of Allowable Costs, having regard to this guidance. To facilitate this, the Secretary of State may require the contractor to show that the requirements are met (with reference to this guidance or otherwise). In such cases, the burden of proof rests with the contractor. Whether or not the Secretary of State requires the contractor to show that the requirements of Allowable Costs are met, the Secretary of State and the contractor must be able to verify, to their satisfaction, that the costs are Allowable Costs.</p>	<ul style="list-style-type: none"> To more accurately describe the provisions of Section 20. To clarify that the legislative requirements are also applicable to QSCs.
	<p>2.3 In relation to a QDC or QSC, and associated reports required under Part 5 of the Regulations, Regulation 20 places a duty on the primary contractor or sub-contractor to keep 'relevant records'. Section 23 of the Act defines relevant records as accounting and other records (whether in hard or electronic form) which the primary contractor or sub-contractor 'may reasonably be expected to keep' and 'which are sufficiently up-to-date and accurate' for use by the Secretary of State or an authorised person for verifying certain matters relating to the price payable under a QDC or QSC, including whether a cost is an Allowable Cost.</p>	<ul style="list-style-type: none"> To note the requirements of Regulation 20 which places a duty on contractors to keep relevant records that may be used for the purpose of verifying that a cost is an Allowable Cost.

Existing guidance	Proposed guidance	Purpose of changes
	<p>2.4 The Act and Regulations do not specify what, if any, other information related to facts, assumptions or calculations is to be provided by a contractor (if required by the Secretary of State), or what standard of information is needed, to show that a cost in a QDC or QSC is an Allowable Cost to the satisfaction of both parties. In determining what type and standard of information is required, the parties should take a proportionate approach considering:</p> <ol style="list-style-type: none"> a. the specific requirements and circumstances of the contract; b. the materiality of particular costs; and c. what it is reasonable to expect would be available. 	<ul style="list-style-type: none"> To indicate the need for the parties to take a proportionate approach in determining what information is required to be satisfied that costs are Allowable and to note influencing factors.
	<p>2.5 The information used to show that costs are Allowable Costs should make sufficiently clear how the costs meet the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.</p>	<ul style="list-style-type: none"> To note the need for information to make clear how the requirements of Allowable Costs are met.

We propose to replace paragraphs 3.1 to 3.7 in the current Allowable Costs guidance with the guidance below.

Key to changes: Text deleted Text revised/moved Text added

Existing guidance	Proposed guidance	Purpose of changes
<p>3.1 Costs are Allowable to the extent they are Appropriate, Attributable to the contract and Reasonable in the circumstances. These criteria apply to all costs (estimated and actual) of a QDC or QSC.</p>	<p>3.1 Costs are Allowable to the extent they are appropriate, attributable to the contract and reasonable in the circumstances. These three requirements apply to all costs of a QDC or QSC, whether estimated or actual, and whether incurred directly or indirectly to enable the performance of the contract.</p>	<ul style="list-style-type: none"> To ensure consistency with the wording of the legislation. To provide clarity that Allowable Costs are those which 'enable the performance' of the contract (consistent with paragraph 4.5 of the guidance).

Existing guidance	Proposed guidance	Purpose of changes
<p>This guidance sets out the principles to be followed. The subsequent paragraphs set out a non-exhaustive list that parties should consider when assessing whether a cost might meet the Appropriate, Attributable and Reasonable criteria and are therefore Allowable.</p>	<p>3.2 This guidance sets out the principles underpinning each requirement and a non-exhaustive list of related factors that the parties should consider when assessing whether particular costs meet the requirements and are, therefore, Allowable Costs. Assessing whether the factors are true requires judgement to be applied by the parties. The relative importance of each factor to the particular costs under consideration, and the level of information required by the parties to be satisfied that the factors are true, are matters for the parties to decide taking account of the circumstances of the case. However, it is unlikely that a requirement will be met where the parties judge none of the underpinning factors to be true.</p>	<ul style="list-style-type: none"> To clarify how the parties should apply the guidance in determining Allowable Costs.
	<p>3.3 The overarching principle is that for costs to be determined Allowable Costs they must support a contract price that delivers good value for money in government expenditure and is fair and reasonable to the contractor.</p>	<ul style="list-style-type: none"> To emphasise the importance of achieving both of these objectives when determining Allowable Costs.
<p>Appropriate 3.2 Guidance on Appropriate costs: A cost is Appropriate if, by its character and nature, it represents a cost that is expected to be incurred in the conduct of delivering the QDC or QSC in question. Appropriate costs are those which should be able to withstand public scrutiny and which can be supported by sufficient justification.</p>	<p>Appropriate 3.4 A cost is appropriate if, by its character, it is a cost that a reasonable person would consider ought to be or have been incurred to enable the performance of the QDC or QSC in question and which would withstand public scrutiny.</p>	<ul style="list-style-type: none"> To clarify the intention of the guidance. To remove the reference to 'sufficient justification' which is dealt with in the proposed guidance at paragraph 2.4.

Existing guidance	Proposed guidance	Purpose of changes
<p>3.3 In order to assess whether a cost is Appropriate, consideration should be given to the following:</p> <ol style="list-style-type: none"> whether a cost might be expected to be incurred in the delivery of the QDC or QSC; whether the cost is suitable for the purpose of the QDC or QSC; whether the inclusion of the cost would withstand public scrutiny; and whether the inclusion of the cost is fair and equitable. 	<p>3.5 In order to assess whether a cost is appropriate, consideration should be given to the following:</p> <ol style="list-style-type: none"> whether a reasonable person, informed of the facts, would consider the cost suitable and necessary to enable the performance of the contract; and whether the cost is of a type that is consistent with the standards of regularity, propriety and prudence expected by Parliament of the Ministry of Defence. 	<ul style="list-style-type: none"> To provide a more explicit statement of how 'public scrutiny' should be considered. To remove consideration of what is 'fair and equitable' which is now addressed in the proposed guidance at paragraph 3.3.
<p>Attributable</p> <p>3.4 Guidance on Attributable costs: A cost is Attributable if it is incurred directly or indirectly for the fulfilment of the QDC or QSC in question and it is necessary to fulfil the requirements of that contract. All costs should be incurred by the contractor and applied to the QDC or QSC on a basis that is consistent with the contracting company's overarching cost accounting practices. The costs should be costs not recovered in any way from another contract, whether past, existing or proposed.</p>	<p>Attributable to the contract</p> <p>3.6 A cost is attributable to the contract if it is incurred by the contractor directly or indirectly to enable the performance of the QDC or QSC in question and is applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State. Costs which are attributable to the contract should not be recovered in any way from another contract, whether past, existing or proposed.</p>	<ul style="list-style-type: none"> To clarify the intention of the guidance. To provide clarity that Allowable Costs are those which 'enable the performance' of the contract (consistent with paragraph 4.5 of the extant guidance). To ensure consistency with the extant guidance at paragraph 4.1 on cost accounting.

Existing guidance	Proposed guidance	Purpose of changes
<p>3.5 In order to assess whether a cost is Attributable, consideration should be given to the following:</p> <ul style="list-style-type: none"> a. whether the treatment is consistent with generally accepted accounting principles; b. whether the cost is borne by the contractor; c. whether the cost has a causal relationship with the contract, in the sense of being required for its delivery; d. whether the cost is identifiable; e. whether the cost is incurred in fulfilling the requirements of the QDC or QSC; and f. whether it can be evidenced that the cost has not already been recovered 	<p>3.7 In order to assess whether a cost is attributable to the contract, consideration should be given to the following:</p> <ul style="list-style-type: none"> a. whether the cost has been or is anticipated to be incurred by the contractor; b. whether the cost has a causal relationship with the performance of the contract; c. whether the allocation and apportionment of the cost to the contract is consistent with the contractor's overarching cost accounting practices or uses a methodology that is agreed with the Secretary of State; and d. whether the contractor has effective controls in place to ensure that costs are only recovered once. 	<ul style="list-style-type: none"> • To clarify the meaning of 'borne by the contractor'. • To enhance consistency in the guidance concerning 'performance of the contract'. • To ensure consistency with the extant guidance at paragraph 4.1 on cost accounting. • To clarify how consideration is given to recovering costs only once.
<p>Reasonable</p> <p>3.6 Guidance on Reasonable costs:</p> <p>A cost is Reasonable if by its nature it does not exceed what might be expected to be incurred in the normal delivery of the QDC or QSC in question, whether under competitive tendering conditions or as a single source contract.</p> <p>Indicators of whether costs are Reasonable include, but are not limited to, the level of competitiveness and/or market testing undertaken in the supply chain, any particular specification and performance requirements, any uncertainty involved, the economic environment, the statutory provisions in place at the time of contracting, the expected benefits provided and any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'.</p>	<p>Reasonable in the circumstances</p> <p>3.8 A cost is reasonable in the circumstances if it is of an amount that is consistent with what a reasonable person would consider ought to be or have been incurred to enable the performance of the QDC or QSC in question and which would withstand public scrutiny.</p>	<ul style="list-style-type: none"> • To clarify the intention of the guidance. • To change the focus of the guidance to consistency with what is considered reasonable, to ensure that consideration is given equally to whether costs are too low as well as whether they are too high. • To reposition the 'indicators of whether costs are Reasonable' as circumstances to which consideration may be given (see new guidance paragraph 3.10).

Existing guidance	Proposed guidance	Purpose of changes
<p>3.7 In order to assess whether a cost is Reasonable, consideration should be given to the following:</p> <ol style="list-style-type: none"> whether it is congruent with meeting the contract requirements; whether the cost would withstand public scrutiny; whether cost estimates are based on empirical evidence, where this is possible; whether the cost is consistent with any available sector/market benchmarks; whether the quantum of the cost is consistent with good business practice; and whether the costs deliver value for money for the UK taxpayer. 	<p>3.9 In order to assess whether a cost is reasonable in the circumstances, consideration should be given to the following:</p> <ol style="list-style-type: none"> whether a reasonable person, informed of the facts, would consider the cost congruent with the performance of the contract; whether the cost is of an amount that is consistent with the standards of regularity, propriety and prudence expected by Parliament of the Ministry of Defence; whether the cost is supported by relevant empirical evidence, where it is reasonable to expect this would be available; whether the cost is consistent with costs of a similar nature that were or are anticipated to be incurred by the contractor in the performance of other contracts or by third parties in similar circumstances; and whether the contractor has taken adequate steps to enhance economy and efficiency in the use of resources. 	<ul style="list-style-type: none"> To provide a more explicit statement of how 'public scrutiny' should be considered. To clarify how relevant empirical evidence should be considered, while noting this may not always be available. To provide a more explicit statement on the application of benchmarking. To remove consideration of 'value for money' which is now addressed in the proposed guidance at paragraph 3.3. To provide a more explicit focus on action to achieve economy and efficiency, which is easier to demonstrate than the achievement of value for money. To remove consideration of 'good business practice' which is both unduly subjective and difficult to evidence.

Existing guidance	Proposed guidance	Purpose of changes
(See 3.6)	<p>3.10 Consideration must be given to the circumstances of the case when determining whether costs are reasonable. Circumstances which may influence costs and which may, therefore, be considered when determining if a cost is reasonable in the circumstances include, but are not limited to:</p> <ol style="list-style-type: none"> a. the level of competitiveness and/or market testing undertaken in the supply chain; b. the particular specification and performance requirements of the contract; c. uncertainty and risk affecting costs; d. events which were not anticipated at the time of agreement; e. the economic environment; f. the statutory provisions in place at the time of contracting; and g. any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'. 	<ul style="list-style-type: none"> • To clarify the need to consider the circumstances of the case. • To identify some circumstances which may be considered. • To clarify that uncertainty may also include risk and will be relevant where this affects costs. • To include consideration of events which were not anticipated at the time of agreement. • To remove consideration of 'expected benefits' which are considered synonymous with the 'specification and performance requirements of the contract' (item 3.10b).

3. Research and development

We propose to replace Part D – Research and development costs in the current Allowable Costs guidance with the guidance below.

Key to changes: Text deleted Text revised/moved Text added

Existing guidance	Proposed guidance	Purpose of changes
D1.1 Contractors will account for private venture research and development expenditure in accordance with the relevant Generally Accepted Accounting Principles. Where it is realistic and suitable to do so, any expenditure of this nature must be allocated as closely as possible to those product groups that the expenditure is designed to benefit. Product groupings already established for the contractor's own purposes will normally be adopted and only revised when this is a necessity to achieve a fair allocation of the expenditure.	(See D.2.3)	<ul style="list-style-type: none"> To enhance brevity and clarity.
D1.2 When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing principles, the following guidelines to assess it as Allowable will normally apply:	(See D.2.3)	<ul style="list-style-type: none"> To enhance brevity and clarity.
a. Any costs relating to projects where the research and development activity has already been funded via other routes should not be an Allowable Cost. In a case of a joint venture between the Secretary of State and other customers, a proportion of costs relevant to the Secretary of State's take up could be Allowable provided these costs have not been recovered elsewhere.	(See D.3.2)	<ul style="list-style-type: none"> To enhance brevity and clarity.

Existing guidance	Proposed guidance	Purpose of changes
<p>b. Research and development costs should not be allowed where there has been no discernible benefit provided to the QDC or QSC as a whole or where sufficient evidence is not available to support the research and development costs.</p>		<ul style="list-style-type: none"> To remove the 'discernible benefit' test. To remove duplication as information requirements are dealt with in paragraphs 2.2 to 2.5 of the proposed guidance.
	<p>D.1 Research</p> <p>D.1.1 Research means original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.</p>	<ul style="list-style-type: none"> To define terms.
	<p>D.1.2 The costs of research undertaken before or during the contract that directly or indirectly enables its performance may be Allowable costs.</p>	<ul style="list-style-type: none"> To acknowledge the different types of research costs that may be Allowable Costs.
	<p>D.1.3 Where the contractor's method for allocating and apportioning research costs means it is not possible or cost effective to show what amount of historic indirect research costs meet the requirements of Allowable Costs, indirect research costs incurred during the period of the contract may be used to determine the historic indirect research costs that are Allowable Costs provided that:</p> <ol style="list-style-type: none"> the research costs incurred during the period of the contract are consistent with historic levels; the parties agree that the indirect research undertaken during the period of the contract is of potential interest to the Secretary of State when considering the specific circumstances of the contract being delivered; indirect research costs are applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State; and costs are only recovered once. 	<ul style="list-style-type: none"> To acknowledge the potential difficulty in applying the AAR test to historic indirect research costs and clarify an alternative approach to determining whether such costs are Allowable Costs.

Existing guidance	Proposed guidance	Purpose of changes
	<p>D.2 Development</p> <p>D.2.1 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.</p>	<ul style="list-style-type: none"> To define terms.
	<p>D.2.2 Development costs that directly or indirectly enable the performance of the contract may be Allowable Costs.</p>	<ul style="list-style-type: none"> To acknowledge the different types of costs that may be Allowable Costs.
(See D.1.1 to D.1.2)	<p>D.2.3 Accounting standards allow contractors to account for development costs in different ways. They will either recognise an intangible asset arising from development expenditure and amortise this over time or will write off the costs as they are incurred. Development costs may be Allowable Costs under either approach and the treatment already established for the contractor's own purposes should normally be adopted.</p>	<ul style="list-style-type: none"> To acknowledge the potential different treatment of such costs and clarify that either approach may be used to determine Allowable Costs.
	<p>D.2.4 Development costs that are recognised as an intangible asset and amortised are dealt with in section G.1 of this guidance.</p>	<ul style="list-style-type: none"> To link to the part of the guidance where these costs are discussed.

Existing guidance	Proposed guidance	Purpose of changes
<p>c. In the case of a product or service under development, the nature of which is such that it will be possible to ascertain the utilisation of the product or service developed, the recovery should be by direct charge to the product or service concerned.</p> <p>d. In the case of private venture research and development, the nature of which is such that it is not possible to ascertain the utilisation of the product or service developed, the costs should be recovered by a charge to the current total output of the product or service group.</p> <p>D1.3 Development expenditure that gives rise to an intangible asset should be attributed to the relevant product or products of the contractor. The intangible asset generated should fulfil the criteria set out in the relevant accounting standard and such expenditure will be charged direct to the products being developed. The costs of this research expenditure would be recovered through the costs of the relevant products when they are sold.</p>	<p>D.2.5 Development costs that are written off as they are incurred should be applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State.</p>	<ul style="list-style-type: none"> • To clarify the treatment of these costs. • To remove references to a contractor's internal accounting practice, which we do not seek to dictate.
<p>D1.4 Due to the timeframes that research and development programmes can span, there may be circumstances where the parties may agree to carry forward a decision on whether costs are Allowable to a future date.</p>		<ul style="list-style-type: none"> • To revert to the requirement in the Regulations to determine Allowable Costs at the time of agreement, during the contract, or after the contract completion date.

Existing guidance	Proposed guidance	Purpose of changes
<p>D1.5 Abortive research and development expenditure should be treated in the same way as any other research and development expenditure and may be an Allowable Cost.</p>	<p>D.3 Other matters</p> <p>D.3.1 Abortive research or development expenditure should be treated in the same way as any other research and development expenditure and may be an Allowable Cost. This recognises that trial and error is normal and inevitable given the nature of such work. The assessment of what is a reasonable level of aborted work will depend on the information available and the specific circumstances of the contract being delivered, similar to the guidance on reworks, wastage and faulty workmanship (E.2).</p>	<ul style="list-style-type: none"> To explain the basis of this guidance. To explain how the parties can assess whether the level of abortive work is reasonable.
<p>(See D.1.2a)</p>	<p>D.3.2 Costs should only be recovered once. Any costs recovered as a direct cost of any contract should not also be allocated and apportioned as an indirect cost.</p>	<ul style="list-style-type: none"> To reiterate this guidance because the potentially complex nature of allocation and apportionment of research and development to different contracts and cost recovery groups mean it is more likely a mistake may be made.
<p>D1.6 Any benefits or credits gained by contractors through the taxation system as a result of research and development expenditure should be offset against Allowable Costs. This can include tax reductions or cash offsets that reduce the tax liability. The costs associated with making such claims should generally be Allowable.</p>	<p>(See E.4.2)</p>	<ul style="list-style-type: none"> To remove this requirement and broaden the guidance to refer to grants and credits more generally in a different section.

We propose to replace Part E.4 in the current Allowable Costs guidance with the guidance below.

This is not part of the specific research and development guidance, but the change is introduced here because previous specific guidance on benefits and credits gained by contractors through the taxation system as a result of research and development expenditure have been merged with the current guidance on refunds, penalties and notional transactions.

Key to changes: Text deleted Text revised/moved Text added

Existing guidance	Proposed guidance	Purpose of changes
<p>E.4 Refunds, penalties and notional transactions</p> <p>E.4.1 Where Reimbursements, credits, grants or refunds are received by contractors and cannot be identified to a particular contract then these should be apportioned to individual contracts to reduce Allowable Costs.</p>	<p>E.4 Reimbursements, notional transactions and penalties</p> <p>E.4.1 Allowable Costs should be net of any reimbursements, credits, grants or refunds received by contractors that directly reduce a particular cost for the contractor.</p>	<ul style="list-style-type: none"> To broaden the guidance to address reimbursement more generally.
	<p>E.4.2 Grants that are not ring-fenced and adjustments made through company income tax regimes are not relevant to the determination of Allowable Costs because they are not given with a view to directly reduce particular costs.</p>	<ul style="list-style-type: none"> To change the existing requirement to offset credits or benefits gained through the taxation system as a result of research and development expenditure. To broaden the guidance to address grants and credits more generally.
<p>E.4.2 Notional transactions are generally not Allowable.</p>	<p>E.4.3 Notional transactions are generally not Allowable Costs.</p>	<ul style="list-style-type: none"> To be consistent with other guidance.
<p>E.4.3 Civil penalties and fines, are not Allowable as these are payments imposed to compensate for harm done through the wrongdoing of the party concerned, which in this case would be the contractor, and as such generally do not meet the Appropriate, Attributable and Reasonable criteria.</p>	<p>E.4.4 Costs arising from civil penalties and fines are not Allowable Costs. Such costs result from charges imposed by third parties on contractors to penalise them for wrongdoing or to derive compensation for harm done. As such, they do not satisfy the requirements of Allowable Costs.</p>	<ul style="list-style-type: none"> To provide clarification.

4. Capital servicing adjustment: Allowable Costs guidance

We propose to replace Part G.2 – Financing costs in the current Allowable Costs guidance with the guidance below.

Key to changes: Text deleted Text revised/moved Text added

Existing guidance	Proposed guidance	Purpose of changes
<p>G2.1 Any costs associated with the raising of capital will generally not be Allowable. The step 6 capital servicing adjustment is intended to compensate for servicing of capital and the SSRO would not expect these to form part of the Allowable Costs.</p> <p>The SSRO publishes separate guidance on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital they employ in delivering QDCs or QSCs.</p>	<p>G.2.1 Costs associated with the raising and servicing of capital are not Allowable Costs. The approach to calculating the step 6 capital servicing adjustment compensates for these costs.</p> <p>The SSRO publishes separate guidance on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital they employ to enable the performance of a QDC or QSC.</p>	<ul style="list-style-type: none"> To enhance brevity and clarity. To align the guidance to specific words and phrases used in the Act, Regulations, and elsewhere in the guidance.

5. Capital servicing adjustment: Profit rate guidance

We propose to replace sections 17 to 23 in the current profit rate guidance with the guidance below. Subsequent paragraphs will be re-numbered.

Key to changes: Text deleted Text revised/moved Text added

Existing guidance	Proposed guidance	Purpose of changes
<p>17. Basis of capital servicing adjustment</p> <p>17.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the capital servicing adjustment:</p> <p>“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.”</p>	<p>17 Basis of the capital servicing adjustment</p> <p>17.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the capital servicing adjustment:</p> <p>“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.”</p>	
<p>17.2 Regulation 11(8) requires that: “In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:</p> <p>a. must have regard to the capital servicing rates in force at the time of the agreement;</p> <p>b. must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are Allowable Costs under the contract; and</p> <p>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.”</p>	<p>17.2 Regulation 11(8) requires that: “In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:</p> <p>a. must have regard to the capital servicing rates in force at the time of the agreement;</p> <p>b. must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are Allowable Costs under the contract; and</p> <p>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.”</p>	

Existing guidance	Proposed guidance	Purpose of changes																
<p>18 Importance of Step 6 adjustment</p> <p>18.1 The capital servicing adjustment ensures that a contractor receives an appropriate and reasonable return on their investment in fixed and working capital. In the calculation of the baseline profit rate the comparator company data is adjusted to set a baseline with respect to capital employed upon which Step 6 can be added. The approach to this adjustment and the capital servicing rates that apply in the calculation of the baseline profit rate are the same as those at Step 6. This process is set out in the Single source baseline profit rate, capital servicing rates and funding adjustment methodology.</p>	(See 17.5)	<ul style="list-style-type: none"> To enhance brevity and clarity. 																
	<p>17.3 Section 30 of the Act sets out that “[the Act] and single source contract regulations apply to qualifying subcontracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors)”.</p>	<ul style="list-style-type: none"> To clarify that the legislative requirements are also applicable to QSCs. 																
<p>18.2 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2018 are:</p> <table border="1" data-bbox="165 1406 568 1619"> <thead> <tr> <th>Item</th> <th>Rate</th> </tr> </thead> <tbody> <tr> <td>Fixed capital</td> <td>X</td> </tr> <tr> <td>Positive working capital</td> <td>X</td> </tr> <tr> <td>Negative working capital</td> <td>X</td> </tr> </tbody> </table>	Item	Rate	Fixed capital	X	Positive working capital	X	Negative working capital	X	<p>17.4 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2019 are:</p> <table border="1" data-bbox="593 1406 995 1619"> <thead> <tr> <th>Item</th> <th>Rate</th> </tr> </thead> <tbody> <tr> <td>Fixed capital</td> <td>X</td> </tr> <tr> <td>Positive working capital</td> <td>X</td> </tr> <tr> <td>Negative working capital</td> <td>X</td> </tr> </tbody> </table>	Item	Rate	Fixed capital	X	Positive working capital	X	Negative working capital	X	
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<p>18.3 To determine this appropriate and reasonable return, the MOD and contractors must have regard to these rates.</p>		<ul style="list-style-type: none"> To enhance brevity and clarity. 																

Existing guidance	Proposed guidance	Purpose of changes
(See 18.1)	17.5 In the calculation of the baseline profit rate (Step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2018) <i>Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology</i> .	<ul style="list-style-type: none"> To enhance brevity and clarity.
<p>19. Calculating the capital servicing adjustment</p> <p>19.1 The Capital Servicing Adjustment (CSA) calculation requires input of three pieces of data that are likely to be held by the prime contractor and their group sub-contractors and not the MOD – the fixed capital, working capital and cost of production. The prime contractor should propose the CSA adjustment to the MOD, supported by the facts, assumptions and calculations relied upon; the MOD should scrutinise those matters and request any further information required to agree the final adjustment.</p>	<p>18 Calculating the capital servicing adjustment</p>	<ul style="list-style-type: none"> To enhance brevity and clarity.
<p>19.2 The calculation is structured around the above-mentioned three elements of capital servicing used when fulfilling a qualifying defence contract, or qualifying sub-contract, - fixed capital and working capital (positive and negative). These elements of capital cost when combined are classified in this guidance as being ‘capital employed’.</p>		<ul style="list-style-type: none"> To remove duplication.
<p>19.3 The total value of capital employed is then assessed in conjunction with the total cost of production in order to apply a rate of capital servicing (by way of a ratio) that is proportionate to the level of capital employed and used in the cost of production for a qualifying defence contract or qualifying sub-contract.</p>	<p>18.1 This guidance sets out the approach that should be followed to calculate the capital servicing adjustment using a ratio of capital employed to the total cost of production (CP:CE ratio) of a relevant unit of business which is likely to be performing the contractor’s obligations under the contract (the “CSA calculation”).</p>	<ul style="list-style-type: none"> To enhance clarity of the purpose and intent of the guidance.

Existing guidance	Proposed guidance	Purpose of changes
<p>19.4 The capital servicing rates published by the Secretary of State are then applied to determine the capital servicing adjustment to be used in Step 6 of the calculation of the contract profit rate.</p>		<ul style="list-style-type: none"> To remove duplication.
<p>19.5 The diagram on the next page sets out the four computations to be followed in order to determine the capital servicing adjustment. A simple worked example is described at Appendix C to this guidance.</p> <p>19.6 The following section sets out the principles to be followed in order to assess the level of capital employed and the total cost of production.</p>	<p>18.2 The next sections of the guidance set out the calculation of Capital Employed and of Cost of Production, which are required for the calculation. The diagrams after that guidance set out the four computations to be performed. A simple worked example is described at Appendix C to this guidance.</p>	<ul style="list-style-type: none"> To enhance brevity and clarity.
	<p>18.3 The CSA calculation compensates for an appropriate and reasonable return on all capital employed by the contractor for the purposes of enabling the contractor to perform the contract. On this basis financing costs should not form part of Allowable Costs.</p>	<ul style="list-style-type: none"> To clearly link this guidance to the Allowable Cost guidance on financing costs.
	<p>18.4 The CSA calculation assumes that the capital intensity of the unit of business is equivalent to the capital intensity of the performance of the contract. This assumption is a reasonable estimate because a unit of business will normally perform many contracts of a similar nature under similar conditions and it is therefore reasonable to expect that the QDC or QSC will be performed on the same basis with equivalent capital requirements.</p>	<ul style="list-style-type: none"> To explain the rationale for the guidance.

Existing guidance	Proposed guidance	Purpose of changes
<p>20 Calculation of capital employed</p> <p>20.1 A contractor must initially establish the average capital employed for the unit of their business most relevant to the qualifying defence contract (or qualifying defence subcontract), such as a subsidiary company, division or site location. The contractor should apply the most relevant unit of their business based upon their professional judgement.</p> <p>20.2 If figures cannot reasonably be isolated then, in exceptional circumstances, capital employed can be calculated for a contractor's business as a whole.</p>	<p>18.5 The contractor must use the information of the unit of business most relevant to the contract, which may be a subsidiary company, division, Qualifying business unit (QBU), or site location, and is selected based upon professional judgement. If reliable information cannot reasonably be isolated to a unit of business the information of the contractor's business as a whole may be used.</p>	<ul style="list-style-type: none"> To include a term understood by contractors through their other reporting. To remove the requirement to only use the information of the business as a whole in exceptional circumstances because it might be reasonable to use the contracting entity's information if it is sufficiently focussed.
	<p>19 Calculation of capital employed</p> <p>19.1 Capital employed is the debt and equity investment necessary for a unit of business to function. Directly calculating this may be difficult because a unit of business may not separately report the debt and equity necessary for a business to function from other debt and equity investment. Capital employed is instead indirectly calculated with reference to the equal and opposite balance sheet items for which more granular information is available.</p>	<ul style="list-style-type: none"> To set out a general definition. To explain how capital employed is estimated from the total of all capital invested.
(See 20.3)	<p>19.2 Capital employed should be computed as the total assets less total liabilities, excluding interest-bearing liabilities, of the business unit.</p>	<ul style="list-style-type: none"> To set out a general definition in accounting terms to ensure consistency.
	<p>19.3 Capital employed is the average capital employed over the same period used to determine cost of production. At a minimum this is the average of the opening and closing position.</p>	<ul style="list-style-type: none"> To ensure consistency between both calculations.

Existing guidance	Proposed guidance	Purpose of changes
<p>20.3 The next step is to allocate the capital employed in the balance sheet (the net assets) between those items that qualify for capital servicing allowances and those that do not.</p>	<p>19.4 The capital employed is adjusted to remove elements that are not part of normal operations, are equivalent to debt, or irrelevant for single source procurement. These adjustments seek to achieve a result that, when taken with the cost of production as a ratio, approximates the capital intensity of the performance of the contract as closely as is practicable.</p>	<ul style="list-style-type: none"> To set out the definition of the required adjustments with more clarity. To explain why these adjustments are being made.
<p>20.4 The list below indicates those items that will generally be excluded in determining the total capital employed:</p> <ol style="list-style-type: none"> goodwill; adverse (debit) balances in retained earnings; investments in shares and securities; shares held in and permanent loans to subsidiary companies; cash demonstrably surplus to requirements (for example short term investments, deposits, and cash demonstrably in excess of the amount required for working cash resources for day to day operations); capital not employed efficiently, such as: <ol style="list-style-type: none"> land and buildings not in occupation; plant and machinery demonstrably not in use; where held for speculative purposes or for long term expansion not yet planned; or where there has been unreasonable delay in disposal of surplus assets. certificates of tax deposit; and where advance payments by the MOD relating to single source contracts have not been accounted for in a way that reduces them. 	<p>19.5 The following items should generally be excluded from the general definition of total assets less total liabilities, except for interest bearing liabilities:</p> <ol style="list-style-type: none"> items not representing capital employed in normal operations, for example: <ol style="list-style-type: none"> intangible assets with an indefinite useful life; fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets investments in shares and securities; loans to or from other companies, including non-trading balances with group entities; assets held for sale and idle assets not required for the normal operation of the business; or cash in excess of the amount required for normal operations; items that are indirect ways of raising money that should be treated as debt equivalents, for example: <ol style="list-style-type: none"> deferred tax assets or liabilities; or retirement benefit surpluses or obligations; and items generally not relevant for single source MOD contracting. 	<ul style="list-style-type: none"> To update the guidance to reflect accounting terms. To remove very rare situations. To re-align the guidance more clearly around three classes of adjustment.

Existing guidance	Proposed guidance	Purpose of changes
<p>20.5 The following items can generally be included in assets in determining the total capital employed in the business unit (these may result in an addition or a deduction from balance sheet figures dependent upon circumstances):</p> <ol style="list-style-type: none"> a. Assets in the course of construction. b. Trading balances with subsidiary, affiliate and other group companies. c. Inventories, which can be included in capital employed based on costs derived from values recorded in the statutory accounts. This is subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of any inventory in the balance sheet, provided it is accompanied by Auditor Attestation. If a contractor has not already done so in its balance sheet then interim payments on account of work in progress are to be deducted. d. Patents and trade-marks, may be included to the extent that a company can demonstrate that they are registered in the name of the contractor and have not lapsed (or the contractor has a valid licence to use) and they actively or defensively contribute to the conduct of the business, even if they are not shown in the contractor's balance sheet. 	(See 19.2)	<ul style="list-style-type: none"> • To enhance brevity and clarity.

Existing guidance	Proposed guidance	Purpose of changes
<p>e. Development expenditure may be included up to the value shown in the balance sheet 'net' of amortisation and impairment. This is provided that orders have been received, or are likely to be received, for the product developed or under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders.</p> <p>f. Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as a source of capital, and is not deducted from assets.</p> <p>g. Progress payments in respect of the partial completion of a contract are deducted from the value of the related work-in-progress and any excess is treated as capital employed.</p> <p>h. Prepayments by the MOD on single source contracts, calculated after adjusting the contractor's work-in-progress for any difference between the balance sheet's valuation of labour and overhead costs and the valuation for pricing purposes, are deducted.</p> <p>i. Where costs are spread over several years in accordance with an agreed spreading schedule any amount not incorporated into prior period pricing rates at a balance</p> <p>j. The net balance sheet figure for trade receivables is included in capital employed. sheet date will be included as an asset in capital employed.</p>	<p>(See 19.2)</p>	<ul style="list-style-type: none"> To enhance brevity and clarity.

Existing guidance	Proposed guidance	Purpose of changes
<p>20.6 Further general adjustments will then be applied in addition to creditors' figures captured in the financial statements.</p> <p>a. Finance lease creditors will be treated as a source of capital and therefore not deducted.</p> <p>b. All loans (including bank overdrafts) are treated as a source of capital, and therefore are not deducted.</p> <p>c. Share capital and any fixed interest loans such as debentures and specific bank (or other) loans, are usually averaged on the balance sheet figures unless any new items have been introduced during the year, when the date of such introduction is used to give a more precise average figure for that year. Short-term and fluctuating borrowed money such as bank overdrafts may be averaged by deducting the balance sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review.</p> <p>d. Current tax liabilities or assets and deferred taxation are treated as a source of capital, and therefore not deducted. Liabilities to make payments in respect of group relief should be treated in the same way.</p> <p>e. Declared dividends are treated as a source of capital, and therefore not deducted.</p> <p>f. Non-current liabilities, including pension liabilities, should be excluded.</p>	<p>(See 19.2)</p>	<ul style="list-style-type: none"> To enhance brevity and clarity.

Existing guidance	Proposed guidance	Purpose of changes
<p>20.7 Provided no further adjustment has taken place in the group accounts, a contractor's total capital employed in the business unit is taken as being the average of its total net assets as shown in the relevant opening and closing balance sheets for the entity for the period under review.</p>	<p>(See 19.3)</p>	<ul style="list-style-type: none"> To move the explanation of how to average the figures to the start of the guidance.
	<p>19.6 Where cash is held in a group pooling arrangement outside the balance sheet of the unit of business used for the calculation, a value of cash required for normal operations of the business unit may be included as an element of capital employed.</p>	<ul style="list-style-type: none"> To allow for a specific situation where cash is held in a pooling arrangement with other group companies.
	<p>19.7 Further adjustments may be required as part of the calculation if they can be reliably estimated and have a material impact on the result. Any adjustment required will depend on the information available and the specific circumstances of the contract being delivered. Examples of such situations are:</p> <ol style="list-style-type: none"> where a pervasive change is expected to occur that will affect the capital employed of the unit of business; or where considering the timing of a significant transaction during the period will give a more precise average. 	<ul style="list-style-type: none"> To allow the information to be adjusted for unusual events where this will make a significant difference to the final result.
<p>21. Fixed and working capital</p> <p>21.1 For these purposes, in order to calculate the split of total capital employed between fixed and working capital (positive or negative), consideration needs to be given to identify those capital items that are of a 'fixed' in nature from the balance sheet. This figure is then subtracted from the total capital employed figure (as described above) and the balance is then determined as being 'working capital'.</p>	<p>20 Fixed and working capital</p> <p>20.1 To calculate the split of capital employed between fixed and working capital employed a contractor should identify balance sheet items that are fixed in nature; this will generally include items that are held for more than one year. This 'fixed capital value' figure is subtracted from the capital employed and the balance is the 'working capital value', which may be positive or negative.</p>	<ul style="list-style-type: none"> To improve clarity.

Existing guidance	Proposed guidance	Purpose of changes
21.2 Adequate justification should be provided to support the calculation of both fixed and working capital.	20.2 Adequate justification should be provided to support the calculation of both fixed and working capital.	
<p>22. Calculation of cost of production</p> <p>22.1 The information required for the calculation of cost of production is derived from the information supplied during the course of the assessment of cost recovery rate claims, such as the financial or management accounts. It will normally include all of the material, labour and overhead costs of the business unit subject to adjustment for certain items outlined in the paragraphs below.</p>		<ul style="list-style-type: none"> To remove the requirement to use specific sources for information
	<p>21 Calculation of cost of production</p> <p>21.1 Cost of production is the cost incurred by the functioning of a business before financing charges; the general definition being operating revenue less operating profit/loss.</p>	<ul style="list-style-type: none"> To set out a general definition in accounting terms to ensure consistency.
<p>22.2 Cost of production, annualised where appropriate, is computed for the same relevant unit for which capital employed is computed. Among other items, it should include:</p> <p>a. direct costs; and</p> <p>b. indirect costs, with the exception of those items set out below.</p>	<p>21.2 Cost of production should be computed for the same relevant unit of business for which capital employed is computed and should be derived from the same information source to ensure both calculations are made on the same basis. The information should be annualised where appropriate because the capital servicing rates to which the CP:CE ratio is applied are on an annual basis.</p>	<ul style="list-style-type: none"> To ensure that both calculations are made on the same basis. To explain why information may need to be annualised.

Existing guidance	Proposed guidance	Purpose of changes
<p>22.3 It should exclude:</p> <ul style="list-style-type: none"> a. capital expenditure; b. the cost of raising and servicing loan capital; c. distribution of profits; d. notional transactions; e. costs related to assets excluded from capital employed; f. discounts allowed on external sales; g. any loss arising from either an excess or deductible provision of a purchased insurance that arises from a MOD claim; h. the cost of premiums and payments for insurance which cover: <ul style="list-style-type: none"> i. that element of consequential loss insurance that relates to loss of profit; and ii. the contractor's own defects in materials or workmanship incident to the normal course of construction, such as the costs to repair defects in materials or workmanship, and for breach of contract. i. compensation payments of an abnormal nature to the extent that they are excluded from overheads; j. lump sum additions to pension schemes to the extent that they are excluded from overheads; k. subscriptions and donations of a political or charitable nature; l. credits, grants or refunds deducted from overheads; and m. any other costs not considered Allowable under the guidance published by the SSRO. 	<p>21.3 The following items should generally be excluded from the general definition of Operating revenue less Operating profit/loss:</p> <ul style="list-style-type: none"> a. the cost of raising and servicing capital; b. costs related to items excluded from capital employed; and c. costs generally not relevant for single source MOD contracting. 	<ul style="list-style-type: none"> • To enhance brevity and clarity.

Existing guidance	Proposed guidance	Purpose of changes																						
	<p>21.4 Where exceptional adjustments have been made to capital employed in accordance with paragraph 19.5, a corresponding adjustment to cost of production may be required.</p>	<ul style="list-style-type: none"> To ensure that the cost of production calculation is consistent with the capital employed calculation. 																						
<p>23. Calculation of capital servicing adjustment</p> <p>23.1 Having followed the processes outlined above, the information available should then be sufficient to allow the four computations to be completed.</p>		<ul style="list-style-type: none"> To enhance brevity and clarity. 																						
<p>23.2 Appendix C to this document sets out a worked example of the calculations required having determined the key information.</p>		<ul style="list-style-type: none"> To remove duplication. 																						
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="background-color: #0056b3; color: white; text-align: center;">Computation 1</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">Determine Ratio of Capital Employed to Cost of Production</td> </tr> <tr> <td style="text-align: center;">Fixed Capital Value</td> </tr> <tr> <td style="text-align: center;">Plus</td> </tr> <tr> <td style="text-align: center;">Working Capital Value (positive or negative)</td> </tr> <tr> <td style="text-align: center;">EQUALS</td> </tr> <tr> <td style="text-align: center;">Total Capital Employed</td> </tr> <tr> <td style="text-align: center;">Divide into</td> </tr> <tr> <td style="text-align: center;">Cost of Production</td> </tr> <tr> <td style="text-align: center;">EQUALS</td> </tr> <tr> <td style="text-align: center;">Cost of Production as a Proportion of Capital Employed (CP:CE)</td> </tr> </tbody> </table>	Computation 1	Determine Ratio of Capital Employed to Cost of Production	Fixed Capital Value	Plus	Working Capital Value (positive or negative)	EQUALS	Total Capital Employed	Divide into	Cost of Production	EQUALS	Cost of Production as a Proportion of Capital Employed (CP:CE)	<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="background-color: #0056b3; color: white; text-align: center;">Computation 1</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">Determine ratio of capital employed to cost of production</td> </tr> <tr> <td style="text-align: center;">Fixed capital value</td> </tr> <tr> <td style="text-align: center;">Plus</td> </tr> <tr> <td style="text-align: center;">Working capital value</td> </tr> <tr> <td style="text-align: center;">EQUALS</td> </tr> <tr> <td style="text-align: center;">Capital employed</td> </tr> <tr> <td style="text-align: center;">Divide into</td> </tr> <tr> <td style="text-align: center;">Cost of production</td> </tr> <tr> <td style="text-align: center;">EQUALS</td> </tr> <tr> <td style="text-align: center;">Cost of production as a proportion of capital employed (CP:CE)</td> </tr> </tbody> </table>	Computation 1	Determine ratio of capital employed to cost of production	Fixed capital value	Plus	Working capital value	EQUALS	Capital employed	Divide into	Cost of production	EQUALS	Cost of production as a proportion of capital employed (CP:CE)	
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<p>Computation 2</p> <p>Determine the individual proportions of Total Capital Employed</p> <p>Fixed Capital Value</p> <p>Divided by</p> <p>Total Capital Employed</p> <p>EQUALS</p> <p>Fixed Capital as a proportion of Capital Employed</p> <p>Working Capital Value (positive or negative)</p> <p>Divided by</p> <p>Total Capital Employed</p> <p>EQUALS</p> <p>Working Capital as a proportion of Capital Employed</p>	<p>Computation 2</p> <p>Determine the individual proportions of capital employed</p> <p>Fixed capital value</p> <p>Divided by</p> <p>Capital employed</p> <p>EQUALS</p> <p>Fixed capital as a proportion of capital employed</p> <p>Working capital value</p> <p>Divided by</p> <p>Capital employed</p> <p>EQUALS</p> <p>Working capital as a proportion of capital employed</p>	
<p>Computation 3</p> <p>Apply Capital Servicing Rates</p> <p>Fixed Capital as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Fixed Capital Servicing Rate</p> <p>PLUS</p> <p>-----</p> <p>Working Capital (positive) as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Positive Working Capital Servicing Rate</p> <p>OR (if Working Capital is negative)</p> <p>Working Capital (negative) as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Negative Working Capital Servicing Rate</p> <p>EQUALS</p> <p>Capital Servicing Rate⁴</p> <p>⁴ The Capital Servicing Rate can be positive or negative.</p>	<p>Computation 3</p> <p>Apply capital servicing rates</p> <p>Fixed capital as a proportion of capital employed</p> <p>Multiplied by</p> <p>Fixed capital servicing rate</p> <p>PLUS</p> <p>-----</p> <p>Working capital (positive) as a proportion of capital employed</p> <p>Multiplied by</p> <p>Positive working capital servicing rate</p> <p>OR (if Working capital is negative)</p> <p>Working capital (negative) as a proportion of capital employed</p> <p>Multiplied by</p> <p>Negative working capital servicing rate</p> <p>EQUALS</p> <p>Capital servicing rate⁵</p> <p>⁵ The capital servicing rate can be positive or negative.</p>	

Existing guidance	Proposed guidance	Purpose of changes
<p style="text-align: center;">Computation 4</p> <p>Calculate the Capital Servicing Adjustment for Step 6</p> <p>Capital Servicing Rate</p> <p style="text-align: center;">Divided by</p> <p>Cost of Production as a proportion of Capital Employed (CP:CE)</p> <p style="text-align: center;"><u>EQUALS</u></p> <p>Capital Servicing Adjustment to be used in Step 6 of CPR</p>	<p style="text-align: center;">Computation 4</p> <p>Calculate the capital servicing adjustment for Step 6</p> <p>Capital servicing rate</p> <p style="text-align: center;">Divided by</p> <p>Cost of production as a proportion of capital employed (CP:CE)</p> <p style="text-align: center;"><u>EQUALS</u></p> <p>Capital servicing adjustment to be used in Step 6 of CPR</p>	

6. Application of the revised guidance

- 6.1 Following due consideration of any points raised in response to this public consultation, and approval by the SSRO's Regulatory Committee, the SSRO intends to publish a summary of consultation responses and its revised guidance on the topics covered herein by 31 January 2019. This will allow stakeholders time to raise awareness of guidance changes with relevant staff and amend, where considered necessary, any of their policies or procedures prior to application of the guidance.
- 6.2 The SSRO proposes that the revised guidance will apply to all new qualifying defence contracts or qualifying sub-contracts entered into or amended on or after 1 April 2019.
- 6.3 The proposed timetable for concluding guidance changes for 2019/20 on the topics in this consultation is summarised below.

Activity	Organisation	Date
Submission of responses to consultation	Stakeholders	7 Dec 2018
Consider consultation responses and prepare final guidance	SSRO	Dec 2018 to Jan 2019
SSRO Regulatory Committee reviews and approves final guidance	SSRO	23 Jan 2019
Publication of consultation response summary and new guidance (revised sections)	SSRO	31 Jan 2019
Awareness raising	SSRO and stakeholders	Feb to Mar 2019
Application of new guidance	Stakeholders	1 Apr 2019

- 6.4 The SSRO welcomes views on the proposed timetable for publication and application of the revised guidance on these topics as part of this consultation.
- 6.5 The timing of the publication and application of any changes to the SSRO's guidance related to cost risk will be considered as part of a separate consultation.

7. Consultation questions

- 7.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on the following consultation questions:
- Do the proposed revisions make the guidance more or less clear?
 - Will the proposed revisions make the guidance more or less easy to apply?
 - Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed guidance changes?
 - Do you have any concerns regarding the proposed publication and application dates of the revised guidance?
 - What, if any, aspects of the SSRO's pricing guidance should the SSRO prioritise for review in 2019?
- 7.2 A consultation response form containing these questions has been published alongside this consultation document on the SSRO's website (<https://www.gov.uk/government/consultations/pricing-guidance-review-2018-consultation-on-changes-for-201920>).
- 7.3 Completed response forms should be sent:
- by email to consultations@ssro.gov.uk (preferred); or
 - by post to SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB.
- 7.4 Responses to the consultation should be received by 7 December 2018. Responses received after this date will not be taken into account in finalising the guidance for 2019/20 but will inform subsequent consideration of guidance changes.
- 7.5 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 via consultations@ssro.gov.uk.
- 7.6 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 form 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.
- 7.7 Stakeholders' attention is drawn to the following SSRO policy statements, available on its website,⁴ 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 General Data Protection Regulation and the Data Protection Act 2018.
- The Single Source Regulations Office: Handling of Commercially Sensitive Information;* and
 - The Single Source Regulations Office: Our Personal Information Charter.*

⁴ <https://www.gov.uk/government/organisations/single-source-regulations-office/about/personal-information-charter>

